

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for **December 2008**, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act. *Commissioner Atkins was Commissioner from July 29, 2002 to August 1, 2008.*

Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

CHRISTOPHER COX, CHAIRMAN

PAUL S. ATKINS, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 59131 / December 22, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13316

In the Matter of

William Edward Sears,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against William Edward Sears ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From at least 1998 through 2003, Sears was a registered representative associated with Metropolitan Investment Securities, Inc. ("MIS"). At all relevant times, MIS was registered with the Commission as a broker-dealer. Sears is a resident of Lake Oswego, Oregon.
2. On December 4, 2008, a final judgment was entered by consent against Sears permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. William Edward Sears and Patricia Jean Sears-Million, Civil Action Number 105-1473 ST, in the United States District Court for the District of Oregon.
3. The Commission's complaint alleged that from September 1998 through July 2003 Sears fraudulently induced his clients to invest in bonds and preferred stock issued by two companies that were related to MIS, Metropolitan Mortgage & Securities, Co. Inc. ("Metropolitan") and Summit Securities, Inc. ("Summit"). As Sears knew, the Metropolitan and Summit securities were risky. Despite this, Sears caused many of his clients to invest from 50% to more than 90% of their limited savings and retirement funds in Metropolitan and Summit securities. To carry out the fraud, the complaint alleged, Sears falsely told his clients that the securities had little or no risk and were as safe as bank certificates of deposit, and falsified information on his clients' brokerage records, in order to circumvent rules designed to limit an investor's exposure to high-risk securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Sears' Offer.

Accordingly, it is hereby ORDERED:

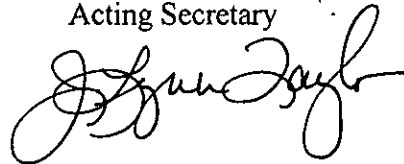
Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Sears be, and hereby is barred from association with any broker or dealer;

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served

as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary

A handwritten signature in cursive script, appearing to read "J. Lynn Taylor".

By: J. Lynn Taylor
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59132 / December 22, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13317

In the Matter of

Patricia Jean Sears-Million,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Patricia Jean Sears-Million ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From at least 1998 through 2003, Sears-Million was a registered representative associated with Metropolitan Investment Securities, Inc. ("MIS"). At all relevant times, MIS was registered with the Commission as a broker-dealer. Sears-Million is a resident of Lake Oswego, Oregon.
2. On December 4, 2008, a final judgment was entered by consent against Sears-Million permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. William Edward Sears and Patricia Jean Sears-Million, Civil Action Number 105-1473 ST, in the United States District Court for the District of Oregon.
3. The Commission's complaint alleged that from September 1998 through July 2003 Sears-Million fraudulently induced her clients to invest in bonds and preferred stock issued by two companies that were related to MIS, Metropolitan Mortgage & Securities, Co. Inc. ("Metropolitan") and Summit Securities, Inc. ("Summit"). As Sears-Million knew, the Metropolitan and Summit securities were risky. Despite this, Sears-Million caused many of her clients to invest from 50% to more than 90% of their limited savings and retirement funds in Metropolitan and Summit securities. To carry out the fraud, the complaint alleged, Sears-Million falsely told her clients that the securities had little or no risk and were as safe as bank certificates of deposit, and falsified information on her clients' brokerage records, in order to circumvent rules designed to limit an investor's exposure to high-risk securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Sears-Million's Offer.

Accordingly, it is hereby ORDERED:

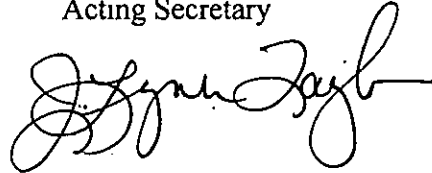
Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Sears-Million be, and hereby is barred from association with any broker or dealer;

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served

as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary

A handwritten signature in cursive script, appearing to read "J. Lynn Taylor".

By: J. Lynn Taylor
Assistant Secretary



SECURITIES AND EXCHANGE COMMISSION

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Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

CHRISTOPHER COX, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

47 Documents

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59034 / December 1, 2008

Admin. Proc. File No. 3-13086

In the Matter of

WORLD ASSOCIATES, INC.

ORDER DISMISSING PROCEEDING

On July 2, 2008, administrative proceedings were instituted against World Associates, Inc. ("World Associates"), pursuant to Section 12(j) of the Securities Exchange Act of 1934. 1/ On July 22, 2008, World Associates filed with the Commission a Form 15-12G/A, pursuant to Rule 12g-4(a)(2) of the Exchange Act, 2/ seeking to deregister its securities voluntarily. In the Form 15-12G/A, World Associates certified that it sought termination based on Exchange Act Rule 12g-4(a)(2), which permits the termination of registration if the issuer certifies that the class of securities being deregistered is "held of record . . . by less than 500 persons; where the total assets of the issuer have not exceeded \$10 million on the last day of each of the issuer's most recent three fiscal years." In the Form 15-12G/A, World Associates certified that its approximate number of holders of record was 311, as of July 14, 2008. The Form 15-12G/A became effective automatically, upon the expiration of ninety days, on October 20, 2008.

On October 30, 2008, the Division of Enforcement filed a motion to dismiss the proceeding, based on the deregistration of World Associates's securities. 3/ We have determined

1/ 15 U.S.C. § 78j(j).

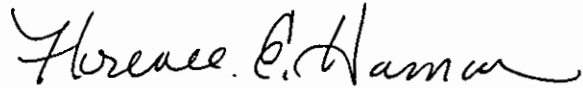
2/ 17 C.F.R. § 240.12g-4(a)(2).

3/ World Associates has not filed a response to the Division of Enforcement's motion.

to grant the Division's motion. World Associates no longer has a class of securities registered under Section 12 of the Exchange Act. Because revocation or suspension of registration are the only remedies available in this proceeding instituted pursuant to Exchange Act Section 12(j), we find it appropriate to dismiss the proceeding. 4/

Accordingly, it is ORDERED that this proceeding be, and it hereby is, dismissed.

By the Commission.



Florence E. Harmon
Acting Secretary

4/ See TelecoBlue, Inc., Securities Exchange Act Rel. No. 58061 (June 30, 2008), __ SEC Docket ____ (dismissing Section 12(j) proceeding with respect to a respondent that "no longer ha[d] a class of securities registered under Section 12 of the Exchange Act"); Enamelon, Inc., Exchange Act Rel. No. 52956 (Dec. 15, 2005), 86 SEC Docket 2944 (same).

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59040 / December 2, 2008

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2811 / December 2, 2008

Admin. Proc. File No. 3-12828

In the Matter of

BYRON S. RAINNER

ORDER REMANDING PROCEEDING TO ADMINISTRATIVE LAW JUDGE

Byron S. Rainer, a registered representative formerly associated with MetLife Financial Services, Inc., which is registered with the Commission as a broker-dealer and an investment adviser, appeals from a decision of an administrative law judge. The law judge barred Rainer from association with any broker, dealer or investment adviser based on Rainer's conviction for wire fraud.

On September 25, 2007, the Commission issued an Order Instituting Proceedings ("OIP") against Rainer alleging that, on February 9, 2006, Rainer pled guilty to one count of wire fraud in violation of 18 U.S.C. § 1343, before the United States District Court for the Northern District of Georgia. The OIP further alleged that, on November 20, 2006, Rainer was sentenced to a prison term of thirty months followed by three years of supervised probation and ordered to make restitution in the amount of \$2,036,134. ^{1/} According to the OIP, the count of the indictment to which Rainer pled guilty alleged, among other things, that "from on or about August 2002

^{1/} We take official notice that Rainer was released from prison in October 2008. See Federal Bureau of Prison's website at <http://www.bop.gov/iloc2/LocateInmate.jsp>. See also Commission Rule of Practice 323, 17 C.F.R. § 201.323 (stating that Commission can take official notice of any material fact that might be judicially noticed by a district court of the United States); and Rule 201(b) of the Federal Rules of Evidence (stating that a district court can take notice of a fact that is "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned").

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through on or about April 2003, Rainer knowingly and willfully devised a scheme and artifice to defraud the Sheriff's Office of Fulton County, Georgia and obtained money and property from the Sheriff's Office of Fulton County, Georgia by means of materially false and fraudulent pretenses, representations and promises."

On October 30, 2007, a telephonic prehearing conference was held, at which Rainer requested that the law judge order the Division of Enforcement (the "Division") to copy and deliver its investigative file to him in prison. The Division advised the law judge that it had not furnished Rainer with its entire investigative file but, rather, had provided him with "the operative documents that we'll be relying on in this case." ^{2/} The Division further informed the law judge that it had also included a letter with its document delivery to Rainer informing him that "if he wants the [Division's] entire [investigative] file that obviously it's at his expense." The Division estimated that the cost of copying the entire file, consisting of "about 20 banker's boxes," would be about \$7,500. The law judge replied that "this proceeding is based on the conviction. So it is not likely -- We're not going to re-litigate the fact of whatever went on that led to the plea and conviction." There was no further discussion by the parties or the law judge of Rainer's request, and the Division never provided Rainer with a complete copy of the investigative file.

Following the prehearing conference, the Division filed a motion for summary disposition. On March 25, 2008, the law judge granted the Division's motion and issued an initial decision barring Rainer from association with any broker or dealer and from association with any investment adviser. ^{3/} Rainer subsequently filed a petition for review of the law judge's decision. Among other matters, Rainer asserts that he "has been denied due process" as a result of the Division's failure to furnish him a copy of its investigative file. In connection with this appeal, Rainer has repeated his request for a copy of the file, and has agreed to pay the costs related to that request.

The Division opposes Rainer's request, asserting that it complied with our Rules of Practice by making its investigative file available at its offices in Atlanta. However, as indicated, Rainer was incarcerated at the time the matter was before the law judge and was, therefore, unable to access the documents at the Division's offices. The Division also contends that it had provided Rainer with "copies of every document that provided the basis for the Division's case

^{2/} The Division stated that these included a copy of the criminal indictment; Rainer's guilty plea and plea agreement; a copy of the judgment in Rainer's criminal case; a copy of Rainer's Form U4, Uniform Application for the Securities Industry; Rainer's Form U5, Uniform Termination Notice; a copy of the organizational registration status for Metropolitan Life Insurance Company as a broker-dealer; and an organizational registration status for Metropolitan Life Insurance Company as an investment adviser.

^{3/} Byron S. Rainer, Initial Decision Rel. No. 347 (Mar. 25, 2008), 92 SEC Docket 3786, 3786.

against" him, although the Division does not dispute that Rainer was not given access to the entire investigative file.

Rule of Practice 230(a)(1) provides that "the Division of Enforcement shall make available for inspection and copying by any party documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings." ^{4/} Rule 230(f) further provides that a respondent "may obtain a photocopy of any documents made available for inspection [provided that] [t]he respondent shall be responsible for the cost of photocopying." In Jose P. Zollino, we observed that, "[w]hile it may be unlikely that the [i]nvestigative [f]ile contains the kind of 'extraordinary mitigative evidence' that would be relevant here, [the respondent] should have been given the opportunity to review it before filing his response to the Division's motion [for summary disposition]." ^{5/}

Because Rainer was not permitted to review the Division's entire investigative file as contemplated by our rules, we believe it is appropriate to remand this case to the law judge for further consideration. ^{6/} On remand, we direct the law judge to ensure that the Division has fully

^{4/} Rule 230(e) directs that documents "shall be made available to the respondent for inspection and copying at the Commission office where they are ordinarily maintained, or at such other place as the parties, in writing, may agree." Comment (a) to Rule 230 states that "[a] respondent's right to inspect and copy documents under this rule is automatic; the respondent does not need to make a formal request for access through the hearing officer." Rules of Practice; Technical Amendments and Corrections, Securities Exchange Act Rel. No. 36174 (Aug. 31, 1995), 60 SEC Docket 245, 245.

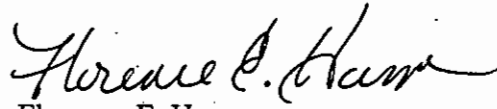
^{5/} Exchange Act Rel. No. 51632 (Apr. 29, 2005), 85 SEC Docket 1292, 1296 (citing John S. Brownson, 55 S.E.C. 1023, 1027 (2002), in which we noted that "[a]bsent extraordinary mitigating circumstances," an individual who has been convicted of securities fraud "cannot be permitted to remain in the securities industry").

^{6/} Cf. Zollino, supra (remanding proceeding to law judge because of failure to accord incarcerated respondent reasonable opportunity to review investigative file before law judge ruled on Division's motion for summary disposition).

complied with Rule 230, and that Rainer has had a reasonable amount of time to review the investigative file before being required to file any pleadings in the case, such as a response to a motion for summary disposition by the Division. In remanding, we express no view as to the outcome.

Accordingly, IT IS ORDERED that the disciplinary proceeding against Byron S. Rainer be, and it hereby is, remanded for further consideration.

By the Commission.



Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59039; File No. SR-NYSEArca-2006-21)

December 2, 2008

Self-Regulatory Organizations; NYSE Arca, Inc.; Order Setting Aside Action by
Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data

On May 23, 2006, NYSE Arca, Inc. ("NYSE Arca" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4 thereunder,² a proposed rule change ("Proposal") to establish fees for the receipt and use of certain market data that the Exchange makes available. The Proposal was published for comment in the Federal Register on June 9, 2006.³ On October 12, 2006, the Commission issued an order, by delegated authority, approving the Proposal.⁴ On November 6, 2006, NetCoalition ("Petitioner") submitted a notice, pursuant to Rule 430 of the Commission's Rules of Practice, indicating its intention to file a petition requesting that the Commission review and set aside the Delegated Order.⁵ On November 8, 2006, the Exchange submitted a response to the Petitioner's Notice.⁶ On November 15, 2006,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 53952 (June 7, 2006), 71 FR 33496 (June 9, 2006).

⁴ Securities Exchange Act Release No. 54597 (October 12, 2006) 71 FR 62029 (October 20, 2006) ("Delegated Order").

⁵ Letter from Markham C. Erikson, Executive Director and General Counsel, NetCoalition, to the Honorable Christopher Cox, Chairman, SEC, dated November 6, 2006 ("Notice").

⁶ Letter from Mary Yeager, Corporate Secretary, NYSE Arca Inc., to the Honorable

Petitioner submitted its petition requesting that the Commission review and set aside the Delegated Order.⁷ On December 27, 2006, the Commission issued an order: (1) granting Petitioner's request for the Commission to review the Delegated Order; (2) allowing any party or other person to file a statement in support of or in opposition to the action made by delegated authority; and (3) continuing the effectiveness of the automatic stay provided in Rule 431(e) of the Commission's Rules of Practice.⁸ The Commission received 25 comments regarding the Petition.⁹

On June 4, 2008, the Commission published notice of a proposed order ("Draft Order") approving the NYSE Arca proposed fees to give the public an additional opportunity to comment.¹⁰ The Commission received 16 comments and three economic assessments in response to the Draft Order.

The Commission has considered the Petition, comments, and economic assessments submitted in response to the Proposal, Petition, and Draft Order. For the reasons described below, it is setting aside the earlier action taken by delegated authority and approving the Proposal directly.

Christopher Cox, Chairman, SEC, dated November 8, 2006 ("NYSE ARCA Petition Response").

⁷ Petition for Commission Review submitted by Petitioner, dated November 14, 2006 ("Petition").

⁸ Securities Exchange Act Release No. 55011 (December 27, 2006).

⁹ The comments on the Petition, as well as the earlier comments on the Proposal, are identified and summarized in section III below. NYSE Arca's responses to the commenters are summarized in section IV below. Comments on the Draft Order are summarized in section V below.

¹⁰ Securities Exchange Act Release No. 57917 (June 4, 2008), 73 FR 32751 (June 10, 2008) ("Draft Order").

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I. Introduction

The Commission's Rules of Practice set forth procedures for the review of actions made pursuant to delegated authority. Rule 431(b)(2) provides that the Commission, in deciding whether to accept or decline a discretionary review, will consider the factors set

forth in Rule 411(b)(2). One of these factors is whether an action pursuant to delegated authority embodies a decision of law or policy that is important and that the Commission should review.

The Petitioner and commenters raised a number of important issues that the Commission believes it should address directly at this time. In particular, section VI below addresses issues related to the nature of the Commission's review of proposed rule changes for the distribution of "non-core" market data, which includes the NYSE Arca data that is the subject of the Proposal. Individual exchanges and other market participants distribute non-core data independently. Non-core data should be contrasted with "core" data -- the best-priced quotations and last sale information of all markets in U.S.-listed equities that Commission rules require to be consolidated and distributed to the public by a single central processor.¹¹ Pursuant to the authority granted by Congress under Section 11A of the Exchange Act, the Commission requires the self-regulatory organizations ("SROs") to participate in joint-industry plans for disseminating core data, and requires broker-dealers and vendors to display core data to investors to help inform their trading and order-routing decisions. In contrast, no Commission rule requires exchanges or market participants either to distribute non-core data to the public or to display non-core data to investors.

Price transparency is critically important to the efficient functioning of the equity markets. In 2006, the core data feeds reported prices for more than \$39.4 trillion in transactions in U.S.-listed equities.¹² In 2006, U.S. broker-dealers earned \$21.7 billion in

¹¹ See section VI.A below for a fuller discussion of the arrangements for distributing core and non-core data.

¹² Source: ArcaVision (available at www.arcavision.com).

commissions from trading in U.S.-listed equities – an amount that does not include any revenues from proprietary trading by U.S. broker-dealers or other market participants.¹³

Approximately 420,000 securities industry professionals subscribe to the core data products of the joint-industry plans, while only about 5% of these professionals have chosen to subscribe to the non-core data products of exchanges.¹⁴

In June 2008, NYSE Arca executed a 16.5% share of trading in U.S.-listed equities.¹⁵ The reasonably projected revenues from the proposed fees for NYSE Arca's non-core data are \$8 million per year.¹⁶ Commenters opposing the Proposal claimed that NYSE Arca exercised monopoly power to set excessive fees for its non-core data and recommended that the Commission adopt a "cost-of-service" ratemaking approach when reviewing exchange fees for non-core data – an approach comparable to the one traditionally applied to utility monopolies.¹⁷

In 2005, however, the Commission stated its intention to apply a market-based approach that relies primarily on competitive forces to determine the terms on which non-core data is made available to investors.¹⁸ This approach follows the clear intent of Congress in adopting Section 11A of the Exchange Act that, whenever possible,

¹³ Frank A. Fernandez, Securities Industry and Financial Markets Association Research Report, "Securities Industry Financial Results: 2006" (May 2, 2006) ("SIFMA Research Report"), at 7-9, 21.

¹⁴ See note 233 below and accompanying text.

¹⁵ See note 205 below and accompanying text.

¹⁶ See note 318 below and accompanying text.

¹⁷ The commenters' views are summarized in section III.A.2 below.

¹⁸ Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37566-37568 (June 29, 2005) ("Regulation NMS Release").

competitive forces should dictate the services and practices that constitute the U.S. national market system for trading equity securities. Section VI discusses this market-based approach and applies it in the specific context of the Proposal by NYSE Arca. The Commission is approving the Proposal primarily because NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal. The Commission believes that reliance on competitive forces, whenever possible, is the most effective means to assess whether proposed fees for non-core data meet the applicable statutory requirements.

The Petitioner and commenters discussed and recommended solutions for a wide range of market data issues that were beyond the scope of the Proposal. The Petitioner particularly called attention to the data needs of users of advertiser-supported Internet web sites, many of whom are individual retail investors. In this regard, the Commission recognizes that exchanges have responded by developing innovative new data products specifically designed to meet the reference data needs and economic circumstances of these Internet users.¹⁹

As noted in section III.A.1 below, some commenters also suggested that, pending a comprehensive resolution of all market data issues (including those related to core data), the Commission should impose a moratorium on all proposed rule changes related to market data. The Commission recognizes the importance of many of the issues raised by commenters relating to core data that are beyond the scope of the Proposal. It is continuing to consider these issues, and others, as part of its ongoing review of SRO

¹⁹ See Securities Exchange Act Release No. 57966 (June 16, 2008), 73 FR 35182 (June 20, 2008) (File No. SR-NYSE-2007-04) (NYSE Real-Time Reference Prices); Securities Exchange Act Release No. 57965 (June 16, 2008), 73 FR 35178 (June 20, 2008) (SR-NASDAQ-2006-060) (Nasdaq Last Sale Data Feeds).

structure, governance, and transparency.²⁰ The Commission does not, however, believe that imposing a moratorium on the review of proposed rule changes related to market data products and fees would be appropriate or consistent with the Exchange Act. A primary Exchange Act objective for the national market system is to promote fair competition.²¹ Failing to act on the proposed rule changes of particular exchanges would be inconsistent with this Exchange Act objective, as well as with the requirements pertaining to SRO rule filings more generally. Accordingly, the Commission will continue to act on proposed rule changes for the distribution of market data in accordance with the applicable Exchange Act requirements.

II. Description of Proposal

Through NYSE Arca, LLC, the equities trading facility of NYSE Arca Equities, Inc., the Exchange makes available on a real-time basis ArcaBookSM, a compilation of all limit orders resident in the NYSE Arca limit order book. In addition, the Exchange makes available real-time information relating to transactions and limit orders in debt securities that are traded through the Exchange's facilities. The Exchange makes ArcaBook and the bond transaction and limit order information (collectively, "NYSE Arca Data") available to market data vendors, broker-dealers, private network providers, and other entities by means of data feeds. Currently, the Exchange does not charge fees for the receipt and use of NYSE Arca Data.

²⁰ See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (proposed rules addressing SRO governance and transparency); Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) ("Concept Release Concerning Self-Regulation").

²¹ Section 11A(a)(1)(C)(ii) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C)(ii).

The Exchange's proposal would establish fees for the receipt and use of NYSE Arca Data. Specifically, the Exchange proposes to establish a \$750 per month access fee for access to the Exchange's data feeds that carry the NYSE Arca Data. In addition, the Exchange proposes to establish professional and non-professional device fees for the NYSE Arca Data.²² For professional subscribers, the Exchange proposes to establish a monthly fee of \$15 per device for the receipt of ArcaBook data relating to exchange-traded funds ("ETFs") and those equity securities for which reporting is governed by the CTA Plan ("CTA Plan and ETF Securities") and a monthly fee of \$15 per device for the receipt of ArcaBook data relating to those equity securities, excluding ETFs, for which reporting is governed by the Nasdaq UTP Plan ("Nasdaq UTP Plan Securities").²³ For non-professional subscribers, the Exchange proposes to establish a monthly fee of \$5 per device for the receipt of ArcaBook data relating to CTA Plan and ETF Securities and a monthly fee of \$5 per device for the receipt of ArcaBook data relating to Nasdaq UTP Plan Securities.²⁴

The Exchange also proposes a maximum monthly payment for device fees paid by any broker-dealer for non-professional subscribers that maintain brokerage accounts

²² In differentiating between professional and non-professional subscribers, the Exchange proposes to apply the same criteria used by the Consolidated Tape Association Plan ("CTA Plan") and the Consolidated Quotation Plan ("CQ Plan") for qualification as a non-professional subscriber. The two plans, which have been approved by the Commission, are available at www.nysedata.com.

²³ The "Nasdaq UTP Plan" is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis. The plan, which has been approved by the Commission, is available at www.utpdata.com.

²⁴ There will be no monthly device fees for limit order and last sale price information relating to debt securities traded through the Exchange's facilities.

with the broker-dealer.²⁵ For 2006, the Exchange proposed a \$20,000 maximum monthly payment. For the months falling in a subsequent calendar year, the maximum monthly payment will increase (but not decrease) by the percentage increase (if any) in the annual composite share volume²⁶ for the calendar year preceding that subsequent calendar year, subject to a maximum annual increase of five percent.

Lastly, the Exchange proposes to waive the device fees for ArcaBook data during the duration of the billable month in which a subscriber first gains access to the data.

III. Summary of Comments Received

The Commission received four comments from three commenters regarding the Proposal after it was published for comment.²⁷ NYSE Arca responded to the

²⁵ Professional subscribers may be included in the calculation of the monthly maximum amount so long as: (1) nonprofessional subscribers comprise no less than 90% of the pool of subscribers that are included in the calculation; (2) each professional subscriber that is included in the calculation is not affiliated with the broker-dealer or any of its affiliates (either as an officer, partner or employee or otherwise); and (3) each such professional subscriber maintains a brokerage account directly with the broker-dealer (that is, with the broker-dealer rather than with a correspondent firm of the broker-dealer).

²⁶ "Composite share volume" for a calendar year refers to the aggregate number of shares in all securities that trade over NYSE Arca facilities for that calendar year.

²⁷ Web comment from Steven C. Spencer, dated June 18, 2006 ("Spencer Letter"); letter from Markham C. Erickson, Executive Director and General Counsel, NetCoalition, to Christopher Cox, Chairman, Commission, dated August 9, 2006 ("NetCoalition I"); and letters from Gregory Babyak, Chairman, Market Data Subcommittee of the Securities Industry Association ("SIA") Technology and Regulation Committee, and Christopher Gilkerson, Chairman, SIA Technology and Regulation Committee, to Nancy Morris, Secretary, Commission, dated June 30, 2006 ("SIFMA I") and August 18, 2006 ("SIFMA II"). The SIA has merged into the Securities Industry and Financial Markets Association ("SIFMA").

comments.²⁸ After granting the Petition, the Commission received 25 comments from 17 commenters regarding the approval of the Proposal by delegated authority.²⁹ Nine

²⁸ Letters from Janet Angstadt, Acting General Counsel, NYSE Arca, to Nancy J. Morris, Secretary, Commission, dated July 25, 2006 ("NYSE Arca Response I"), and August 25, 2006 ("NYSE Arca Response II").

²⁹ Letters from Christopher Gilkerson and Gregory Babyak, Co-Chairs, Market Data Subcommittee of SIFMA Technology and Regulation Committee, dated February 14, 2008 ("SIFMA VIII"); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated February 7, 2007 ("SIFMA VII"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated January 11, 2008 ("NetCoalition V"); The Honorable Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated December 12, 2007 ("Kanjorski Letter"); Melissa MacGregor, Vice President and Assistant General Counsel, SIFMA, dated November 7, 2007 ("SIFMA VI"); The Honorable Richard H. Baker, Member of Congress, dated October 1, 2007 ("Baker Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated September 14, 2007 ("NetCoalition IV"); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated August 1, 2007 ("SIFMA V"); Jeffrey Davis, Vice President and Deputy General Counsel, The Nasdaq Stock Market ("Nasdaq"), dated May 18, 2007 ("Nasdaq Letter"); David T. Hirschmann, Senior Vice President, Chamber of Commerce of the United States of America, dated May 3, 2007 ("Chamber of Commerce Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated March 6, 2007 ("NetCoalition III"); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated March 5, 2007 ("SIFMA IV"); Joseph Rizzello, Chief Executive Officer, National Stock Exchange ("NSX"), dated February 27, 2007 ("NSX Letter"); Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("ABA"), dated February 12, 2007 ("ABA Letter"); James A. Forese, Managing Director and Head of Global Equities, Citigroup Global Markets Inc. ("Citigroup"), dated February 5, 2007 ("Citigroup Letter"); Meyer S. Frucher, Chairman and Chief Executive Officer, PHLX, dated January 31, 2007 ("PHLX Letter"); Amex, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, ISE, The Nasdaq Stock Market, NYSE, NYSE Arca, and Philadelphia Stock Exchange ("PHLX") (collectively, the "Exchange Market Data Coalition"), dated January 26, 2007 ("Exchange Market Data Coalition Letter"); Oscar N. Onyema, Senior Vice President and Chief Administrative Officer, American Stock Exchange LLC ("Amex"), dated January 18, 2007 ("Amex Letter"); Sanjiv Gupta, Bloomberg, dated January 17, 2007 ("Bloomberg Letter"); Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, dated January 17, 2007 ("Financial Services Roundtable Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated January 17, 2007 ("NetCoalition II"); Michael J. Simon,

commenters urged the Commission to set aside the action by delegated authority,³⁰ and five commenters supported the action by delegated authority.³¹ One commenter expressed no views regarding the specifics of the Proposal, but urged the Commission to address market data fees as part of a more comprehensive modernization of SROs in light of recent market structure developments.³² NYSE Arca responded to the comments submitted after the Commission granted the Petition.³³ Three commenters submitted additional comments addressing NYSE Arca's response and arguments raised by other commenters, or provided additional information.³⁴

The comments submitted in connection with the Proposal and the Petition are summarized in this section. NYSE Arca's responses are summarized in section IV below.

A. Commenters Opposing the Action by Delegated Authority

Secretary, International Securities Exchange, LLC ("ISE"), dated January 17, 2007 ("ISE Letter"); Jeffrey T. Brown, Senior Vice President, Office of Legislative and Regulatory Affairs, Charles Schwab & Co., Inc. ("Schwab"), dated January 17, 2007 ("Schwab Letter"); and Ira Hammerman, Senior Managing Director and General Counsel, SIFMA, dated January 17, 2007 ("SIFMA III"); and letter from David Keith, Vice President, Web Products and Solutions, The Globe and Mail, to the Honorable Christopher Cox, Chairman, Commission, dated January 17, 2007 ("Globe and Mail Letter").

³⁰ SIFMA III and IV, and Bloomberg, Chamber of Commerce, Citigroup, Financial Services Roundtable, Globe and Mail, NetCoalition, NSX, and Schwab Letters.

³¹ Amex, Exchange Market Data Coalition, ISE, Nasdaq, and PHLX Letters.

³² ABA Letter at 1.

³³ Letter from Mary Yeager, Corporate Secretary, NYSE Arca, to the Honorable Christopher Cox, Chairman, Commission, dated February 6, 2007 ("NYSE Arca Response III").

³⁴ Nasdaq Letter; SIFMA IV, V, and VI; NetCoalition III and IV.

1. Need for a Comprehensive Review of Market Data Issues

Several commenters seeking a reversal of the staff's approval of the Proposal by delegated authority believed that recent regulatory and market structure developments warrant a broader review of market data fees and of the Commission's procedures for reviewing and evaluating market data proposals.³⁵ According to these commenters, these developments include the transformation of most U.S. securities exchanges into for-profit entities; the increasing importance of single-market depth-of-book information following decimalization and the adoption of Regulation NMS; and the absence of competitive forces that could limit the fees that an exchange may charge for its depth-of-book data. Some commenters believed that the Commission should consider not only market data fees, but also the contract terms governing the use of an exchange's market data, which may impose additional costs and include restrictions on the use of the data.³⁶

In light of the significance and complexity of the issues raised, several commenters asked the Commission not only to reverse the staff's action, but also to impose a moratorium on the approval or processing of market data proposals while the Commission conducts a broader review of the issues associated with market data, including "the underlying issues of market structure, market power, transparency, and ease of dissemination and analysis of market data."³⁷

³⁵ Citigroup Letter at 2; SIFMA III at 10, 26; SIFMA IV at 15. See also ABA Letter at 1; Bloomberg Letter at 7-8; NetCoalition I at 2; NetCoalition III at 13. Among other things, the Bloomberg and Citigroup Letters support the recommendations in SIFMA III. Bloomberg Letter at 8 n. 19; Citigroup Letter at 1.

³⁶ Citigroup Letter at 2; SIFMA III at 23.

³⁷ Citigroup Letter at 2. See also ABA Letter at 3; Financial Services Roundtable Letter at 1; NetCoalition III at 13; Schwab Letter at 1; SIFMA III at 26; SIFMA IV at 15.

2. Need for a Cost-Based Justification of Market Data Fees

Several commenters argued that the staff erred in approving the Proposal because NYSE Arca did not provide a cost-based justification for the Proposal's market data fees or other evidence to demonstrate that its proposed fees meet the applicable Exchange Act standards.³⁸ They asserted that the Exchange Act requires that an exchange's market data fees be "fair and reasonable," "not unreasonably discriminatory," and "an equitable allocation of costs,"³⁹ and that the Commission apply a cost-based standard in evaluating market data fees.⁴⁰ One commenter argued that market data fees "must be reasonably related to market data costs" and that the Commission should require exchanges to identify and substantiate their market data costs in their market data fee proposals.⁴¹

Several commenters argued that the Commission itself has recognized the need for a cost-based justification of market data fees.⁴² They believed that the Commission's position in its 1999 market information concept release⁴³ "underscores the fundamental role that a rigorous cost-based analysis must play in reviewing market data fee filings."⁴⁴ In particular, these commenters cited the following statement from the release:

³⁸ Bloomberg Letter at 3; Petition at 5; SIFMA I at 6; SIFMA III at 20.

³⁹ Schwab Letter at 4; SIFMA III at 19; SIFMA IV at 7.

⁴⁰ Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11; Schwab Letter at 3; SIFMA I at 6; SIFMA III at 16; SIFMA IV at 10.

⁴¹ SIFMA III at 1, 20.

⁴² Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11; Schwab Letter at 3; SIFMA III at 20; SIFMA IV at 10.

⁴³ Securities Exchange Act Release No. 42208 (December 9, 1999), 64 FR 70613 (December 17, 1999) ("Market Information Concept Release").

⁴⁴ NetCoalition II at 3. See also Bloomberg Letter at 2; SIFMA I at 6.

[T]he fees charged by a monopolistic provider of a service (such as the exclusive processors of market information) need to be tied to some type of cost-based standard in order to preclude excessive profits if fees are too high or underfunding or subsidization if fees are too low. The Commission therefore believes that the total amount of market information revenues should remain reasonably related to the cost of market information.⁴⁵

Similarly, a commenter stated that the Commission acknowledged in its Concept Release Concerning Self-Regulation that the amount of market data revenues should be reasonably related to the cost of market information.⁴⁶ Another commenter, citing proceedings involving Instinet's challenge to proposed NASD market data fees,⁴⁷ argued that the Commission in that case "emphatically embraced the cost-based approach to setting market data fees . . .," and insisted on a strict cost-based justification for the market data fees at issue.⁴⁸

The commenters believed, further, that the costs attributable to market data should be limited to the cost of collecting, consolidating, and distributing the data,⁴⁹ and that market data fees should not be used to fund regulatory activities or to cross-subsidize an

⁴⁵ 64 FR at 70627 (cited in Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11 n. 47; SIFMA III at 1). One commenter maintained that the cost-based analysis requirement is based on Congressional concerns regarding the dangers of exclusive processors, in the context of either consolidated or single-market data. NetCoalition II at 3.

⁴⁶ NetCoalition III at 11 n. 47.

⁴⁷ Securities Exchange Act Release No. 20874 (April 17, 1984), 49 FR 17640 (April 24, 1984), *aff'd sub nom. NASD, Inc. v. SEC*, 802 F.2d 1415 (D.C. Cir. 1986).

⁴⁸ SIFMA IV at 10.

⁴⁹ Citigroup Letter at 1; SIFMA III at 21. One commenter believed that the Commission "should create standards that allow producers of market data to recover their costs and make a reasonable profit (e.g., a 10% return), but not an excessive profit." Schwab Letter at 6.

exchange's competitive operations.⁵⁰ One commenter maintained that, in the absence of cost data, the Commission cannot determine whether NYSE Arca uses market data revenues to subsidize competitive activities.⁵¹ In particular, the commenter believed that the Commission must scrutinize the cost justification for NYSE Arca's fees to "be sure that NYSE Arca is not using its market power in the upstream data market as the exclusive processor for this data . . . to price squeeze its competitors in the downstream transaction market and to cross-subsidize its reduction in transaction fees."⁵²

One commenter argued that NYSE Arca's proposed fees are not an "equitable allocation" of costs among its users and are unreasonably discriminatory because the fees are based on the number of people who view the data. Thus, a broker-dealer with many customers seeking to view market data pays considerably more for market data than an institution or algorithmic trader that pays only for the data link to its computer systems.⁵³

3. Exchange Act Rule 19b-4 Process

One commenter argued that the Proposal fails to satisfy the requirements of Exchange Act Rule 19b-4 and Form 19b-4, because, among other things, the Proposal does not: (1) explain why NYSE Arca must charge for data that it previously provided

⁵⁰ SIFMA III at 8; SIFMA IV at 10. The commenter believed that other costs, including member regulation and market surveillance, should be funded by listing, trading, and regulatory fees, rather than market data fees. See SIFMA III at 21. Another commenter maintained that funding regulatory activities through an explicit regulatory fee, rather than through market data revenues, "would be more logical and transparent . . ." NSX Letter at 2. See also Schwab Letter at 5.

⁵¹ SIFMA IV at 10.

⁵² SIFMA IV at 10.

⁵³ Schwab Letter at 4. The commenter argued that this fee structure "is a subsidization program whereby exchanges rebate revenue to their favored traders based on market data fees imposed on retail investors." Id.

free of charge; (2) address the change in circumstances caused by the NYSE's conversion from a member-owned, not-for-profit entity to a shareholder-owned, for-profit entity; (3) address the effect of the fee on retail investors, whom the commenter believes will be denied access to NYSE Arca's data as a result of the fees; (4) explain how making available a faster single-market data feed at a high price, while most investors must rely on slower consolidated market data products, is consistent with the mandates under the Exchange Act for equal access to and transparency in market data; and (5) include the contract terms governing access to and use of NYSE Arca's data or address the administrative costs and burdens that the contract terms impose.⁵⁴ Another commenter, citing the Petition, asserted that the Proposal fails to satisfy the requirements of Form 19b-4 because it provides no disclosure regarding the burdens on competition that could result from its proposed fees or a justification for the proposed fees.⁵⁵

Commenters also raised more general concerns regarding the Exchange Act Rule 19b-4 rule filing process as it applies to proposed rule changes relating to market data. In light of the significant policy issues that market data proposals raise, commenters questioned whether such proposals should be eligible to be effective upon filing pursuant to Exchange Act Rule 19b-4(f)(6).⁵⁶ One commenter believed that all market data proposals should be subject to notice and comment, and that the Commission should provide a 30-day comment period for such proposals.⁵⁷ In addition, the commenter

⁵⁴ SIFMA III at 11-12.

⁵⁵ Bloomberg Letter at 3. See also Petition at 6-7.

⁵⁶ Baker Letter at 1-2; SIFMA III at 22; Bloomberg Letter at 6.

⁵⁷ SIFMA III at 22.

cautioned that the rule filing process should not become a "rubberstamp" of an exchange's proposal.⁵⁸ One commenter suggested that the Commission narrow its delegation of authority with respect to proposed rule changes to exclude proposals that have generated significant public comment.⁵⁹

4. Importance of Depth-of-Book Data

One commenter maintained that because single-market depth-of-book data products have significant advantages over consolidated top-of-book products in terms of both speed and the depth of interest displayed, many broker-dealers believe that it is prudent to purchase single-market depth-of-book data to satisfy their best execution and Regulation NMS order routing obligations.⁶⁰ The commenter noted that NYSE Arca has indicated in its advertising materials that its ArcaBook data feed is approximately 60 times faster than the consolidated data feeds and displays six times the liquidity within five cents of the inside quote.⁶¹ The commenter also maintained that the NYSE has

⁵⁸ SIFMA I at 2 n. 3.

⁵⁹ NetCoalition III at 3-4.

⁶⁰ SIFMA III at 5-6. The commenter stated that depth-of-book information has become more important because of the reduction in liquidity at the inside quote and the increase in quote volatility since decimalization, and because depth-of-book quotations are likely to become more executable following the implementation of Regulation NMS. SIFMA III at 12-13. Similarly, another commenter maintained that, through Regulation NMS, the Commission "has imposed a system that requires access to depth-of-book information." Schwab Letter at 5. Likewise, a commenter believed that market participants require depth-of-book information to trade effectively in decimalized markets. SIFMA IV at 8. See also NetCoalition III at 5.

⁶¹ SIFMA III at 14 n. 24.

linked its depth-of-book products to best execution by stating that “NYSE Arca’s market data products are designed to improve trade execution.”⁶²

One commenter argued that the central processors that distribute consolidated data have little incentive to invest in modernizing their operations.⁶³ Another commenter believed that the disparity between faster and more expensive depth-of-book proprietary data feeds and the slower, less costly, and less valuable consolidated data feeds results in a “two-tiered structure with institutions having access to prices not reasonably available to small investors . . .,” circumstances that the commenter believed “recreate the informational advantage that once existed on the physical floors of the open outcry markets.”⁶⁴

Another commenter believed that depth-of-book information should be considered basic information for retail investors as well as professional investors and that one goal of the National Market System should be to assure that “all investors . . . whether professional or non-professional . . . have equal access to the same quality information, at a reasonable price, and at the same time.”⁶⁵ Similarly, a commenter believed that retail investors require quotations beyond the national best bid or offer to assess the quality of the executions they receive.⁶⁶

⁶² SIFMA IV at 12.

⁶³ SIFMA III at 13.

⁶⁴ Financial Services Roundtable Letter at 3. One commenter believed that market participants who choose not to purchase depth-of-book data will face the informational disadvantages that Regulation NMS seeks to eliminate. NSX Letter at 2.

⁶⁵ SIFMA IV at 13.

⁶⁶ NetCoalition III at 5 n. 16.

5. Lack of Competition in Market Data Pricing

Commenters argued that there are no effective competitive or market forces that limit what an exchange may charge for its depth-of-book data.⁶⁷ Although one commenter acknowledged the argument that competition in the market for liquidity and transactions could serve as a constraint on what exchanges may charge for their data products, the commenter believed that the consolidations of the NYSE with Archipelago and Nasdaq with BRUT and INET have limited this constraint.⁶⁸ The commenter also asserted that competition in the market for order execution is not the same as competition in the market for market data, and that an economic analysis must consider the market for market data from the consumer's perspective.⁶⁹ Because proprietary market data is a "sole-source product," the commenter believed that no market forces operate on the transaction between an exchange and the consumer of its data.⁷⁰ The commenter believed that the unique characteristics of the market for market data—including increased market concentration and market participants' obligation to purchase sole-source proprietary market data to trade effectively—resulted in a "classic economic market failure . . . that requires comprehensive regulatory intervention to ensure 'fair and reasonable' prices."⁷¹ Similarly, another commenter maintained that, with respect to

⁶⁷ NetCoalition III at 9; SIFMA III at 16-17; SIFMA IV at 5.

⁶⁸ SIFMA III at 17.

⁶⁹ SIFMA IV at 5. See also NetCoalition III at 2.

⁷⁰ SIFMA IV at 5.

⁷¹ SIFMA IV at 8. The commenter believed that Congress envisioned the Commission regulating exclusive processors in a manner similar to the way in which public utilities are regulated. SIFMA I at 5.

market data that is exclusive to an exchange, “[t]here is no way for competitive forces to produce market-driven or ‘fair and reasonable’ prices required by the Exchange Act . . .

”⁷²

Other commenters believed that an exchange has a monopoly position as the exclusive processor of its proprietary data that “creates a serious potential for abusive pricing practices,”⁷³ and urged the Commission to consider the lack of competition and the inability to obtain market data from other sources.⁷⁴ One commenter asserted that “broker-dealers will . . . be forced to purchase market data at a fixed and . . . arbitrary price” until market data fees are reformed.⁷⁵

In addition, several commenters believed that the transformation of most U.S. securities exchanges from not-for-profit membership organizations to for-profit entities has eliminated an important constraint on market data fees as the for-profit exchanges seek to maximize value for their shareholders.⁷⁶ In this regard, one commenter explained that “exchanges are beholden to their shareholders to increase revenue, and market data is

⁷² NetCoalition III at 2.

⁷³ Schwab Letter at 6. See also Spencer Letter.

⁷⁴ Citigroup Letter at 1. Similarly, a commenter believed that “[u]nless checked by effective regulatory oversight . . . exchanges have both the incentives and the power to charge whatever they can for the market data over which they have exclusive control.” SIFMA III at 4. The commenter also asserted that “[t]he lack of both economic market forces and comprehensive oversight of exchanges as the sole-source processors of market data . . . has allowed the exchange to simply ‘name their prices’” SIFMA IV at 2.

⁷⁵ NSX Letter at 2.

⁷⁶ ABA Letter at 2-3; Financial Services Roundtable Letter at 2; Schwab Letter at 5; SIFMA III at 24.

the revenue stream that holds the greatest potential for doing so.”⁷⁷ Other commenters argued that the advent of for-profit exchanges has eliminated the governance checks on market data pricing that operated when exchange members – broker-dealers who were obligated to purchase consolidated market data – sat on the boards of the non-profit, member-owned exchanges.⁷⁸

6. Increase in Market Data Revenues

With respect to the increase in the NYSE Group’s market data revenues following its merger with Archipelago, one commenter stated that “NYSE Group’s reported market data segment revenues totaled \$57.5 million in the third quarter of 2006: up 33.7% from the same three month period in 2005.”⁷⁹ According to the commenter, the NYSE Group attributed its revenue growth in market data to the contribution of NYSE Arca’s operations following the completion of the merger between the NYSE and Archipelago on March 7, 2006.⁸⁰ The commenter maintained that Nasdaq has experienced similar growth in its market data revenues and that the exchanges “propose to charge fees for a series of market data products that, when multiplied by the number of potential subscribers, are resulting in increased costs of doing business totaling tens of millions of dollars per year for some individual firms and hundreds of millions of dollars per year across the financial markets.”⁸¹ The commenter identified the current fees for proprietary

⁷⁷ Schwab Letter at 5. See also NetCoalition II at 4; SIFMA III at 24; SIFMA IV at 2.

⁷⁸ Financial Services Roundtable Letter at 2; NetCoalition II at 4; SIFMA III at 15.

⁷⁹ SIFMA III at 18-19 (citations omitted).

⁸⁰ SIFMA III at 18 (citation omitted).

⁸¹ SIFMA III at 4.

and consolidated market data products and claimed that investors ultimately pay these fees.⁸²

7. Recommended Solutions

To address the issues raised by market data fees, the commenters suggested several potential solutions. One commenter recommended that the Commission adopt a specialized market data form for market data rule proposals that would require a detailed justification of proposed fee changes by the SROs.⁸³ The commenter believed that the form should, among other things, require an exchange to substantiate its historical costs of producing market data, its current market data revenues, how and why its costs have changed and the existing revenue is no longer appropriate, how the fee would impact market participants, how the revenues would be used, and the contract terms, system specifications, and audit requirements that would be associated with the proposed fee change.⁸⁴

The commenter also believed that the contract terms governing the use of market data should be included in market data rule filings and subject to notice and comment.⁸⁵ The commenter maintained that the contract terms are effectively non-negotiable and that the compliance costs associated with them may affect the efficiency and transparency of the markets. Another commenter asserted that exchange market data contracts limit the use and dissemination of the data provided under the contracts, potentially impairing the

⁸² SIFMA IV at 14 and Appendix A.

⁸³ SIFMA III at 21-22.

⁸⁴ SIFMA III at 21-22.

⁸⁵ SIFMA III at 23.

flow and further analysis of the information, and impose administrative and technological burdens on firms.⁸⁶

The commenters also suggested structural changes to address market data issues, including requiring exchanges to place their market data operations in a separate subsidiary and to make their raw market data available to third parties on the same terms as they make the data available to their market data subsidiary and to the independent central processor.⁸⁷ The commenters believed that this could encourage competition in providing market data products and services⁸⁸ and create a mechanism for free market pricing.⁸⁹

Finally, the commenters suggested that the Commission increase the quality and depth of the required consolidated quotation information to allow retail investors to determine the prices at which their orders will be executed and to observe pricing movements in the market.⁹⁰ One commenter recommended that the Commission require exchanges to consolidate and distribute their top and depth-of-book data, and that the associated costs be paid by investors who act on the information.⁹¹

B. Commenters Supporting the Action by Delegated Authority

⁸⁶ Citigroup Letter at 2.

⁸⁷ Bloomberg Letter at 4; Kanjorski Letter at 1; NetCoalition I at 2; Schwab Letter at 7; SIFMA III at 24-25.

⁸⁸ SIFMA III at 25.

⁸⁹ Schwab Letter at 7.

⁹⁰ Schwab Letter 5; SIFMA III at 25-26.

⁹¹ NSX Letter at 2. Other commenters endorse this recommendation. NetCoalition III at 7, 13; SIFMA IV at 15.

Several commenters who supported the approval of the Proposal by delegated authority argued that the staff applied the correct legal standard⁹² and that the broader policy questions raised by the Petition should be addressed in the context of Commission rulemaking, rather than in connection with a specific exchange market data proposal.⁹³

Several commenters rejected the assertion that a cost-based standard is the correct standard for the Commission to apply in reviewing market data fee proposals.⁹⁴ In this regard, the commenters distinguished between the standards applicable to “core” market data (i.e., consolidated quotation and last sale data for U.S.-listed equities) and the standards applicable to proprietary market data products.⁹⁵ One commenter maintained that the Commission, in adopting Regulation NMS, authorized exchanges to distribute market data outside of the national market system plans, subject to the general fairness and nondiscrimination standards of Rule 603 of Regulation NMS, but “otherwise [left] to free market forces the determination of what information would be provided and at what price.”⁹⁶ Another commenter, noting that the Commission specifically considered and refrained from adopting the cost-based standard that NetCoalition proposes, argued that NetCoalition’s approach “would replace Regulation NMS . . . with a complex and

⁹² Amex Letter at 2; ISE Letter at 3; PHLX Letter at 2-3.

⁹³ Amex Letter at 4; PHLX Letter at 8.

⁹⁴ Exchange Market Data Coalition Letter at 2; ISE Letter at 3; PHLX Letter at 4.

⁹⁵ Amex Letter at 1; ISE Letter at 2-3; PHLX Letter at 4-5.

⁹⁶ Amex Letter at 2. The commenter noted that exchange fees also are subject to the requirements of Section 6(b)(4) of the Exchange Act. See also PHLX Letter at 7.

intrusive rate-making approach that is inconsistent with the goals of the . . . [Exchange Act] and would be more costly than beneficial.”⁹⁷

One commenter disagreed with the assertion that an exchange possesses monopoly pricing power with respect to its proprietary data products. It contended that assertions concerning an exchange’s monopoly pricing power “ignore . . . market reality and market discipline. If any exchange attempts to charge excessive fees, there simply will not be buyers for such products.”⁹⁸ Nasdaq noted that, as of April 30, 2007, over 420,000 professional users purchased core data, but less than 19,000 professional users purchased TotalView, Nasdaq’s proprietary depth-of-book order product.⁹⁹ It concluded that “[b]roker-dealers may claim they are required to purchase TotalView, but their actions indicate otherwise.”¹⁰⁰

The commenters emphasized that the exchanges face significant competition in their efforts to attract order flow:

Exchanges compete not only with one another, but also with broker-dealers that match customer orders within their own systems and also with a proliferation of alternative trading systems (“ATSs”) and electronic communications networks (“ECNs”) that the Commission has also

⁹⁷ Exchange Market Data Coalition Letter at 2. One commenter asserted that “[a]pplying NetCoalition’s proposed strict cost-based fee analysis to every exchange market data rule filing is unworkable and . . . is not required under the Act.” ISE Letter at 3. Similarly, noting that SROs must ensure that market data is not corrupted by fraud or manipulation, another commenter believed that it would be virtually impossible to identify the costs specifically associated with the production of market data versus other SRO functions. PHLX Letter at 6.

⁹⁸ ISE Letter at 3. Similarly, another commenter noted that the users of data will purchase data “if it provides them value and is priced reasonably.” Amex Letter at 1.

⁹⁹ Nasdaq Letter at 6.

¹⁰⁰ Nasdaq Letter at 6.

nurtured and authorized to execute trades in any listed issue. As a result, market share of trading fluctuates among execution facilities based on their ability to service the end customer. The execution business is highly competitive and exhibits none of the characteristics of a monopoly as suggested in the NetCoalition Petition.¹⁰¹

Similarly, another commenter stated that “the market for proprietary data products is currently competitive and inherently contestable because there is fierce competition for the inputs necessary to the creation of proprietary data and strict pricing discipline for the proprietary products themselves.”¹⁰² It also noted that market data “is the totality of the information assets that each Exchange creates by attracting order flow” and emphasized that “[i]t is in each Exchange’s best interest to provide proprietary information to investors to further their business objectives, and each Exchange chooses how best to do that.”¹⁰³ Commenters stated that, in the absence of a regulatory requirement to provide non-core market data, it is necessary to provide a financial or other business incentive for exchanges to make such data available.¹⁰⁴

IV. NYSE Arca Responses to Commenters

A. Response to Commenters on Proposal

In its responses to commenters on the Proposal, the Exchange argued that the Proposal establishes “a framework for distributing data in which all vendors and end users are permitted to receive and use the Exchange’s market data on equal, non-

¹⁰¹ Exchange Market Data Coalition Letter at 4.

¹⁰² Nasdaq Letter at 7.

¹⁰³ Id. at 3, 4.

¹⁰⁴ Amex Letter at 1; ISE Letter at 2; PHLX Letter at 7.

discriminatory terms.”¹⁰⁵ The Exchange asserted that the proposed professional and non-professional device fees for the NYSE Arca Data were fair and reasonable because they “are far lower than those already established – and approved by the Commission – for similar products offered by other U.S. equity exchanges and stock markets.”¹⁰⁶ In particular, the Exchange noted that the proposed \$15 per month device fee for each of the ArcaBook data products is less than both the \$60 per month and \$70 per month device fees that the NYSE and Nasdaq, respectively, charge for comparable market data products.¹⁰⁷

With respect to its proposed fees, the Exchange noted, further, that it had invested significantly in its ArcaBook products, including making technological enhancements that allowed the Exchange to expand capacity and improve processing efficiency as message traffic increased, thereby reducing the latency associated with the distribution of ArcaBook data.¹⁰⁸ The Exchange stated that “[i]n determining to invest the resources necessary to enhance ArcaBook technology, the Exchange contemplated that it would seek to charge for the receipt and use of ArcaBook data.”¹⁰⁹ The Exchange also emphasized the reasonableness of its proposed fee relative to other comparable market data products, asserting, for example, that “NYSE Arca is at the inside price virtually as often as Nasdaq, yet the proposed fee for ArcaBook is merely one-fifth of the TotalView

¹⁰⁵ NYSE Arca Response I at 2.

¹⁰⁶ Id.

¹⁰⁷ NYSE Arca Response I at 2-3.

¹⁰⁸ NYSE Arca Response II at 2.

¹⁰⁹ Id. at 3.

fee.”¹¹⁰ Moreover, it stated that its decision to commence charging for ArcaBook data was based on its view that “market data charges are a particularly equitable means for funding a market’s investment in technology and its operations. In contrast with transaction, membership, listing, regulatory and other SRO charges, market data charges cause all consumers of a securities market’s services, including investors and market data vendors, to contribute.”¹¹¹

The Exchange stated that it proposes to use the CTA and CQ Plan contracts to govern the distribution of NYSE Arca Data and that it was not amending the terms of these existing contracts or imposing restrictions on the use or display of its data beyond those that are currently set forth in the contracts.¹¹² Further, the Exchange specifically noted that these contracts do not prohibit a broker-dealer from making its own data available outside of the CTA and CQ Plans.¹¹³ Finally, the Exchange argued that by using this current structure, it believes that the administrative burdens on firms and vendors should be low.¹¹⁴

B. Response to Commenters on Petition

In its response to commenters on the Petition, the Exchange argued that recent market-based solutions have mooted the concerns expressed in the Petition regarding the

¹¹⁰ Id.

¹¹¹ Id. at 4.

¹¹² NYSE Arca Response I at 3.

¹¹³ Id. at n. 12 and accompanying text.

¹¹⁴ Id. at 5.

affordability of market data for internet portals.¹¹⁵ In particular, the Exchange noted that the NYSE recently submitted a proposed rule change for a market data product that would provide unlimited real-time last sale prices to vendors for a fixed monthly fee ("NYSE Internet Proposal").¹¹⁶ The Exchange stated that this NYSE Internet Proposal "would meet the needs of internet portals and add to the number of choices that are available to intermediaries and investors for their receipt of real-time prices."¹¹⁷ The Exchange asserted that the NYSE Internet Proposal "provides a significant benefit to investors" since "it adds to the data-access alternatives available to them and improves the quality, timeliness and affordability of data they can receive over the internet."¹¹⁸

The Exchange also reiterated the argument that the proposed market data fees meet the statutory standards for such fees under the Exchange Act.¹¹⁹ The Exchange argued that the fees represent an equitable allocation of fees and charges since they "represent the first time that [the Exchange] has established a fee that a person or entity other than an [Exchange] member or listed company must pay" and are being imposed "on those who use the facilities of [the Exchange] but do not otherwise contribute to [the Exchange's] operating costs."¹²⁰

¹¹⁵ NYSE Arca Response III at 5-6.

¹¹⁶ See id. at 5.

¹¹⁷ NYSE Arca Response III at 5.

¹¹⁸ Id.

¹¹⁹ Id. at 11.

¹²⁰ Id.

The Exchange argued that the proposed market data fees are not “unreasonably discriminatory” since “all professional subscribers are subject to the same fees and all nonprofessional subscribers are subject to the same fees.”¹²¹ The Exchange noted that the only discrimination that occurs is the “reasonable” distinction that would require professional subscribers to pay higher fees than nonprofessional subscribers.¹²²

The Exchange asserted that the fees are fair and reasonable because: (1) “they compare favorably to the level of fees that other U.S. markets and the CTA and Nasdaq/UTP Plans impose for comparable products”; (2) “the quantity and quality of data NYSE Arca includes in Arca Book compares favorably to the data that other markets include in their market data products”; and (3) “the fees will enable NYSE Arca to recover the resources that NYSE Arca devoted to the technology necessary to produce Arca Book data.”¹²³

The Exchange also rejected the Petitioner’s assertion that the Exchange acted “arbitrarily or capriciously” by using a comparison of similar market data fees in setting the level of the proposed fees.¹²⁴ The Exchange noted that in addition to studying “what other markets charge for comparable products,” the Exchange also considered: (1) the needs of those entities that would likely purchase the Arca Book data; (2) the “contribution that revenues from Arca Book Fees would make toward replacing the revenues that NYSE Arca stands to lose as a result of the removal of the NQDS service

¹²¹ Id.

¹²² Id.

¹²³ Id. at 11-12.

¹²⁴ Id. at 12.

from the Nasdaq/UTP Plan”; (3) “the contribution that revenues accruing from Arca Book Fees would make toward NYSE Arca’s market data business”; (4) the contribution that revenues accruing from Arca Book Fees would make toward meeting the overall costs of NYSE Arca’s operations”; (5) “projected losses to NYSE Arca’s business model and order flow that might result from marketplace resistance to Arca Book Fees”; and (6) “the fact that Arca Book is primarily a product for market professionals, who have access to other sources of market data and who will purchase Arca Book only if they determine that the perceived benefits outweigh the cost.”¹²⁵

The Exchange also rejected the Petitioner’s assertion that all proposed market data fees must be subjected to a rigorous cost-based analysis.¹²⁶ The Exchange noted that the Petitioner “is able to cite only one instance” that supports such an assertion.¹²⁷ The Exchange also noted that Petitioner “fails to mention that a significant portion of the industry” expressed opposition to a cost-based approach to analyzing market data fees in response to various Commission releases and other initiatives.¹²⁸ The Exchange argued that a cost-based analysis of market data fees is impractical because “[i]t would

¹²⁵ Id. at 12-13.

¹²⁶ Id. at 13.

¹²⁷ Id.

¹²⁸ Id. at 14-15. The Exchange referenced opposition in the industry to a cost-based analysis of market data fees expressed in connection with the Market Information Concept Release, the Concept Release Concerning Self-Regulation, the Regulation NMS initiative, and the Commission’s Advisory Committee on Market Information.

inappropriately burden both the government and the industry, stifle competition and innovation, and in the end, raise costs and, potentially, fees.”¹²⁹

The Exchange also disputed Petitioner’s argument that the Exchange’s proposed market data fees amount to an exercise of monopoly pricing power.¹³⁰ It noted that “[m]arkets compete with one another by seeking to maximize the amount of order flow that they attract. The markets base the competition for order flow on such things as technology, customer service, transaction costs, ease of access, liquidity and transparency.”¹³¹ The Exchange noted that “[t]he Commission has prescribed top-of-the-book consolidated market data as the data required for best execution purposes” and that there is “no regulatory requirement” for brokers to receive depth-of-book or other proprietary market data products.¹³² Accordingly, the Exchange asserted that no monopoly power exists, and that the marketplace determines the fees charged by the Exchange for depth-of-book market data.¹³³ Further, the Exchange claimed that if the market data fees were excessive, market participants “would forego Arca Book data and would choose to receive the depth-of-book service of other markets.”¹³⁴ It noted that:

¹²⁹ Id. at 15 (citing NYSE Response to Market Information Concept Release (April 10, 2000) (emphasis in original)).

¹³⁰ Id. at 16.

¹³¹ Id. at 16. See also id. at 18 (“If too many market professionals reject Arca Book as too expensive, NYSE Arca would have to reassess the Arca Book Fees because Arca Book data provides transparency to NYSE Arca’s market, transparency that plays an important role in the competition for order flow.”)

¹³² Id. at 18.

¹³³ Id.

¹³⁴ Id.

As a result of all of the choices and discretion that are available to brokers, the displayed depth-of-book data of one trading center does not provide a complete picture of the full market for the security. It displays only a portion of all interest in the security. A brokerage firm has potentially dozens of different information sources to choose from in determining if, where, and how to represent an order for execution.¹³⁵

The Exchange also addressed other concerns raised by commenters in connection with the Petition. First, the Exchange indicated that it has no intention of retroactively imposing the proposed market data fees.¹³⁶ The Exchange also disputed a commenter's statement which indicated that "market data revenues of the NYSE Group (the parent company of Exchange and NYSE) for the third quarter of 2006 rose 33.7% from the year earlier."¹³⁷ According to the Exchange, this statistic does not demonstrate "a significant increase in market data revenues during 2006" since the 2005 market data revenue from the NYSE Group used to generate this statistic did not include the Exchange's market data revenue because the Exchange was not part of the NYSE Group in 2005.¹³⁸ The Exchange notes that the combined market data revenues for the Exchange and NYSE have actually declined slightly.¹³⁹ Lastly, the Exchange rejects the commenters' contention that a significant speed variance exists between proprietary market data products and the consolidated data feed that markets make available under the CQ and Nasdaq/UTP Plans. The Exchange notes that the "variations in speed are measured in

¹³⁵ Id. at 17.

¹³⁶ Id. at 20.

¹³⁷ Id.

¹³⁸ Id.

¹³⁹ Id. at n. 50 and accompanying text. According to the Exchange, pro forma results indicate that the Exchange and NYSE received a combined \$242 million in 2005, while they only received a combined \$235 million in 2006.

milliseconds” and that “[f]rom a display perspective the difference is imperceptible.”¹⁴⁰

Furthermore, the Exchange notes that the CQ Plan participants have undertaken a technology upgrade that would reduce the latency of the consolidated feed from “several hundred milliseconds to approximately 30 milliseconds.”¹⁴¹

V. Comments on the Draft Order

The Commission received 16 comments from 12 commenters regarding the Draft Order,¹⁴² three of which also submitted economic studies analyzing the Draft Order’s rationale for approving the Proposal.¹⁴³

¹⁴⁰ Id. at 21.

¹⁴¹ Id.

¹⁴² Letters from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated November 17, 2008 (“SIFMA X”) (attaching supplemental report by Securities Litigation & Consulting Group, Inc.); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated October 14, 2008 (“NetCoalition VII”) (attaching report by Dr. David S. Evans dated October 10, 2008); Bart M. Green, Chairman, and John Giese, President and CEO, Security Traders Association (“STA”), dated September 11, 2008 (“STA Letter”); Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq OMX Group, Inc., dated September 10, 2008 (“Nasdaq III”) and August 1, 2008 (“Nasdaq II”); Joseph Rizzello, Chief Executive Officer, NSX, dated September 9, 2008 (“NSX II”); Richard Bartlett, Managing Director, Citigroup Global Markets Inc., dated July 11, 2008 (“Citigroup II”); David T. Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness of the United States Chamber of Commerce, dated July 10, 2008 (“Chamber of Commerce II”); Michael J. Simon, Secretary, ISE, dated July 10, 2008 (“ISE II”); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated July 10, 2008 (attaching report by Dr. David S. Evans) (“NetCoalition VI”); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated July 10, 2008 (“NetCoalition V”); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated July 10, 2008 (attaching report by the Securities Litigation & Consulting Group, Inc.) (“SIFMA IX”); Mary Yeager, Corporate Secretary, NYSE Arca, to Florence Harmon, Acting Secretary, Commission, dated July 8, 2008 (“NYSE Arca IV”); and Christopher Perry, Thomson Reuters Markets, dated July 8, 2008 (“Thomson Reuters Letter”); and web comments from William C. Martin, Principal, Indie Research, LLC and Founder,

NetCoalition and SIFMA did not believe that the Draft Order's analytical framework would meet the Commission's responsibilities under the Exchange Act for reviewing market data fees.¹⁴⁴ In this regard, SIFMA stated that "there is . . . no basis for the presumption in the [Draft] Order that [the] statutory requirements are satisfied if the Commission is able to conclude that 'significant competitive forces' exist in the context of an exchange fee proposal."¹⁴⁵ NetCoalition asserted that Congress urged the Commission not to rely on competitive forces in the context of exclusive processors of data.¹⁴⁶

Some commenters questioned the extent of exchange competition for order flow and whether such competition results in fair and reasonable market data fees.¹⁴⁷ The SLCG Study asserted that competition for order flow does not assure competitive pricing

RagingBull.com, dated July 9, 2008 ("Indie Research Comment"); and Kreg Rutherford ("Rutherford Comment").

¹⁴³ David S. Evans, "Response to Ordoover and Bamberger's Statement Regarding the SEC's Proposed Order Concerning the Pricing of Depth-of-Book Market Data" ("Evans II"), which was submitted with NetCoalition VII; David S. Evans, "An Economic Assessment of Whether 'Significant Competitive Forces' Constrain an Exchange's Pricing of Its Depth-of-Book Market Data" ("Evans Report"), which was submitted with NetCoalition VI; Securities Litigation and Consulting Group, Inc. ("SLCG"), "An Economic Study of Securities Market Data Pricing by the Exchanges" ("SLCG Study"), which was submitted with SIFMA IX and a supplemental analysis to the SLCG Study ("SLCG II"), which was submitted with SIFMA X; and Statement of Janusz Ordoover and Gustavo Bamberger, dated August 1, 2008 ("Ordoover/Bamberger Statement" or "Statement"), which was submitted with Nasdaq II.

¹⁴⁴ NetCoalition V at 7-9; SIFMA IX at 9-11.

¹⁴⁵ SIFMA IX at 10.

¹⁴⁶ NetCoalition V at 9-10.

¹⁴⁷ Citigroup II at 2; Indie Research Comment; NetCoalition VI at 1; NSX II at 5; SIFMA IX at 3; STA Letter at 3.

for depth-of-book data and that reliance on competitive forces was inappropriate because the NYSE and Nasdaq exert monopoly pricing power with respect to their depth-of-book data.¹⁴⁸ The Evans Report maintained that order flow competition is reflected in transaction fees and liquidity rebates, which are structured to attract order flow, but not in depth-of-book data fees, which do not vary according to the data purchaser's trading volume.¹⁴⁹ NetCoalition and SIFMA also questioned whether the Draft Order's conclusion that depth-of-book data is not necessary to meet a broker-dealer's duty of best execution would be reached in other legal contexts.¹⁵⁰

Several commenters believed that the NYSE and NYSE Arca must be considered to be a single enterprise for purposes of analyzing market power with respect to depth-of-book data, and that the Draft Order erred in treating them as separate entities.¹⁵¹ In this regard, the Evans Report found that, because the NYSE and NYSE Arca are controlled by a single corporate entity that will coordinate the pricing of the depth-of-book products of its subsidiaries to maximize its own profits, the NYSE's depth-of-book data cannot act as a competitive constraint on the pricing of NYSE Arca's depth-of-book data.¹⁵²

Commenters opposing the Draft Order also believed that the Commission must obtain and analyze data regarding NYSE Arca's costs of collecting and disseminating depth-of-book information to determine whether its proposed fees meet the Exchange

¹⁴⁸ SLCG Study at 2 and 34.

¹⁴⁹ Evans Report at 13-16.

¹⁵⁰ NetCoalition V at 7; SIFMA IX at 20.

¹⁵¹ SIFMA IX at 3; Evans Report at 5-6; SLCG Study at 12.

¹⁵² Evans Report at 5-6.

Act's requirements.¹⁵³ One commenter stated that, in the absence of cost data, the Commission lacks an effective basis for evaluating whether proposed market data fees are fair or reasonable.¹⁵⁴ In addition, these commenters suggested that because the Commission concluded that a cost-based analysis was required in the context of a fee dispute between Nasdaq and the CTA, the Commission should require the same cost-based analysis for exchanges' market data fees.¹⁵⁵ Another commenter believed that the exchanges' use of market data fees to fund rebates to order entry firms suggested that market data pricing is "neither competitive nor efficient."¹⁵⁶

NetCoalition and SIFMA asserted that the Draft Order would in effect be an amendment of Rule 19b-4 and thus would constitute agency rulemaking that must be published for notice and comment under the Administrative Procedures Act.¹⁵⁷ Another commenter believed that greater transparency prior to the publication of the Draft Order would have allowed the Commission to gather additional data.¹⁵⁸

¹⁵³ NetCoalition V at 15-18; SIFMA IX at 4.

¹⁵⁴ SIFMA IX at 4. Similarly, the SLCG Study maintained that it is not possible to assess the extent of NYSE Arca's market power in establishing fees for Arca Book data without information concerning the costs of collecting and distributing the data. Accordingly, the SLCG Study asserted that the Commission could not reasonably conclude that the NYSE was subject to competitive forces in establishing the proposed Arca Book data fees. SLCG Study at 31-32.

¹⁵⁵ NetCoalition V at 15-18; SIFMA IX at 11-13.

¹⁵⁶ STA Letter at 3.

¹⁵⁷ NetCoalition V at 18; SIFMA IX at 16.

¹⁵⁸ Chamber of Commerce II at 2.

Five commenters, including NYSE Arca, supported issuance of the Draft Order.¹⁵⁹ They generally agreed that significant competitive forces operate in the distribution of non-core data and will constrain the exchanges in setting the terms for such data. For example, ISE agreed with the Draft Order's analysis of the relationship between non-core data and attracting order flow, noting that it views its proprietary depth-of-book options data service as an important means to advertise the prices available on the ISE and to attract orders to ISE.¹⁶⁰ It currently offers the service free of charge, but only 15% of its members have chosen to subscribe to the service.¹⁶¹

Similarly, Thomson Reuters believed that the Commission's Draft Order correctly analyzed the competitive forces applicable to the establishment of fees for depth-of-book data.¹⁶² In particular, the commenter agreed that, in light of the competitive market for order flow and trade execution, an exchange would have strong competitive reasons to price its depth-of-book data so that the data would be distributed widely to those most likely to use it to trade.¹⁶³ The commenter also believed that "the application of market forces to the consolidation and distribution of market data is generally preferable to increased government supervision of the process of setting fees for and licensing subscribers to market data."¹⁶⁴

¹⁵⁹ ISE II, Nasdaq II, NYSE Arca IV, Rutherford Comment, and Thomson Reuters Letter.

¹⁶⁰ ISE II at 2.

¹⁶¹ Id.

¹⁶² Thomson Reuters Letter at 3.

¹⁶³ Id.

¹⁶⁴ Id. at 2.

The Ordovery/Bamberger Statement noted that unnecessary regulation of a market characterized by effective competition can distort the operation of the market and produce "unforeseen and unintended consequences," and that "cost-based regulation can create significant inefficiencies and distortions."¹⁶⁵ It identified market data and trade execution services as an example of "joint products" with "joint costs" that determine a trading platform's total return.¹⁶⁶ The Statement noted that competition among trading platforms could be expected to limit the return each platform earned from the sale of joint products, although different platforms could select different pricing strategies and means of recovering costs.¹⁶⁷

Another commenter believed that NYSE Arca's proprietary data would benefit retail investors and that the Exchange's proposed fees are fair compensation for its data.¹⁶⁸ Noting that U.S. exchanges face increasing competition from foreign markets, dark pools, and electronic communications networks, the commenter stated that it is important for U.S. exchanges to have the ability to offer real-time market data.¹⁶⁹ Finally, NYSE Arca believed that the Commission's standard would spur innovation and

¹⁶⁵ Ordovery/Bamberger Statement at 2, 3 n. 4.

¹⁶⁶ Id. at 3-4.

¹⁶⁷ Id. at 4. See also id. at 3 n. 4 ("It is widely accepted that there is no meaningful way to allocate 'common costs' across different joint products. For this reason, 'cost-based' regulation of the price of market data would require inherently arbitrary cost allocations.").

¹⁶⁸ Rutherford Comment.

¹⁶⁹ Id.

allow markets to introduce new market data products more quickly, thereby enhancing the competitiveness of the U.S. securities markets.¹⁷⁰

VI. Discussion

The Commission finds that the Proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, it is consistent with Section 6(b)(4) of the Exchange Act,¹⁷¹ which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other parties using its facilities, and Section 6(b)(5) of the Exchange Act,¹⁷² which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission also finds that the Proposal is consistent with the provisions of Section 6(b)(8) of the Exchange Act,¹⁷³ which requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Finally, the Commission finds that the Proposal is

¹⁷⁰ NYSE Arca IV at 2.

¹⁷¹ 15 U.S.C. 78f(b)(4).

¹⁷² 15 U.S.C. 78f(b)(5).

¹⁷³ 15 U.S.C. 78f(b)(8).

consistent with Rule 603(a) of Regulation NMS,¹⁷⁴ adopted under Section 11A(c)(1) of the Exchange Act, which requires an exclusive processor that distributes information with respect to quotations for or transactions in an NMS stock to do so on terms that are fair and reasonable and that are not unreasonably discriminatory.¹⁷⁵

A. Commission Review of Proposals for Distributing Non-Core Data

The standards in Section 6 of the Exchange Act and Rule 603 of Regulation NMS do not differentiate between types of data and therefore apply to exchange proposals to distribute both core data and non-core data. Core data is the best-priced quotations and comprehensive last sale reports of all markets that the Commission, pursuant to Rule 603(b), requires a central processor to consolidate and distribute to the public pursuant to joint-SRO plans.¹⁷⁶ In contrast, individual exchanges and other market participants distribute non-core data voluntarily. As discussed further below, the mandatory nature of the core data disclosure regime leaves little room for competitive forces to determine products and fees. Non-core data products and their fees are, by contrast, much more sensitive to competitive forces. For example, the Commission does not believe that

¹⁷⁴ 17 CFR 242.603(a).

¹⁷⁵ NYSE Arca is an exclusive processor of the NYSE Arca Data under Section 3(a)(22)(B) of the Exchange Act, 15 U.S.C. 78c(a)(22)(B), which defines an exclusive processor as, among other things, an exchange that distributes information with respect to quotations or transactions on an exclusive basis on its own behalf.

¹⁷⁶ See Rule 603(b) of Regulation NMS ("Every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.")

broker-dealers are required to purchase depth-of-book order data, including the NYSE Arca data, to meet their duty of best execution.¹⁷⁷ The Commission therefore is able to use competitive forces in its determination of whether an exchange's proposal to distribute non-core data meets the standards of Section 6 and Rule 603.

The requirements for distributing core data to the public were first established in the 1970s as part of the creation of the national market system for equity securities.¹⁷⁸ Although Congress intended to rely on competitive forces to the greatest extent possible to shape the national market system, it also granted the Commission full rulemaking authority in the Exchange Act to achieve the goal of providing investors with a central source of consolidated market information.¹⁷⁹

Pursuant to this Exchange Act authority, the Commission has required the SROs to participate in three joint-industry plans ("Plans") pursuant to which core data is distributed to the public.¹⁸⁰ The Plans establish three separate networks to disseminate core data for NMS stocks: (1) Network A for securities primarily listed on the NYSE; (2) Network C for securities primarily listed on Nasdaq; and (3) Network B for securities

¹⁷⁷ See notes 259-266 below and accompanying text.

¹⁷⁸ These requirements are discussed in detail in section III of the Concept Release on Market Information, 64 FR at 70618-70623.

¹⁷⁹ H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 92 (1975) ("Conference Report").

¹⁸⁰ The three joint-industry plans, approved by the Commission, are: (1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for securities primarily listed on an exchange other than Nasdaq; (2) the CQ Plan, which disseminates consolidated quotation information for securities primarily listed on an exchange other than Nasdaq; and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq. The CTA Plan and CQ Plan are available at www.nysedata.com. The Nasdaq UTP Plan is available at www.utpdata.com.

primarily listed on exchanges other than the NYSE and Nasdaq. For each security, the data includes: (1) a national best bid and offer ("NBBO") with prices, sizes, and market center identifications; (2) the best bids and offers from each SRO that include prices, sizes, and market center identifications; and (3) last sale reports from each SRO. The three Networks establish fees for this core data, which must be filed for Commission approval.¹⁸¹ The Networks collect the applicable fees and, after deduction of Network expenses, distribute the remaining revenues to their individual SRO participants.

The Plans promote the wide availability of core market data.¹⁸² For each of the more than 7000 NMS stocks, quotations and trades are continuously collected from many different trading centers and then disseminated to the public by the central processor for a Network in a consolidated stream of data. As a result, investors have access to a reliable source of information for the best prices in NMS stocks. Commission rules long have required broker-dealers and data vendors, if they provide any data to customers, to also provide core data to investors in certain contexts, such as trading and order-routing.¹⁸³ In addition, compliance with the trade-through requirements of Rule 611 of Regulation NMS¹⁸⁴ necessitates obtaining core quotation data because it includes all the quotations that are entitled to protection against trade-throughs.¹⁸⁵

¹⁸¹ Rule 608(b)(1) of Regulation NMS, 17 CFR 242.608(b)(1).

¹⁸² The Plan provisions for distributing quotation and transaction information are discussed in detail in section II of the Concept Release on Market Information, 64 FR at 70615-70618.

¹⁸³ Rule 603(c) of Regulation NMS, 17 CFR 242.603(c).

¹⁸⁴ 17 CFR 242.611.

¹⁸⁵ Rule 600(b)(57)(iii) of Regulation NMS, 17 CFR 242.600(b)(57)(iii) (definition of "protected bid" and "protected offer" limited to the best bids and best offers of

For many years, the core data distributed through the Networks overwhelmingly dominated the field of equity market data in the U.S. With the initiation of decimal trading in 2001, however, the value to market participants of non-core data, particularly depth-of-book order data, increased.¹⁸⁶ An exchange's depth-of-book order data includes displayed trading interest at prices inferior to the best-priced quotations that exchanges are required to provide for distribution in the core data feeds. Prior to decimal trading, significant size accumulated at the best-priced quotes because the minimum spread between the national best bid and the national best offer was 1/16th, or 6.25 cents. When the minimum inside spread was reduced to one cent, the size displayed at the best quotes decreased substantially, while the size displayed at the various one-cent price points away from the inside quotes became a more useful tool to assess market depth.

In 2005, the Commission adopted new rules that, among other things, addressed market data.¹⁸⁷ Some commenters on the rule proposals recommended that the Commission eliminate or substantially modify the consolidation model for distributing core data. In addressing these comments, the Commission described both the strengths and weaknesses of the consolidation model. It emphasized the benefits of the model for

SROs). The Commission decided not to adopt a proposal which would have protected depth-of-book quotations against trade-throughs if the market displaying such quotations voluntarily disseminated them in the consolidated quotation stream. Regulation NMS Release, 70 FR at 37529.

¹⁸⁶ Commenters on the Draft Order cited statements by the Commission's Chairman in 2002 as indicating competitive forces do not apply to non-core market data. SIFMA IX at 4-5; SLCG Study at 28-29; STA Letter at 3-4. Up to that time, however, nearly all market data revenues had been derived from core data. Accordingly, the characteristics of market data revenues in the 70 years prior to 2002 shed no light on the current state of competition for non-core data.

¹⁸⁷ Regulation NMS Release, 70 FR at 37557-37570.

retail investors, but noted the limited opportunity for market forces to determine the level and allocation of fees for core data and the negative effects on innovation by individual markets in the provision of their data.¹⁸⁸

The Commission ultimately decided that the consolidation model should be retained for core data because of the benefit it afforded to investors, namely “helping them to assess quoted prices at the time they place an order and to evaluate the best execution of their orders against such prices by obtaining data from a single source that is highly reliable and comprehensive.”¹⁸⁹

With respect to the distribution of non-core data, however, the Commission decided to maintain a deconsolidation model that allows greater flexibility for market forces to determine data products and fees.¹⁹⁰ In particular, the Commission both authorized the independent dissemination of an individual market’s or broker-dealer’s trade data, which previously had been prohibited by Commission rule, and streamlined the requirements for the consolidated display of core market data to customers of broker-dealers and vendors.¹⁹¹ Most commenters supported this approach.¹⁹² A few

¹⁸⁸ Id. at 37558.

¹⁸⁹ Id. at 37504.

¹⁹⁰ When describing the deconsolidation model in the context of deciding whether to propose a new model for core data, the Commission noted that “the strength of this model is the maximum flexibility it allows for competitive forces to determine data products, fees, and SRO revenues.” Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126, 11177 (March 9, 2004). As discussed in the text, the Commission decided to retain the consolidation model, rather than proposing a new deconsolidation model, for core data.

¹⁹¹ See Regulation NMS Release, 70 FR at 37566-37567 (addressing differences in distribution standards between core data and non-core data).

¹⁹² Id.

commenters, however, recommended that “the Commission should expand the consolidated display requirement to include additional information on depth-of-book quotations, stating that the NBBO alone had become less informative since decimalization.”¹⁹³ Such an approach effectively would have treated an individual market’s depth-of-book order data as consolidated core data and thereby eliminated the operation of competitive forces on depth-of-book order data. The Commission did not adopt this recommendation, but instead decided to:

allow market forces, rather than regulatory requirements, to determine what, if any, additional quotations outside the NBBO are displayed to investors. Investors who need the BBOs of each SRO, as well as more comprehensive depth-of-book information, will be able to obtain such data from markets or third party vendors.¹⁹⁴

Some commenters on the Proposal and the Petition recommended fundamental changes in the regulatory treatment of non-core data in general and depth-of-book quotations in particular.¹⁹⁵ The Commission, however, considered this issue in 2005 and continues to hold the views just described. It does not believe that circumstances have changed significantly since 2005 and will continue to apply a primarily market-based approach for assessing whether exchange proposals to distribute non-core data meet the applicable statutory standards.

The Exchange Act and its legislative history strongly support the Commission’s reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among

¹⁹³ Id. at 37567 (citation omitted).

¹⁹⁴ Id. (citations omitted) (emphasis added).

¹⁹⁵ See section III.A.4 above.

multiple markets and market participants trading the same products is the hallmark of the national market system.¹⁹⁶ A national market "system" can be contrasted with a single monopoly market that overwhelmingly dominates trading its listed products. Congress repeatedly emphasized the benefits of competition among markets in protecting investors and promoting the public interest. When directing the Commission to facilitate the establishment of a national market system, for example, Congress emphasized the importance of allowing competitive forces to work:

In 1936, this Committee pointed out that a major responsibility of the SEC in the administration of the securities laws is to "create a fair field of competition." This responsibility continues today. The bill would more clearly identify this responsibility and clarify and strengthen the SEC's authority to carry it out. The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services.¹⁹⁷

In addition, Congress explicitly noted the importance of relying on competition in overseeing the activities of the SROs:

S. 249 would give the SEC broad authority not only to oversee the general development of a national market system but also to insure that the ancillary programs of the self-regulatory organizations and their affiliates are consistent with the best interests of the securities industry and the investing public. . . . This is not to suggest that under S. 249 the SEC would have either the responsibility or the power to operate as an 'economic czar' for the development of a national market system. Quite the contrary, for a fundamental premise of the bill is that the initiative for the development of the facilities of a national market system must come from private interests and will depend on the vigor of competition within the securities industry as broadly defined.¹⁹⁸

¹⁹⁶ See, e.g., Exchange Act Section 11A(a)(1)(C)(ii).

¹⁹⁷ S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) ("Senate Report").

¹⁹⁸ Senate Report at 12.

With respect to market information, Congress again expressed its preference for the Commission to rely on competition, but noted the possibility that competition might not be sufficient in the specific context of core data – the central facilities for the required distribution of consolidated data to the public:

It is the intent of the conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed. The conferees expect, however, that in those situations where competition may not be sufficient, such as in the creation of a composite quotation system or a consolidated transactional reporting system, the Commission will use the powers granted to it in this bill to act promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system are put into effect as rapidly as possible.¹⁹⁹

The Commission's approach to core data and non-core data follows this Congressional intent exactly. With respect to the systems for the required distribution of consolidated core data, the Commission retained a regulatory approach that uses joint-industry plans and a central processor designed to assure access to the best quotations and most recent last sale information that is so vital to investors. With respect to non-core data, in contrast, the Commission has maintained a market-based approach that leaves a much fuller opportunity for competitive forces to work.

This market-based approach to non-core data has two parts. The first is to ask whether the exchange was subject to significant competitive forces in setting the terms of its proposal for non-core data, including the level of any fees. If an exchange was subject to significant competitive forces in setting the terms of a proposal, the Commission will approve the proposal unless it determines that there is a substantial countervailing basis to find that the terms nevertheless fail to meet an applicable requirement of the Exchange

¹⁹⁹ Conference Report at 92 (emphasis added).

Act or the rules thereunder. If, however, the exchange was not subject to significant competitive forces in setting the terms of a proposal for non-core data, the Commission will require the exchange to provide a substantial basis, other than competitive forces, in its proposed rule change demonstrating that the terms of the proposal are equitable, fair, reasonable, and not unreasonably discriminatory.

As discussed above, the Commission believes that, when possible, reliance on competitive forces is the most appropriate and effective means to assess whether terms for the distribution of non-core data are equitable, fair and reasonable, and not unreasonably discriminatory. If competitive forces are operative, the self-interest of the exchanges themselves will work powerfully to constrain unreasonable or unfair behavior. As discussed further below, when an exchange is subject to competitive forces in its distribution of non-core data, many market participants would be unlikely to purchase the exchange's data products if it sets fees that are inequitable, unfair, unreasonable, or unreasonably discriminatory. As a result, competitive forces generally will constrain an exchange in setting fees for non-core data because it should recognize that its own profits will suffer if it attempts to act unreasonably or unfairly. For example, an exchange's attempt to impose unreasonably or unfairly discriminatory fees on a certain category of customers would likely be counter-productive for the exchange because, in a competitive environment, such customers generally would be able respond by using alternatives to the exchange's data.²⁰⁰ The Commission therefore believes that the existence of significant

²⁰⁰ See, e.g., Richard Posner, Economic Analysis of Law § 9.1 (5th ed. 1998) (discussing the theory of monopolies and pricing). See also U.S. Dep't of Justice & Fed'l Trade Comm'n, Horizontal Merger Guidelines § 1.11 (1992), as revised (1997) ("DOJ Merger Guidelines") (explaining the importance of alternative products in evaluating the presence of competition and defining markets and

competition provides a substantial basis for finding that the terms of an exchange's fee proposal are equitable, fair, reasonable, and not unreasonably or unfairly discriminatory.

Even when competitive forces are operative, however, the Commission will continue to review exchange proposals for distributing non-core data to assess whether there is a substantial countervailing basis for determining that a proposal is inconsistent with the Exchange Act.²⁰¹ For example, an exchange proposal that seeks to penalize market participants for trading in markets other than the proposing exchange would present a substantial countervailing basis for finding unreasonable and unfair discrimination and likely would prevent the Commission from approving an exchange proposal.²⁰² In the absence of such a substantial countervailing basis for finding that a proposal failed to meet the applicable statutory standards, the Commission would approve the exchange proposal as consistent with the Exchange Act and rules applicable to the exchange.

B. Review of Competitive Forces Applicable to NYSE Arca

market power). Courts frequently refer to the Department of Justice and Federal Trade Commission merger guidelines to define product markets and evaluate market power. See, e.g., FTC v. Whole Foods Market, Inc., 502 F. Supp. 2d 1 (D.D.C. 2007); FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004).

²⁰¹ See Exchange Act Section 19(b)(2) ("The Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding.")

²⁰² Cf. Regulation NMS Release, 70 FR at 37540 (in discussion of market access fees under Rule 610 of Regulation NMS, the Commission noted that "any attempt by an SRO to charge differential fees based on the non-member status of the person obtaining indirect access to quotations, such as whether it is a competing market maker, would violate the anti-discrimination standard of Rule 610.").

The terms of an exchange's proposed rule change to distribute market data for which it is an exclusive processor must, among other things, provide for an equitable allocation of reasonable fees under Section 6(b)(4), not be designed to permit unfair discrimination under Section 6(b)(5), be fair and reasonable under Rule 603(a)(1), and not be unreasonably discriminatory under Rule 603(a)(2). Because NYSE Arca is proposing to distribute non-core data, the Commission reviewed the terms of the Proposal under the market-based approach described above. The first question is whether NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal.

At least two broad types of significant competitive forces applied to NYSE Arca in setting the terms of its Proposal to distribute the ArcaBook data: (1) NYSE Arca's compelling need to attract order flow from market participants; and (2) the availability to market participants of alternatives to purchasing the ArcaBook data.

1. Competition for Order Flow

Attracting order flow is the core competitive concern of any equity exchange – it is the “without which, not” of an exchange's competitive success. If an exchange cannot attract orders, it will not be able to execute transactions. If it cannot execute transactions, it will not generate transaction revenue. If an exchange cannot attract orders or execute transactions, it will not have market data to distribute, for a fee or otherwise, and will not earn market data revenue.²⁰³

In the U.S. national market system, buyers and sellers of securities, and the broker-dealers that act as their order-routing agents, have a wide range of choices of

²⁰³ See Exchange Market Data Coalition Letter at 3 (“The end product of these efforts – the listings, the members, the trading facilities, the regulation – is market data. Market data is the totality of the information assets that each Exchange creates by attracting order flow.”).

where to route orders for execution. They include, of course, any of the nine national securities exchanges that currently trade equities, but also include a wide variety of non-exchange trading venues: (1) electronic communication networks ("ECNs") that display their quotes directly in the core data stream by participating in FINRA's Alternative Display Facility ("ADF") or displaying their quotations through an exchange; (2) alternative trading systems ("ATs") that offer a wide variety of order execution strategies, including block crossing services for institutions that wish to trade anonymously in large size and midpoint matching services for the execution of smaller orders; and (3) securities firms that primarily trade as principal with their customer order flow.

NYSE Arca must compete with all of these different trading venues to attract order flow, and the competition is fierce. For example, in its response to the commenters, NYSE Arca notes that its share of trading in 2005 was 3.6% in Network A stocks, 23% in Network C stocks, and 30% in Network B stocks.²⁰⁴ More recently during June 2008,

²⁰⁴ NYSE Arca Response III at 18 n. 44. The NYSE and NYSE Arca are wholly-owned subsidiaries of NYSE Group, Inc. One commenter stated that the NYSE had "combined Arca's liquidity pool with its own," and that "the networking effect of the NYSE Group's combined pool of liquidity" had resulted in "greater market power over its pricing for market data." SIFMA IV at 8 (emphasis in original). In fact, the NYSE and NYSE Arca liquidity pools have not been combined. The two exchanges operate as separate trading centers with separate limit order books, and each distributes its depth-of-book order data separately for separate fees. In analyzing the competitive position of NYSE Arca for purposes of distributing such data, the Commission has considered NYSE Arca both as a trading center separate from the NYSE and as part of the same corporate group as NYSE. It finds that in both contexts NYSE Arca was subject to significant competitive forces in setting the terms for the ArcaBook data. See section VI.C below for a discussion of the regulatory requirements applicable to individual national securities exchanges operating separate liquidity pools.

NYSE Arca share volume was 14.0% in Network A stocks, 16.1% in Network C stocks, and 26.7% in Network B stocks, adding up to 16.5% of total U.S. market volume.²⁰⁵

Given the competitive pressures that currently characterize the U.S. equity markets, no exchange can afford to take its market share percentages for granted – they can change significantly over time, either up or down.²⁰⁶ Even the most dominant exchanges are subject to severe pressure in the current competitive environment. For example, the NYSE's reported market share of trading in NYSE-listed stocks declined from 79.1% in January 2005 to 30.6% in June 2008.²⁰⁷ In addition, a non-exchange entrant to equity trading – the BATS ECN – has succeeded in capturing 7.4% of trading in NYSE-listed stocks and 10.3% of trading in Nasdaq-listed stocks.²⁰⁸ Another ECN – Direct Edge – has a matched market share of 3.7% in NYSE-listed stocks and 5.8% in Nasdaq-listed stocks.²⁰⁹ Moreover, nearly all venues now offer trading in all U.S.-listed

²⁰⁵ Source: ArcaVision (available at www.arcavision.com); see also NYSE Arca Response III at 18 (“NYSE Arca does not maintain a dominant share of the market in any of the three networks.”).

²⁰⁶ See Exchange Market Data Coalition Letter at 4 (“Exchanges compete not only with one another, but also with broker dealers that match customer orders within their own systems and also with a proliferation of alternative trading systems (“ATSS”) and electronic communications networks (“ECNs”) that the Commission has also nurtured and authorized to execute trades in any listed issue. As a result, market share of trading fluctuates among execution facilities based upon their ability to service the end customer.”).

²⁰⁷ Source: ArcaVision (available at www.arcavision.com).

²⁰⁸ Lehman Brothers, Inc., Equity Research, “Exchanges June Volume Analysis” at 2 (July 2, 2008) (“Lehman Trading Volume Analysis”) at 2. The Commission recently granted an application by BATS Exchange, Inc. for registration as a national securities exchange. Securities Exchange Act Release No. 58375 (Aug. 18, 2008), 73 FR 49498 (Aug. 21, 2008).

²⁰⁹ Lehman Trading Volume Analysis at 2.

equities, no matter the particular exchange on which a stock is listed or on which the most trading occurs. As a result, many trading venues stand ready to provide an immediately accessible order-routing alternative for broker-dealers and investors if an exchange attempts to act unreasonably in setting the terms for its services.

Table 1 below provides a useful recent snapshot of the state of competition in the U.S. equity markets in the month of June 2008:²¹⁰

²¹⁰ Source: ArcaVision (available at www.arcavision.com).

Table 1 Reported Share Volume in U.S-Listed Equities during June 2008 (%)			
Trading Venue	All Stocks	NYSE-Listed	Nasdaq-Listed
All Non-Exchange	31.9	28.9	38.0
Nasdaq	30.4	23.0	42.7
NYSE	17.4	30.6	0.0
NYSE Arca	16.5	14.0	16.1
National Stock Exchange	1.8	1.4	2.4
International Stock Exchange	0.9	1.4	0.2
American Stock Exchange	0.5	0.0	0.0
Chicago Stock Exchange	0.4	0.5	0.3
CBOE Stock Exchange	0.1	0.1	0.2
Philadelphia Stock Exchange	0.1	0.1	0.1

Perhaps the most notable item of information from Table 1 is that non-exchange trading venues collectively have a larger share of trading than any single exchange. Much of this volume is attributable to ECNs such as BATS and Direct Edge, noted above. In addition, the proliferation of non-exchange pools of liquidity has been a significant development in the U.S. equity markets.²¹¹ Broker-dealers often check the

²¹¹ See, e.g., NYSE Arca Response III at 17 (“If the brokerage firm is unable to internalize the trade, typically, it next takes the order to dark pools, crossing networks, ECNs, alternative trading systems, or other non-traditional execution facilities to search for an execution.”); <http://www.advancedtrading.com/directories/darkpool> (directory of more than 20 non-exchange pools of liquidity that are classified as “independent,” “broker-dealer-owned,” and “consortium-owned.”).

liquidity available in these pools as a first choice prior to routing orders to an exchange. In sum, no exchange possesses a monopoly, regulatory or otherwise, in the execution of order flow from broker-dealers.

The market share percentages in Table 1 strongly indicate that NYSE Arca must compete vigorously for order flow to maintain its share of trading volume. As discussed below, this compelling need to attract order flow imposes significant pressure on NYSE Arca to act reasonably in setting its fees for depth-of-book order data, particularly given that the market participants that must pay such fees often will be the same market participants from whom NYSE Arca must attract order flow.²¹² These market participants particularly include the large broker-dealer firms that control the handling of a large volume of customer and proprietary order flow. Given the portability of order flow from one trading venue to another, any exchange that sought to charge unreasonably high data fees would risk alienating many of the same customers on whose orders it depends for competitive survival.²¹³

²¹² See, e.g., Exchange Market Data Coalition Letter at 4 ("It is in the Exchange's best interest to provide proprietary information to investors to further their business objectives, and each Exchange chooses how best to do that."); Nasdaq Letter at 9 ("Like the market for electronic executions, the related market for proprietary data is also influenced by the equity investments of major financial institutions in one or more exchanges Equity investors control substantial order flow and transaction reports that are the essential ingredients of successful proprietary data products. Equity investors also can enable exchanges to develop competitive proprietary products").

²¹³ See NYSE Arca Response III at 16 ("Markets compete with one another by seeking to maximize the amount of order flow that they attract. The markets base competition for order flow on such things as technology, customer service, transaction costs, ease of access, liquidity and transparency. In recent months, significant changes in market share, the rush to establish trade-reporting facilities for the reporting of off-exchange trades, frequent changes in transaction fees and new market data proposals have provided evidence of the intensity of the competition for order flow.").

Some commenters asserted that an exchange's distribution of depth-of-book order data is not affected by its need to attract order flow.²¹⁴ Attracting order flow and distributing market data, however, are in fact two sides of the same coin and cannot be separated.²¹⁵ Moreover, the relation between attracting order flow and distributing market data operates in both directions. An exchange's ability to attract order flow determines whether it has market data to distribute, while the exchange's distribution of market data significantly affects its ability to attract order flow.²¹⁶

For example, orders can be divided into two broad types – those that seek to offer liquidity to the market at a particular price (non-marketable orders) and those that seek an immediate execution by taking the offered liquidity (marketable orders). The wide distribution of an exchange's market data, including depth-of-book order data, to many market participants is an important factor in attracting both types of orders. Depth-of-book order data consists of non-marketable orders that a prospective buyer or seller has chosen to display. The primary reason for a prospective buyer or seller to display its trading interest at a particular price, and thereby offer a free option to all market

²¹⁴ See section III.A.5 above.

²¹⁵ See, e.g., Larry Harris, Trading and Exchanges, Market Microstructure for Practitioners 99 (2003) (noting that it would be “very difficult for innovative trading systems to compete for order flow” if the data from those trading venues were not distributed).

²¹⁶ See, e.g., NYSE Arca Response III at 13 (in setting level of fees, one factor was “projected losses to NYSE Arca’s business model and order flow that might result from marketplace resistance to Arca Book Fees”); Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (September 14, 2001), Section VII.B.1 (available at www.sec.gov) (“[A] market’s inability to widely disseminate its prices undoubtedly will adversely impact its ability to attract limit orders and, ultimately, all order flow. This barrier to intermarket competition, in turn, could decrease liquidity and innovation in the marketplace.”).

participants at that price, is to attract contra trading interest and a fast execution. The extent to which a displayed non-marketable order attracts contra interest will depend greatly on the wide distribution of the displayed order to many market participants. If only a limited number of market participants receive an exchange's depth-of-book order data, it reduces the chance of an execution for those who display non-marketable orders on that exchange. Limited distribution of displayed orders thereby reduces the ability of the exchange to attract such orders. Moreover, by failing to secure wide distribution of its displayed orders, the exchange will reduce its ability to attract marketable orders seeking to take the displayed liquidity. In other words, limited distribution of depth-of-book order data will limit an exchange's ability to attract both non-marketable and marketable orders. Consequently, an exchange generally will have strong competitive reasons to price its depth-of-book order data so that it will be distributed widely to those most likely to use it to trade.²¹⁷

A notable example of the close connection between a trading venue's distribution of order data and its ability to attract order flow was provided by the Island ECN in 2002. To avoid the application of certain regulatory requirements, Island ceased displaying its order book to the public in three very active exchange-traded funds ("ETFs") in which it

²¹⁷ See NYSE Arca Response III at 18 ("If too many market professionals reject Arca Book as too expensive, NYSE Arca would have to reassess the Arca Book Fees because Arca Book data provides transparency to NYSE Arca's market, transparency that plays an important role in the competition for order flow."). This pressure on exchanges to distribute their order data widely is heightened for those exchanges that have converted from member-owned, not-for profit entities to shareholder-owned, for-profit companies. For-profit exchanges are more likely to place greater importance on distributing market information widely than on limiting such information for the use of their members.

enjoyed a substantial market share. After going “dark,” Island’s market share in the three ETFs dropped by 50%.²¹⁸

This competitive pressure to attract order flow is likely what led NYSE Arca, and its predecessor corporation, to distribute its depth-of-book order data without charge in the past.²¹⁹ It now has made a business decision to begin charging for that data, apparently believing that it has a sufficiently attractive data product that the benefit obtained from increased data revenues will outweigh the potential harm of reduced order flow if significant numbers of data users choose not to pay the fee.²²⁰ Commenters concede that NYSE Arca is entitled to charge a fee for its depth-of-book order data,²²¹ but claim that the fee chosen by NYSE Arca is unaffected by its need to attract order

²¹⁸ See Terrence Hendershott and Charles. M. Jones, “Island Goes Dark: Transparency, Fragmentation, and Regulation,” 18 The Review of Financial Studies (No. 3) 743, 756 (2005); see also Nasdaq Letter at 7 (“[T]he market for proprietary data products is currently competitive and inherently contestable because there is fierce competition for the inputs necessary to the creation of proprietary data and strict pricing discipline for the proprietary data products themselves.”). In contrast to the Island example, and as noted in the Nasdaq Letter at 9, an element of the BATS ECN’s business strategy over the last two years in gaining order flow has been to provide its order data to customers free of charge. See BATS Trading, Newsletter (July 2007) (available at <http://www.batstrading.com/newsletters/0707Newsletter.pdf>) (“BATS has chosen not to charge for many of the things for which our competitors charge. . . . More importantly, our market data is free. Why would a market charge its participants for the data they send to that market? Feel free to pose this same question to our competitors.”).

²¹⁹ Cf. NYSE Arca Response III at 4 (“Several years ago, certain [ECNs] began to make their real-time quotes available for free in order to gain visibility in the market place.”).

²²⁰ NYSE Arca Response I at 4 (“[F]ees will enable the Exchange to further diversify its revenue to compete with its rivals. The Exchange believes that its business has reached the point where its customers are willing to pay for the value of the Exchange’s information.”).

²²¹ See, e.g., Petition at 9; SIFMA I at 7.

flow.²²² The Commission disagrees and notes that NYSE Arca, in setting the fee, acknowledged that it needed to balance its desire for market data revenues with the potential damage that a high fee would do to its ability to attract order flow.²²³

2. Availability of Alternatives to ArcaBook Data

In addition to the need to attract order flow, the availability of alternatives to an exchange's depth-of-book order data significantly affects the terms on which an exchange distributes such data.²²⁴ The primary use of depth-of-book order data is to assess the depth of the market for a stock beyond that which is shown by the best-priced quotations that are distributed in core data. Institutional investors that need to trade in large size typically seek to assess market depth beyond the best prices, in contrast to retail investors who generally can expect to receive the best price or better when they trade in smaller sizes.²²⁵

²²² See notes 147-149 above and accompanying text.

²²³ NYSE Arca Response III at 13 (in setting the level of fees for ArcaBook data, NYSE Arca considered "projected losses to NYSE Arca's business model and order flow that might result from marketplace resistance to" the fees).

²²⁴ See NYSE Arca Response III at 13 (in setting fees for ArcaBook data, NYSE Arca considered "the fact that Arca Book is primarily a product for market professionals, who have access to other sources of market data and who will purchase Arca Book only if they determine that the perceived benefits outweigh the cost"); see also the authorities cited in note 200 above. In considering antitrust issues, courts have recognized the value of competition in producing lower prices. See, e.g., *Leegin Creative Leather Products v. PSKS, Inc.*, 127 S. Ct. 2705 (2007); *Atlanta Richfield Co. v. United States Petroleum Co.*, 495 U.S. 328 (1990); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *State Oil Co. v. Khan*, 522 U.S. 3 (1997); *Northern Pacific Railway Co. v. U.S.*, 356 U.S. 1 (1958).

²²⁵ The market information needs of retail investor are discussed at notes 229-336 below and accompanying text.

In setting the fees for its depth-of-book order data, an exchange must consider the extent to which sophisticated traders would choose one or more alternatives instead of purchasing the exchange's data.²²⁶ Of course, the most basic source of information concerning the depth generally available at an exchange is the complete record of an exchange's transactions that is provided in the core data feeds. In this respect, the core data feeds that include an exchange's own transaction information are a significant alternative to the exchange's depth-of-book data product.

For more specific information concerning depth, market participants can choose among the depth-of-book order products offered by the various exchanges and ECNs.²²⁷ A market participant is likely to be more interested in other exchange and ECN products when the exchange selling its data has a small share of trading volume, because the depth-of-book order data provided by other exchanges and ECNs will be proportionally more important in assessing market depth. As a result, smaller exchanges may well be inclined to offer their data for no charge or low fees as a means to attract order flow. Even larger exchanges, however, must consider the lower fees of other exchanges in setting the fees for the larger exchanges' data. Significant fee differentials could lead to

²²⁶ See NYSE Arca Response III at 17 ("As a result of all of the choices and discretion that are available to brokers, the displayed depth-of-book data of one trading center does not provide a complete picture of the full market for a security. . . . A brokerage firm has potentially dozens of different information sources to choose from in determining if, where, and how to represent an order for execution.").

²²⁷ See Nasdaq Letter at 7-8 ("The large number of SROs, TRFs, and ECNs that currently produce proprietary data or are currently capable of producing it provides further pricing discipline for proprietary data products. As shown on Exhibit A, each SRO, TRF, ECN and BD is currently permitted to produce proprietary data products, and many currently do or have announced plans to do so, including Nasdaq, NYSE, NYSEArca, and BATS.").

shifts in order flow that, over time, could harm a larger exchange's competitive position and the value of its non-core data.

Market depth also can be assessed with tools other than depth-of-book order data. For example, market participants can "ping" the various markets by routing oversized marketable limit orders to access an exchange's total liquidity available at an order's limit price or better.²²⁸ In contrast to depth-of-book order data, pinging orders have the important advantage of searching out both displayed and reserve (*i.e.*, nondisplayed) size at all price points within an order's limit price. Reserve size can represent a substantial portion of the liquidity available at exchanges.²²⁹ It often will be available at prices that are better than or equal to an exchange's best displayed prices, and none of this liquidity will be discernible from an exchange's depth-of-book order data. Pinging orders thereby give the sender an immediate and more complete indication of the total liquidity available at an exchange at a particular time. Moreover, sophisticated order routers are capable of maintaining historical records of an exchange's responses to pinging orders over time to gauge the extent of total liquidity that generally can be expected at an exchange. These

²²⁸ See Regulation NMS Release, 70 FR at 37514 (discussion of pinging orders noting that they "could as aptly be labeled 'liquidity search' orders").

²²⁹ See, *e.g.*, NYSE Arca Response III at 17 (noting that brokers "may elect to have NYSE Arca hold a portion of the order as hidden interest that NYSE Arca holds in reserve, which means that NYSE Arca will not include the undisplayed portion of the order as part of the Arca Book display"); Michael Scotti, "The Dark Likes Nasdaq," *Traders Magazine* (May 1, 2007) (quoting statement of Nasdaq's executive vice president that 15 to 18 percent of Nasdaq's executed liquidity is non-displayed).

records are a key element used to program smart order routing systems that implement the algorithmic trading strategies that have become so prevalent in recent years.²³⁰

Another alternative to depth-of-book order data products offered by exchanges is the threat of independent distribution of order data by securities firms and data vendors.²³¹ As noted above, one of the principal market data reforms adopted in 2005 was to authorize the independent distribution of data by individual firms. To the extent that one or more securities firms conclude that the cost of exchange depth-of-book order products is too high and appreciably exceeds the cost of aggregating and distributing such data, they are entitled to act independently and distribute their own order data, with or without a fee. Indeed, a consortium of major securities firms in Europe has undertaken such a market data project as part of the implementation of the Markets in Financial Instruments Directive ("MiFID") adopted by the European Union.²³² No securities statute or regulation prevents U.S. firms from undertaking an analogous project in the

²³⁰ See, e.g., www.advancedtrading.com/directories/dark-algorithms (descriptions of product offerings for "dark algorithms" that seek undisplayed liquidity at multiple trading venues); EdgeTrade, Inc., "EdgeTrade issues white paper on market fragmentation and unprecedented liquidity opportunities through smart order execution" (September 10, 2007) (available at www.edgetrade.com) ("EdgeTrade's smart order execution strategy . . . simultaneously sprays aggregated dark pools and public markets, and then continuously moves an order in line with shifting liquidity until best execution is fulfilled.").

²³¹ See Nasdaq Letter at 3 ("Proprietary optional data may be offered by a single broker-dealer, a group of broker-dealers, a national securities exchange, or a combination of broker-dealers or exchanges, unlike consolidated data which is only available through a consortium of SROs.").

²³² The project – currently named "Markit BOAT" – distributes both quotes and trades and is described at <http://www.markit.com/information/boat/boat-data.html>. It currently charges fees of 120 euros per month per user for its quote and trade data. See Nasdaq Letter at 9 (noting the potential for firms to export Project BOAT technology to the United States).

U.S. for the display of depth-of-book order data. This data could encompass orders that are executed off of the exchanges, as well as orders that are submitted to exchanges for execution. If major U.S. firms handling significant order flow participated in the project, the project could collect and distribute data that covered a large proportion of liquidity in U.S. equities.

The Commission recognizes that the depth-of-book order data for a particular exchange may offer advantages over the alternatives for assessing market depth. The relevant issue, however, is whether the availability of these alternatives imposes significant competitive restraints on an exchange in setting the terms, particularly the fees, for distributing its depth-of-book order data. For example, Nasdaq has a substantial trading share in Nasdaq-listed stocks, yet only 19,000 professional users purchase Nasdaq's depth-of-book data product and 420,000 professional users purchase core data in Nasdaq-listed stocks.²³³ A reasonable conclusion to draw from this disparity in the number of professional users of consolidated core data and Nasdaq's non-core data is that the great majority of professional users either believe they do not need Nasdaq's depth-of-book order data or simply do not think it is worth \$76 per month to them (approximately \$3.50 per trading day) compared to other sources of information on market depth in Nasdaq-listed stocks. The fact that 95% of the professional users of core data choose not to purchase the depth-of-book order data of a major exchange strongly suggests that no exchange has monopoly pricing power for its depth-of-book order data.²³⁴

²³³ Nasdaq Letter at 6.

²³⁴ See id. ("Empirical sales data for Nasdaq TotalView, Nasdaq's proprietary depth-of-book data, demonstrate that broker-dealers do not consider TotalView to be

In sum, there are a variety of alternative sources of information that impose significant competitive pressures on an exchange in setting fees for its depth-of-book order data. The Commission believes that the availability of these alternatives, as well as NYSE Arca's compelling need to attract order flow, imposed significant competitive pressure on NYSE Arca to act equitably, fairly, and reasonably in setting the terms of the Proposal.

3. Response to Commenters on Competition Issues

Some commenters suggested that exchanges are not constrained by competitive forces in distributing their order data because Exchange Act rules require broker-dealers to provide their orders to an exchange, and that exchanges therefore enjoy a regulatory monopoly.²³⁵ As discussed above, however, exchanges face fierce competition in their efforts to attract order flow. For the great majority of orders, Exchange Act rules do not

required for compliance with Regulation NMS or any other regulation. . . . [O]f the 735 broker-dealer members that trade Nasdaq securities, only 20 or 2.7 percent spend more than \$7,000 per month on TotalView users. Nasdaq understands that firms with more than 100 TotalView professional users generally provide TotalView to only a small fraction of their total user populations.”).

²³⁵ See, e.g., Bloomberg Letter at 4; Financial Services Roundtable Letter at 1; NetCoalition III at 6. Some commenters suggested that broker-dealers were required to provide their data to exchanges for free and then buy that data back from the exchanges. NSX Letter at 1; SIFMA III at 12. A broker-dealer, however, has no need to buy back its own data, with which it is already familiar. Rather, broker-dealers need to see data submitted by other broker-dealers and market participants. This need is served by the core function of a securities exchange, which is to provide a central point for bringing buy and sell orders together, thereby enabling the resulting market data to be distributed to all market participants. See, e.g., Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1) (“exchange” defined as, among other things, “facilities for bringing together purchasers and sellers of securities”).

require that they be routed to an exchange.²³⁶ These include all marketable orders and most non-marketable orders. With respect to certain types of non-marketable orders, two Exchange Act rules can require broker-dealers to provide such orders to an exchange in certain circumstances, but only when the broker-dealer chooses to do business on the exchange. Rule 602 of Regulation NMS²³⁷ requires certain broker-dealers, once they have chosen to communicate quotations on an exchange, to provide their best quotations to the exchange.²³⁸ Rule 604 of Regulation NMS²³⁹ requires market makers and specialists to reflect their displayable customer limit orders in their quotations in certain circumstances, but provides an exception if the order is delivered for display through an exchange or FINRA, or to a non-exchange ECN that delivers the order for display through an exchange or FINRA. Most significantly, while these rules can require certain orders to be displayed through an exchange or FINRA, broker-dealers have a great deal of flexibility in deciding which exchange or FINRA. As discussed above, exchanges

²³⁶ For example, a broker-dealer commenter asserted that exchanges enjoy a “government-protected monopoly” as exclusive processors of their market information. Schwab Letter at 6; see also SIFMA IV at 7 (“Normal market forces cannot be relied upon here because of the unique structure of the market for data that the exchanges compile from their captive broker-dealer customers and then sell back to them.”). As noted in Table 1 above, non-exchange trading venues now execute more volume in U.S.-listed equities than any single exchange.

²³⁷ 17 CFR 242.602 (previously designated as Rule 11Ac1-1).

²³⁸ Only broker-dealers that choose to participate on an exchange as “responsible broker-dealers” are required to provide their best bid and best offer to such exchange. Rule 602(b) and Rule 600(b)(65)(i) of Regulation NMS. Broker-dealers that participate only in the over-the-counter (i.e., non-exchange) market as responsible broker-dealers are required to provide their quotations to FINRA, a not-for-profit membership organization of broker-dealers. Rule 602(b) and Rule 600(b)(65)(ii) of Regulation NMS.

²³⁹ 17 CFR 242.604 (previously designated as Rule 11Ac1-4).

compete vigorously to display the non-marketable orders handled by broker-dealers. No particular exchange has a regulatory monopoly to display these orders.²⁴⁰

Some commenters asserted that exchanges act as monopolies in distributing depth-of-book order data because they are the exclusive processors of such data, as defined in Section 3(a)(22)(B) of the Exchange Act. Many businesses, however, are the exclusive sources of their own products, but this exclusivity does not mean that a business has monopoly pricing power when selling its product and is impervious to competitive pressures. The particular circumstances of the business and its product must be examined. As discussed above, the U.S. exchanges are subject to significant competitive forces in setting the terms for their depth-of-book order products, including the need to attract order flow and the availability of alternatives to their depth-of-book order products. Consequently, NYSE Arca does not have monopoly pricing power for ArcaBook data merely because it meets the statutory definition of an exclusive processor of the data.²⁴¹

²⁴⁰ One commenter asserted that “exchanges have government-granted exclusive access to market data for securities listed in their respective markets.” SIFMA I at 12. In fact, a listing exchange does not have any particular privileges over other exchanges in attracting quotation and trade data in its listed stocks. Rather, other exchanges are free to trade such stocks pursuant to unlisted trading privileges, and the listing exchange must compete with those exchanges for order flow. If the listing exchange is unable to attract order flow, it will not have quotations or trades to distribute.

²⁴¹ A straightforward example may help illustrate this point. Table 1 shows that there are several exchanges with a very small share of trading volume. Such an exchange would meet the statutory definition of an exclusive processor, but clearly would be unable to exert monopoly pricing power if it attempted to sell its depth-of-book order data at an unreasonably high price. Accordingly, the relevant issue is not whether an exchange falls within the statutory definition of an exclusive processor, but whether it is subject to significant competitive forces in setting the terms for distribution of its depth-of-book data.

Commenters cited a decision of the U.K. competition authorities concerning proposed acquisitions of the London Stock Exchange plc ("LSE") for the proposition that an exchange is a monopolist of its proprietary market information.²⁴² Their reliance on this decision is misplaced for two important reasons. First, unlike the U.S. where the core data feeds provide an essential source of information for every exchange's most valuable data – its best quoted prices and last sale information – the LSE's proprietary data is the sole source of information for trading on the LSE. As a result, market participants have few, if any, useful alternatives for LSE proprietary data. In the U.S., in contrast, the availability of an exchange's essential trading information in the core data feeds, as well as other valuable alternatives, discussed above, for assessing market depth beyond the best quoted prices, precludes the U.S. exchanges from exerting monopoly power over the distribution of their non-core data. Second, there historically has been very little effective competition among markets for order flow in the U.K. The U.K. Competition Commission, for example, found that the most important competitive constraint on the LSE was not the existence of other trading venues with significant trading volume in LSE-listed stocks, but rather "primarily, the threat that [other exchanges, including foreign exchanges such as the NYSE and Nasdaq] will expand their services and compete directly with LSE."²⁴³ In contrast, the U.S. has a national market system for trading equities in which competition is provided not merely by the threat of

²⁴² NetCoalition IV at 9; SIFMA V at 8.

²⁴³ U.K. Competition Commission, A Report on the Proposed Acquisition of London Stock Exchange plc by Deutsche Borse AG or Euronext NV (November 2005), at 57 (emphasis added). The intensity of competition among markets trading the same products in Europe could increase substantially in the wake of the implementation of MiFID in November 2007.

other markets attempting to trade an exchange's listed products, but by the on-the-ground existence of multiple markets with a significant share of trading in such products. These competitors also distribute depth-of-book order products with substantial liquidity in the same stocks included in an exchange's depth-of-book product. In sum, the competitive forces facing NYSE Arca in its distribution of ArcaBook data were entirely inapplicable to the LSE in its distribution of proprietary data in 2005.

In addition, the existence of significant competitive forces applicable to NYSE Arca renders inapposite the citations of commenters to statements in Exchange Act legislative history and Commission releases regarding monopoly data distribution. Such statements were made in the context of the central processors of core data for the Networks, which in fact have monopoly pricing power for such mandated data. Central processors of core data therefore are in a very different economic and legal position than NYSE Arca as exclusive processor for its depth-of-book order data.²⁴⁴

²⁴⁴ One commenter cited two papers for the claim that exchanges have government-conferred monopolies over the collection and distribution of trading data. NetCoalition IV at 9-10 (citing Wilkie Farr & Gallagher, counsel to Bloomberg L.P., "Discussion Paper: Competition, Transparency, and Equal Access to Financial Market Data" (September 24, 2002) (submitted by Bloomberg L.P. in consultation with George A. Hay and Erik R. Sirri); Erik R. Sirri, "What glory price? Institutional form and the changing nature of equity trading" (Federal Reserve Bank of Atlanta 2000 Financial Markets Conference on e-Finance, October 15-17). Dr. Sirri currently is Director of the Commission's Division of Trading and Markets. The papers were prepared when he was not a member of the Commission's staff. As discussed at length above, the commenter's claim that exchanges have a monopoly over the collection and distribution of trading data confuses core data, which Commission rules require to be collected by a central processor pursuant to the joint-industry Plans, and non-core data, which the individual exchanges must compete to attract from market participants. Indeed, the major shifts in order flow among exchanges and other trading venues in the years since the papers were written in 2000 and 2002 amply demonstrate that no exchange has a monopoly over the collection of orders displayed in the exchanges' depth-of-book data feeds. As noted above (text accompanying note

For example, commenters cited a passage from the legislative history of the 1975 amendments to the Exchange Act for the proposition that any exclusive processor must be considered a monopoly, but this passage applies only to the central processors of consolidated core data that Rule 603(b) requires to be consolidated:

Despite the diversity of views with respect to the practical details of a national market system, all current proposals appear to assume there will be an exclusive processor or service bureau to which the exchanges and the NASD will transmit data and which in turn will make transactions and quotation information available to vendors of such information. Under the composite tape "plan" declared effective by the Commission, SIAC would serve as this exclusive processor. The Committee believes that if such a central facility is to be utilized, the importance of the manner of its regulation cannot be overestimated. . . . The Committee believes that if economics and sound regulation dictate the establishment of an exclusive central processor for the composite tape or any other element of the national market system, provision must be made to insure that this central processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms. Although the existence of a monopolistic processing facility would not necessarily raise antitrust problems, serious antitrust questions would be posed if access to this facility and its services were not available on reasonable and nondiscriminatory terms to all in the trade or its charges were not reasonable.²⁴⁵

These Congressional concerns apply to a central processor that has no competitors in the distribution of data that must be consolidated from all the markets. They do not apply to the independent distribution of non-core data by an individual exchange that is subject to significant competitive forces.

207), for example, the NYSE's market share in its listed stocks has declined from 79.1% in January 2005 to 30.6% in June 2008. For these reasons and those explained in the text, the two papers are outdated. Neither the NYSE, nor any other exchange, currently has a monopoly over the collection and distribution of depth-of-book order data in its listed stocks.

²⁴⁵ Senate Report at 11-12 (emphasis added).

Commenters on the Draft Order questioned whether its reliance on competitive forces is consistent with Exchange Act legal standards.²⁴⁶ Their discussion, however, appears to conflate: (1) the factual issue of whether competitive forces significantly constrain the exchanges in setting the terms for their non-core data; with (2) the legal issue of whether, if such competitive forces exist, the Commission is authorized to consider those forces in determining whether an exchange proposal meets the applicable Exchange Act standards. If an exchange could, in fact, exert monopoly power over its pricing of non-core data, it obviously would be inappropriate for the Commission to rely on non-existent competitive forces as a basis for approving an exchange proposal. If significant competitive forces do apply to an exchange, the Commission believes that considering them in its review is fully consistent with its regulatory responsibilities.

For example, the Commission does not agree with commenters' argument that the phrase "fair and reasonable" in the Exchange Act requires the Commission always to undertake a cost-based review of proposed exchange fees because it uses such an approach when applying the fair and reasonable standard in other circumstances.²⁴⁷ Applying the abstract standard "fair and reasonable" to a specific proposal necessitates the use of factors that are appropriate to the circumstances. In assessing the fairness and reasonableness of a price, courts have emphasized that the existence of competitive forces is a particularly appropriate factor.²⁴⁸

²⁴⁶ NetCoalition V at 7-18; SIFMA IX at 8-20.

²⁴⁷ NetCoalition V at 15-18; SIFMA IX at 12-13.

²⁴⁸ See, e.g., Morgan Stanley Capital Group, Inc. v. Public Utility Dist. No. 1, 554 U.S. ___, 128 S.Ct. 2733, 2738 (2008) ("The statutory requirement that rates be 'just and reasonable' is obviously incapable of precise judicial definition, and we afford great deference to the Commission in its rate decisions. We have

In addition, commenters on the Draft Order asserted that it improperly relied on competition to the exclusion of all other factors.²⁴⁹ In fact, the Commission considered several factors. The first step of the market-based approach to non-core data proposals examines competitive factors to determine whether there is a substantial basis to believe that a proposed fee meets the applicable Exchange Act standards. In the second step, the Commission will evaluate whether there nevertheless is a substantial countervailing basis to find that a proposal is inconsistent with the Exchange Act, including the unfair discrimination concerns raised by a commenter.²⁵⁰

Commenters also cited a passage from the Commission's Market Information Concept Release for the proposition that an exchange must submit cost data to justify a proposed fee for the exchange's depth-of-book order data.²⁵¹ The Release stated that

repeatedly emphasized that the Commission is not bound to any one ratemaking formula.") (citations omitted); Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870 (D.C. Cir. 1993) ("[T]he Supreme Court 'has repeatedly held that the just and reasonable standard does not compel the Commission to use any single pricing formula . . . ,' and we have indicated that when there is a competitive market FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a 'just and reasonable' result.") (citations omitted).

²⁴⁹ NetCoalition V at 8-9; SIFMA IX at 10-11.

²⁵⁰ SIFMA IX at 11.

²⁵¹ See section III.A.2 above. As noted in section III.A.7 above, commenters recommended a variety of market data regulatory solutions, in addition to a cost-based justification of fees. One was a regulatory mandate that exchanges place their market data operations in separate subsidiaries and provide their data to third parties on the same terms they make the data available to the subsidiary. Given its determination that NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal, the Commission does not believe this regulatory mandate is necessary or appropriate. It also notes that the recommendation alone would not address the potential problem of an exchange's unreasonably high fees under the per device fee structure that is used throughout the exchange industry. For example, the proposed fees for ArcaBook data would be levied based on the number of professional and non-professional subscribers who receive the data on

"the total amount of market information revenues should remain reasonably related to the cost of market information."²⁵² The Market Information Concept Release, however, was published in 1999, prior to the start of decimal trading and to the increased usefulness of non-core data distributed outside the Networks. The Market Information Concept Release in general, and the cited statement in particular, solely addressed a central exclusive processor that has no competitors in distributing consolidated core data to the public pursuant to the Plans.²⁵³

their devices. Regardless of whether subscribers obtained their data from an exchange subsidiary or another competing vendor, the exchange would receive the same total amount of fees based on the total number of subscribers who chose to receive the data. From the standpoint of maximizing its revenues from per device fees, the exchange likely would be indifferent to whether subscribers purchased through its subsidiary or elsewhere. It therefore would be willing to make the data available to its subsidiary for the same per device fees that it made the data available to third parties. Moreover, to the extent that an exchange would want to benefit a subsidiary that it was required to create to act as a vendor of market data, that requirement need not cause the exchange to charge lower fees. Instead, it could create conflicts of interest under which the exchange would have incentives to favor the subsidiary over other vendors in ways that might be difficult to monitor effectively. Under its proposal, NYSE Arca will make the ArcaBook data available to vendors on a non-discriminatory basis. For the same reason that NYSE Arca's proposed fees for the ArcaBook data are not unreasonably high – the competitiveness of the market for that data – other potential problems cited by commenters as arising in a non-competitive environment are not an obstacle to approval of the NYSE Arca proposal under the relevant Exchange Act provisions and rules.

²⁵² 64 FR at 70627.

²⁵³ See, e.g., 64 FR at 70615 ("These [joint-SRO] plans govern all aspects of the arrangements for disseminating market information. . . . The plans also govern two of the most important rights of ownership of the information – the fees that can be charged and the distribution of revenues derived from those fees. As a consequence, no single market can be said to fully 'own' the stream of consolidated information that is made available to the public. Although markets and others may assert a proprietary interest in the information that they contribute to the stream, the practical effect of comprehensive federal regulation of market information is that proprietary interests in this information are subordinated to the Exchange Act's objectives for a national market system.")

Moreover, the Commission did not propose, much less adopt, a “strictly cost-of-service (or ‘ratemaking’) approach to its review of market information fees in every case,” noting that “[s]uch an inflexible standard, although unavoidable in some contexts, can entail severe practical difficulties.”²⁵⁴ Rather, the Commission concluded that “Congress, consistent with its approach to the national market system in general, granted the Commission some flexibility in evaluating the fairness and reasonableness of market information fees.”²⁵⁵

Some commenters suggested that depth-of-book order data has become so important since the initiation of decimal trading that broker-dealers now are effectively required to purchase the exchanges’ depth-of-book data products.²⁵⁶ No regulatory

²⁵⁴ 64 FR at 70619. In the Market Information Concept Release, the Commission discussed the one context in which it had previously adopted a strict cost-of-service standard for market data fees – a denial of access proceeding involving the NASD and Instinet. See supra, note 47. It emphasized, however, that the scope of its decision was limited to the “particular competitive situation presented in the proceedings.” 64 FR at 70622-70623. Specifically, the NASD essentially had sought to charge a retail rate for a wholesale product that would have severely curtailed the opportunity for a data vendor like Instinet to compete with the NASD in the retail market. The practical difficulties of implementing the strict cost-of-service approach were amply demonstrated by the long and difficult history of the attempt to determine the NASD’s cost of producing the data. See 64 FR at 70623.

²⁵⁵ Id. at 70619. Commenters also pointed to Commission and staff statements about costs in the context of the entry of an exchange as a new participant in one of the Plans. NetCoalition IV at 12-14; SIFMA V at 9-10. Again, competitive forces are not operative in this context because Rule 603(b) requires an exchange to join the Plans and disseminate its best quotations and trades through a central processor in the core data feeds. A cost-based analysis is necessary in this context, not because it is universally required by the Exchange Act to determine fair and reasonable fees, but because the absence of competitive forces impels the use of a regulatory alternative.

²⁵⁶ See section III.A.4 above. Commenters cited a passage from the Regulation NMS Release for the proposition that exchanges could exert market power when distributing non-core data. NetCoalition III at 6; SIFMA V at 11-12. The

requirement, however, compels broker-dealers to purchase an exchange's depth-of-book order data. As discussed above, only core data is necessary for broker-dealers to comply with the consolidated display requirements of Rule 603(c) of Regulation NMS.²⁵⁷ In addition, only core data is necessary to comply with the trade-through requirements of Rule 611 of Regulation NMS.²⁵⁸

Commenters also asserted that an exchange's depth-of-book order data may be necessary for a broker-dealer to meet its duty of best execution to its customers.²⁵⁹ The Commission believes, however, that broker-dealers are not required to obtain depth-of-book order data, including the NYSE Arca data, to meet their duty of best execution. For example, a broker-dealer can satisfy this duty "to seek the most favorable terms reasonably available under the circumstances for a customer's transaction"²⁶⁰ by, among other things, reviewing executions obtained from routing orders to a market. Under established principles of best execution, a broker-dealer is entitled to consider the cost

concern mentioned in the Regulation NMS Release, however, explicitly applied only to the "best quotations and trades" of an SRO – i.e., an SRO's core data – and not to non-core data.

²⁵⁷ Note 183 above and accompanying text. Rule 603(c) requires broker-dealers and vendors, in certain trading and order-routing contexts, to provide a consolidated display of the national best bid and offer and the most recent last sale report. All of this information is included in the core data feeds.

²⁵⁸ Note 185 above and accompanying text. When it adopted Regulation NMS, the Commission declined to adopt a proposal that would have extended trade-through protection to depth-of-book quotations if the market displaying such quotations voluntarily disseminated them in the consolidated core quotation stream. Regulation NMS Release, 70 FR at 37529.

²⁵⁹ See notes 60 above and accompanying text.

²⁶⁰ See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, 48322 (Sept. 12, 1996) ("Order Handling Rules Release").

and difficulty of trading in a particular market, including the costs and difficulty of assessing the liquidity available in that market, in determining whether the prices or other benefits offered by that market are reasonably available.²⁶¹ Although the Commission has urged broker-dealers to "evaluate carefully" the different options for execution, we have acknowledged that cost considerations are legitimate constraints on what a broker-dealer must do to obtain best execution.²⁶² In order to "evaluate carefully" execution options a broker-dealer need not purchase all available market data. The Commission does not view obtaining depth-of-book data as a necessary prerequisite to broker-dealers' satisfying the duty of best execution.²⁶³

²⁶¹ See Order Handling Rules Release, 61 FR at 48323 (acknowledging that, consistent with best execution, broker-dealers may take into account cost and feasibility of accessing markets and their price information); Regulation NMS Release, 70 FR at 37538 n. 341 (noting that the "cost and difficulty of executing an order in particular market" is a relevant factor in making a best execution determination). NYSE Arca and Nasdaq also stated their view that depth-of-book order products are not required for best execution purposes. NYSE Arca Response III at 18; Nasdaq Letter at 5-6.

²⁶² Order Execution Obligations, Proposing Release, Securities Exchange Act Release No. 36310 (Sept. 29, 1995), 60 FR 52792 at 52794 (Oct. 10, 1995) ("While not all markets and trading systems are equally accessible to large and small broker-dealers, and not all order handling technologies are equally affordable to all broker-dealers, when efficient and cost-effective systems are readily accessible, broker-dealers must evaluate carefully whether they can be used in fulfilling their duty of best execution.").

²⁶³ Some broker-dealers may conclude that, as a business matter to attract customers and generate commissions, they should obtain depth-of-book order data from one or more exchanges to inform their order-routing and pricing decisions. As with any other business decision, if the costs of obtaining the market data outweigh the benefits, broker-dealers will not buy it. This will put pressure on the exchange selling the data to lower the price that it charges. If, however, such firms believed that an exchange's depth-of-book order product is overpriced for certain business purposes, they could limit their use of the product to other contexts, such as "black-box" order routing systems and a block trading desk, where the depth-of-book data feed is most directly used to assess market depth. The firm would not display the data widely throughout the firm as a means to minimize the fees that

Commenters on the Draft Order questioned whether it lowered the standard of best execution and whether its reasoning would be accepted in other legal contexts,²⁶⁴ but the commenters cited no legal authority to support their concerns. Moreover, contrary to the claim that “ascertaining the total price of an average retail trade requires depth of book data,”²⁶⁵ the inferior prices in depth-of-book data provide a poor basis to assess the quality of execution of retail orders. As discussed below, the availability of substantial undisplayed liquidity enables such orders to be executed on average at prices better than even the best displayed quotes in core data.²⁶⁶ In sum, the Commission has not lowered the standard of best execution by recognizing that there are reasonable tools other than depth-of-book data to obtain high-quality executions of customer orders.

4. Response to Economic Assessments of the Draft Order

Three commenters submitted economic assessments (with supplements) of the Draft Order. The Ordovery/Bamberger Statement agreed with the Draft Order’s conclusion that NYSE Arca was subject to significant competitive forces that constrained its pricing of the ArcaBook data. It noted that “if competition is effective, regulation is

must be paid for the data. This limited use of the data would drastically reduce the revenues that an exchange might have sought to obtain by charging a high fee and therefore be self-defeating for the exchange. In sum, exchanges will be subject to competitive pressures to price their depth-of-book order data in a way that will promote wider distribution and greater total revenues.

²⁶⁴ NetCoalition V at 7; SIFMA IX at 19-20.

²⁶⁵ NetCoalition V at 7 (emphasis in original).

²⁶⁶ The execution quality of retail orders is discussed below at notes 306-308 and accompanying text.

not only not needed, but can distort the operations of the market and lead to unforeseen and unintended consequences that can harm the trading public.”²⁶⁷

In contrast, the SLCG Study and the Evans Report disputed that Draft Order’s conclusion that NYSE Arca was subject to significant competitive forces. As discussed below, the Commission has reviewed their data and analysis and does not find them persuasive for three broad reasons:

(1) although the two assessments purport to accept that exchanges must compete to attract order flow, their theoretical attempts to wall off this order flow competition from data competition are unconvincing – the two market forces are integrally linked in the real world of exchange competition;

(2) in rejecting all potential substitutes for an exchange’s depth-of-book data, the two economic assessments focus narrowly on whether alternatives replicate the exchange’s specific data and thereby miss the critically important bigger picture of whether such data is in fact necessary for traders effectively to assess the available liquidity in a stock; and

(3) the two economic assessments fail to recognize the important ways in which the Exchange Act regulatory structure effectively promotes market data competition, yet suggest regulatory alternatives that would be costly and difficult to implement and still would offer less reason to expect an efficient outcome than relying primarily on the current level of competitive forces.

a. Order Flow and Market Data Competition

²⁶⁷ Ordoover/Bamberger Statement at 2.

Both economic assessments purport to accept the existence of competition for order flow among exchanges and other trading venues.²⁶⁸ They take different approaches, however, in attempting to explain why this competition for order flow does not impose significant constraints on the exchanges in setting the terms for their depth-of-book data.

In its analysis of the “supply-side conditions” of market data, the SLCG Study says that it will explain “why fierce competition among exchanges is not likely to result in competitively priced exclusive data when significant ‘network externalities’ are present in the market for order flow.”²⁶⁹ Its analysis is unpersuasive for two primary reasons. First, if network externalities are truly operative in the market for order flow, they should impede competition for order flow. For example, the SLCG Study notes that “[a]t the individual security level, the order flow externality makes it highly likely that a dominant liquidity-providing market center will emerge.”²⁷⁰ The SLCG Study does not explain, however, how network externalities could operate in the market for order flow, impede competition for market data, but not impede fierce competition for order flow. If there is competition for order flow, there necessarily will be competition for the supply of market data because order flow creates the very data to be supplied, and vice versa. The defect of the SLCG analysis highlights the difficulty of separating two aspects of exchange competition that are integrally linked.

²⁶⁸ SLCG Study at 2; Evans Report at 2.

²⁶⁹ SLCG Study at 2.

²⁷⁰ SLCG Study at 3.

Second, the SLCG Study attempts to show that NYSE Euronext and Nasdaq dominate trading in, respectively, NYSE-listed stocks and Nasdaq-listed stocks by offering Herfindahl Index statistics on market concentration. Based on these statistics, the SLCG Study concludes that “trading is highly concentrated and that the listing exchange is the dominant exchange.”²⁷¹

This conclusion badly misuses the Herfindahl Index. In particular, a “concentrated” market as measured by the Herfindahl Index does not mean there is an absence of competition in the market. Rather, the U.S. Department of Justice (“DOJ”) uses the Index to assess whether the existing competition in a market would be substantially lessened by a proposed merger.²⁷² In this case, the SLCG Study’s misuse of the Herfindahl Index is quite apparent, given that the DOJ specifically found that the U.S. equity markets were competitive in November 2005 when it investigated the merger of NYSE and Archipelago Holdings and the merger of Nasdaq and Instinet Group Inc.²⁷³ The DOJ concluded that neither merger would be “likely to reduce competition substantially” because the “planned and likely entry of several firms . . . should result in

²⁷¹ SLCG Study at 10.

²⁷² DOJ Merger Guidelines § 0.1 (“The Guidelines are designed primarily to articulate the analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition, not to describe how the Agency will conduct the litigation of cases that it decides to bring.”).

²⁷³ U.S. Department of Justice, Press Release No. 05-616, “Department of Justice Antitrust Division Statement on the Closings of Its Two Stock Exchange Investigations” (Nov. 16, 2005) (available at http://www.usdoj.gov/opa/pr/2005/November/05_at_616.html).

additional viable alternatives to the two merged firms sufficient to ensure that the markets remain competitive.²⁷⁴

Level of concentration alone does not reliably indicate the level of competition in an industry. It is only one of a series of indicators that may be used when analyzing competition and is a more appropriate metric in some industries than others. In particular, industry concentration is a more relevant measure of competitiveness in markets where barriers to entry enable large firms to increase equilibrium prices by restricting the quantity supplied.²⁷⁵ As the last three years have shown, new competitors in the U.S. equity markets have captured significant trading volume and have imposed strong competitive pressure on the primary listing exchanges. Indeed, the NYSE – the exchange with the highest market share in its listed stocks in November 2005 – has seen its share of trading in those stocks drop from 79.1% to 30.6%.²⁷⁶ This is hardly evidence

²⁷⁴ See also Comments of the United States Department of Justice, Review of the Regulatory Structure Associated with Financial Institutions, Section III.C. (Jan. 31, 2008) (available at <http://www.usdoj.gov/atr/public/comments/229911.htm>) (“This structure [of the equity markets] – and its regulatory overlay – permits multiple exchanges and electronic trading venues to offer the same or equivalent instruments. There is significant competition among multiple equity trading venues, with low execution fees, narrow spreads, and widespread system innovation – all to the benefit of consumers.”); Nasdaq III at 3.

²⁷⁵ See, e.g., Jean Tirole, The Theory of Industrial Organization 209-221 (1998).

²⁷⁶ See note 207 above and accompanying text. The SLCG Study and Evans Report asserted that the Draft Order failed to consider the effect of competition at the individual stock level, noting, for example, that Nasdaq’s market share in Nasdaq-listed stocks is higher than for other stocks. SLCG Study at 11; Evans Report at 7. The Draft Order did, in fact, consider the market share of NYSE Arca in various categories of stocks, as well as the NYSE in NYSE-listed stocks. See 73 FR at 32673. Moreover, as noted in Table 1 above, no exchange (or even NYSE and NYSE Arca combined) currently executes more than 45% of the volume in its listed stocks. The relatively small variations in market share across different stocks are consistent with the Commission’s finding that the exchanges are subject to significant competitive forces, particularly given the ready portability

of network externalities that “are such powerful forces that listing exchanges are able to survive as natural monopolies.”²⁷⁷

The U.S. equity markets are characterized by other key features that contribute to a competitive outcome regardless of concentration levels. One is the ability of firms quickly to expand their order and trade processing capacity. As a result, capacity constraints play at best a minor role in the way that firms compete for order flow, and competition is driven primarily by pricing strategies rather than quantity choice. A well established principle of industrial organization literature is that industries in which price is the main strategic choice show more competitive outcomes.²⁷⁸ Another characteristic of the U.S. equity markets that promotes competition is low switching costs.²⁷⁹ Market participants can easily switch their order flow from one market to another. Indeed, they can participate in many markets at the same time and simultaneously offer and take liquidity from multiple limit order books. Finally, promoting competition is an integral element of the regulatory structure of the U.S. equity markets. The Commission has adopted numerous regulations over the past decade, including Regulation ATS, the Order

of order flow from one exchange to another (as well evidenced by the decline in the NYSE’s market share in its listed stocks). Any attempt by an exchange to capitalize on its market share in one stock or group of stocks by acting unreasonably with respect to its customers is likely to drive that order flow away and soon end whatever “dominance” the exchange once had.

²⁷⁷ SLCG Study at 19. See Ordoover/Bamberger Statement at 15 (“HHI analysis can be unreliable when the shares of firms in the market can change rapidly (i.e., competition can be vigorous and intense even in markets in which measured HHI is high if firms can rapidly gain or lose share.”).

²⁷⁸ See, e.g., Tirole, note 275 above, at 307-314.

²⁷⁹ See, e.g., Paul Klemperer, “Markets with Consumer Switching Costs,” Q. J. Econ. 375-394 (1987).

Handling Rules, and Regulation NMS, that have enabled smaller markets to compete with larger markets and made it much more difficult for large exchanges to retain market share should they attempt to exert market power. In sum, the U.S. equity markets have the hallmarks of an industry in which concentration is not a very informative measure of the level of competition.

The calculations in the SLCG Study also grossly overstate the level of concentration in the U.S. equity markets. First, for Nasdaq, the SLCG Study combines the volume of trades actually executed by Nasdaq – its “matched” volume – with volume that is executed by non-exchange trading venues and merely reported to the joint FINRA/Nasdaq TRF. The non-exchange trades do not reflect liquidity in Nasdaq or in its depth-of-book data. In June 2008, for example, Nasdaq reported 42.7% matched volume in Nasdaq-listed stocks, while the Nasdaq/FINFA TRF reported 23.3% volume in Nasdaq-listed stocks.²⁸⁰ The SLCG Study thereby erroneously inflated Nasdaq’s market share by more than 50%.

Second, the SLCG statistics combine volume for NYSE and NYSE Arca, even though they operate separate liquidity pools. As discussed below,²⁸¹ the Exchange Act precludes anti-competitive tying of the liquidity pools of separately registered national

²⁸⁰ Source: www.nasdaqtrader.com. See also Nasdaq III at 1-2. SLCG II notes that Nasdaq itself defines “total market share” to include TRF trades. SLCG II at 4. Nasdaq’s Form 10-K, however, specifically distinguishes between “matched market share” and “total market share” and defines matched market share to include only transactions that are executed on Nasdaq’s systems. See Nasdaq, Form 10-K for period ending December 31, 2007 (filed February 25, 2008), at 44-45. Transactions executed by entities other than Nasdaq and merely reported to the joint FINRA/Nasdaq TRF are irrelevant when assessing Nasdaq’s share of liquidity.

²⁸¹ Note 309 below and accompanying text.

securities exchanges even if they are under common control. Accordingly, their separate liquidity pools eliminate any network externalities between NYSE and NYSE Arca and undercut much of the SLCG analysis of market concentration. The SLCG Study does not address how network externalities could apply across separate, untied, liquidity pools.

Even if the reported market shares of NYSE and NYSE Arca are combined, however, it would not change the Commission's conclusion that NYSE Arca faced significant competitive forces in setting the terms for the ArcaBook data. The combined market share of NYSE and NYSE Arca in NYSE-listed stocks in June 2008 was 44.6%, down from 53.6% in December 2007, and comparable to the 42.7% market share of Nasdaq in Nasdaq-listed stocks in June 2008.²⁸²

The third problem with the SLCG Study's calculation of market concentration is that it fails to examine the quotes of venues other than NYSE, NYSE Arca, and Nasdaq when measuring displayed liquidity – particularly the quotes of BATS and Direct Edge, which are the fourth and fifth largest equity trading centers in the U.S. Both ECNs display their best quotes in the core data feeds through either the International Securities Exchange ("ISE") or National Stock Exchange ("NSX") and offer their depth-of-book data directly to customers without charge. BATS also makes depth-of-book data available to the public without charge on its Internet web site.

The displayed liquidity of venues other than the primary listing exchanges is quite substantial, resulting in displayed liquidity concentration that is much less than reported trading volume concentration. For example, on July 31, 2008, the best displayed

²⁸² See Table 1, note 210 above and accompanying text.

quotations in the core data feeds for the six stocks analyzed in the SLCG Report were as follows.²⁸³

²⁸³ Source: ArcaVision (available at www.arcavision.com). The data combines bids and offers to determine size and percentage of time at the NBBO. For example, if an exchange always quoted at both the national best bid and the national best offer for 500 shares, its size would be 1000 shares and its percentage would be 100.

Table 2 Exchange Quotation Comparison Share Size (% of time at NBBO)					
	NYSE	NYSE Arca	Nasdaq	ISE	NSX
C	2,199 (81%)	5,933 (89%)	8,069 (93%)	4,821 (88%)	3,948 (72%)
GE	2,848 (87%)	5,728 (92%)	8,594 (95%)	4,829 (91%)	3,199 (85%)
XOM	883 (49%)	606 (77%)	941 (75%)	470 (63%)	576 (22%)
AAPL	NA	250 (52%)	307 (57%)	473 (0.4%)	332 (63%)
GOOG	NA	212 (46%)	194 (48%)	127 (0.1%)	202 (49%)
MSFT	NA	8,149 (95%)	18,311 (97%)	3,848 (8%)	10,822 (95%)

The liquidity offered by the ECNs also is substantial at their depth-of-book prices outside the best prices that are included in the core data feeds. For example, snapshots of BATS depth-of-book data on July 31, 2008 reflect the following liquidity available at its best prices and within four cents away from its best prices:²⁸⁴

²⁸⁴

Source: BATS (snapshots taken from www.batstrading.com at approximately 11:53 AM on July 31, 2008).

Table 3 BATS Order Book Liquidity July 31, 2008		
	Shares at Best Prices	Shares Within Four Cents
C	12,950	39,036
GE	8,438	37,176
XOM	800	1500
AAPL	400	2100
GOOG	300	0
MSFT	16,200	60,876

The SLCG Study erroneously calculated the concentration of displayed liquidity by extrapolating from the reported trading volume of BATS and Direct Edge rather than directly examining their quoted liquidity.²⁸⁵ It thereby missed an essential aspect of assessing liquidity in the current equity markets.

For its part, the Evans Report recognizes the exceptionally strong competition for order flow that characterizes the U.S. equities markets. Indeed, it describes the ongoing price war in transaction fees and rebates among equity trading centers in their efforts to attract order flow. The Evans Report concludes, however, that exchanges are impervious to their compelling need to attract order flow when it comes to setting the terms for their

²⁸⁵ SLCG Study at 46. The SLCG Study also measured all liquidity between the reported high and low price for the trading day (*id.* at 43), which at any particular time will include liquidity far away from the inside prices that is of little value to traders.

depth-of-book order data. It finds that the relationship between order flow competition and depth-of-book data “is neither strong nor direct.”²⁸⁶

To support this conclusion, the Evans Report asserts that transaction fees and rebates are directly related to order flow competition, while data fees are not.²⁸⁷ As noted in the Draft Order, however, the Exchange Act precludes exchanges from adopting terms for data distribution that unfairly discriminate by favoring participants in an exchange’s market or penalizing participants in other markets.²⁸⁸ Accordingly, the fact that exchanges do not directly link their data fees to order flow providers sheds no light on whether order flow and market data competition are related.

The direct connection between order flow and data competition is based on “but-for” causation – if an exchange does not compete successfully for order flow from its customers (in part with market data), it will not generate transactions (or transaction fees) and will have no market data to sell. The two types of competition therefore are

²⁸⁶ Evans Report at 13. One commenter asserted that exchanges do not have an incentive to keep market data fees low because they rebate market data fees to attract order flow. STA Letter at 3; see also Evans II at 12. Exchange rebates of market data fees, however, relate to core data fees, not to the non-core data fees that are the subject of this filing. Moreover, the exchange rebates of core data fees apply primarily to trades that are reported to one of the trade reporting facilities jointly operated by FINRA and different exchanges. These trades are executed in the OTC market, not on the exchanges. The exchanges compete to attract reports of these trades by rebating core market data revenues to the entity that actually executed the trade. Consequently, the market data fee rebates result in revenues flowing through the exchanges to the OTC entities that provided the price discovery.

²⁸⁷ Evans Report at 15-16.

²⁸⁸ 73 FR at 32762, 32768. See also Ordovery/Bamberger Statement at 17 (“The Commission’s proscription of ‘discriminatory’ fees for market data would constrain any attempt by NYSE Arca or Nasdaq to price discriminate between different types of customers (i.e., charge higher prices to customers with relatively inelastic demand for non-core data.”).

integrally connected in the dynamic process of operating a securities exchange. This connection pressures exchanges not to take any action with respect to market data that might jeopardize its position in the competition for order flow. To do otherwise would jeopardize the exchange's own lifeline.

Charging unreasonably high fees for depth-of-book data would jeopardize an exchange's order flow in two respects. First, wide dissemination of an exchange's data is an important tool to attract order flow.²⁸⁹ The Draft Order cited the instructive real-world example when Island ECN stopped displaying its order book and promptly lost 50% of its market share.²⁹⁰ The Evans Report concedes that "a viable trading venue must make some of its market data available,"²⁹¹ but nevertheless asserts that this competitive force does not affect the terms on which an exchange must make data available to its customers. An exchange competing to attract customers is unlikely to be as sanguine about the effects of an attempt to charge these customers unreasonably high fees for its data.²⁹²

²⁸⁹ See Thomson Reuters Letter at 3 ("Given the competitive market for order flow and trade execution, we agree that 'an exchange generally will have strong competitive reasons to price its depth-of-book order data so that it will be distributed widely to those most likely to use it to trade.'") (quoting Draft Order).

²⁹⁰ 73 FR at 32764.

²⁹¹ Evans Report at 19. Evans II also states that it "does not assume that no relationship whatsoever exists between the pricing of depth-of-book data and the volume of order flow." Evans II at 11, n. 28. For the reasons discussed in this Order, the Commission agrees that there is such a relationship. The Evans analysis appears to disagree primarily about the strength of that relationship and the extent to which it significantly constrains the exchanges in pricing their depth-of-book data.

²⁹² See Ordoover/Bamberger Statement at 9 ("large shifts in trading volume indicate that traders can, and do, quickly move their orders from one exchange to another").

Second, as noted in the Draft Order,²⁹³ the exchange must market its data products to many of the same customers to which it must appeal for order flow. This integral connection between order flow and data competition is strikingly highlighted by the language of the Evans Report itself: “[A]n exchange with substantial liquidity maintains significant leverage over the consumers of its depth-of-book data. That dynamic – significant leverage over market data customers and little or no leverage over providers and takers of liquidity – results in prices for market data that reflect significant market power and prices for order flow that reflect competitive conditions.”²⁹⁴ This is a purely theoretical distinction between customers that does not exist in the real world in which exchanges must compete. Exchanges must grapple with the competitive pressures of marketing their data services to many of the same customers to whom they are marketing their transaction services.

b. Substitutes for Depth-of-Book Data

The two economic assessments conclude that none of the alternatives for an exchange’s depth-of-book data noted in the Draft Order – core data, depth-of-book data from other trading centers, pinging for liquidity, and the threat of independent distribution of non-core data by broker-dealers – significantly constrain the pricing of the exchange’s depth-of-book data. The Evans Report, for example, focuses on the unique nature of a particular exchange’s data and asks whether there are any substitutes that replicate the exchange’s “unique” data.²⁹⁵ This focus is too narrow, however, and fails

²⁹³ 73 FR at 32764.

²⁹⁴ Evans Report at 17-18.

²⁹⁵ Evans Report at 6-7. Evans II repeats this analysis. Evans II at 6. The relevant issue, however, is not whether the content of one exchange’s data is a perfect

capture the bigger picture of what traders need when they assess liquidity in a stock and of where an exchange's depth-of-book data fits into this picture.²⁹⁶

The starting point in assessing the value of liquidity information is to recognize that price matters a great deal to traders. The more aggressive the price of a bid or offer at a particular size, the more valuable the information is to traders. Conversely, the less aggressive the price of a bid or offer, the less valuable the information is to traders. An exchange's depth-of-book data reflects displayed liquidity at prices inferior to the quoted NBBO. The value of the exchange's depth-of-book data therefore does not include: (1) undisplayed liquidity at prices better than the NBBO (available at exchanges, ECNs, non-exchange liquidity pools, and OTC market makers), which can be accessed by pinging orders and can be tracked (and thereby usefully predicted) by comparing an exchange's trade reports with its best quotes, both of which are found in core data; (2) displayed liquidity at the NBBO, which is provided by the best quotes in core data; (3) undisplayed

substitute for another exchange's data. The issue is whether, given all of the available sources of information for assessing liquidity and trading in today's highly automated and competitive market structure (which includes both quoting markets and many dark pools), an exchange's depth-of-book data is so critically important that the exchange is not significantly constrained by competitive forces in pricing that data. For the reasons discussed in this Order, the Commission finds that NYSE Arca was significantly constrained by competitive forces when it priced its depth-of-book data at approximately \$1.50 per trading day for market professionals.

²⁹⁶ See Ordoover/Bamberger Statement at 7 ("[T]he amount of available liquidity in depth-of-book data at prices different from the current [NBBO] is only a fraction of the liquidity that would be available at any particular price if the market-clearing price changed. For this reason, the percentage of trading in one or more stocks accounted for by any particular exchange overstates the relative importance of depth-of-book market data from that exchange for identifying liquidity that would be available at prices other than the current NBBO.").

liquidity at the NBBO, which, as with undisplayed liquidity inside the NBBO, can be accessed by pinging orders and usefully predicted with core data.

The reason why these alternative sources of liquidity information are so valuable is that traders in today's markets almost always prefer to trade at the current NBBO or better, rather than accepting the inferior prices reflected in an exchange's depth-of-book data. Because traders naturally prefer to trade at these better prices, an overwhelming majority of trades on an exchange are executed at prices superior to the prices available in the exchange's depth-of-book data. For example, the exchanges' public reports on order execution quality under Rule 605 show that the following percentages of executed share volume of marketable orders were at prices equal to or better than the NBBO in May 2008: Nasdaq – 97%, NYSE Arca – 92%, and NYSE – 90%.²⁹⁷ Notably, these percentages remain steady even as order sizes increase from 100 shares to 9999 shares. Stated another way, more than 90% of the time, traders do not access the liquidity displayed in an exchange's depth-of-book order data, even for large orders.

Given the inferiority of depth-of-book prices, the competitive constraints faced by an exchange in marketing its depth-of-book data to professional traders becomes more understandable. The data is useful primarily as background information on liquidity outside the best prices, but professional traders are able to use core data and pinging orders to assess liquidity and trade effectively at better prices. Moreover, an exchange that attempted to charge unreasonably high fees for its depth-of-book data also would have to consider the actions that many data users might take to avoid paying the

²⁹⁷ Source: Rule 605 reports for May 2008 of NYSE and NYSE Arca (available at www.nyse.com) and Nasdaq (available at www.nasdaqtrader.com). Rule 605 reports cover orders with sizes up to 9999 shares. The average trade size for U.S.-listed stocks currently is less than 300 shares.

exchange's high fees. One potential alternative would be for firms to "piggyback" on the services of another firm that had purchased the data, rather than paying the data fee themselves. For example, buy-side institutions could use the algorithmic order routing services of a broker that had purchased an exchange's depth-of-book data, rather than buying the exchange's data and routing orders themselves. The availability of such alternatives increases the elasticity of demand for an exchange's depth-of-book data.

The information preferences of securities professionals are strongly evidenced by the data they currently choose to purchase. As noted in the Draft Order, Nasdaq offers its depth-of-book data product for all U.S.-listed stocks for \$76 per month, or approximately \$3.50 per trading day. Of the 420,000 professional users who purchase core data in Nasdaq-listed stocks, only 19,000 professional users purchase Nasdaq's depth-of-book data product. The Evans Report attempts to dismiss this fact by claiming that Nasdaq is a "monopolist" that has "set prices above competitive levels so that only those that value its product highly will purchase the product."²⁹⁸ Yet Nasdaq has priced its depth-of-book product at a level that is not much more than the price of a cup of coffee per trading day. Nasdaq's pricing decision is much more consistent with the view that Nasdaq faces

²⁹⁸ Evans Report at 8 n. 24. The Evans Report also incorrectly cites revenue figures from Nasdaq's 2007 Form 10-K for the proposition that Nasdaq "was able to extract more than 50% of its 2007 market data revenue from its sale of unconsolidated data." *Id.* at 17. This analysis overlooks that Nasdaq separately reports its consolidated data revenues from non-Nasdaq-listed stocks (known as Network A and Network B stocks) under a heading called "Execution and trade reporting revenues." Nasdaq did not disclose the specific amount of its consolidated data revenues from Network A and Network B stocks in 2007, but they were substantial. For example, the total core data revenues allocated to SROs in 2004 were \$155 million for Network A stocks and \$100 million in Network B stocks (Regulation NMS Release, 70 FR at 37558). As shown in Table 1 above, Nasdaq currently has a 23.9% share of trading in Network A stocks, and its share of trading in Network B stocks is higher.

significant competitive pressures in attempting to market its depth-of-book data product to the approximately 400,000 securities professionals that currently purchase only core data, than the Evans Report view that Nasdaq is a monopolist coercing the 19,000 securities professionals who are willing to pay \$3.50 for Nasdaq's "unique" data.²⁹⁹

In sum, depth-of-book data is most accurately characterized as useful, but not essential, for professional traders. NYSE Arca has priced the ArcaBook data for all U.S.-listed stocks at approximately \$1.50 per trading day for professional users. The Commission believes that this pricing decision cannot reasonably be interpreted as that of a monopolist able to take advantage of its market power over a small group of professionals who value the data highly, but rather that of an exchange facing significant competitive pressures in attempting to sell its data to a large number of professionals.

The Draft Order also noted the opportunity for new entrants to the market for non-core data, specifically noting a comparable initiative in Europe by a number of major securities firms.³⁰⁰ The Evans Report asserts a myriad of theoretical obstacles to

²⁹⁹ Nasdaq has priced its depth-of-book data for NYSE-listed stocks at \$6 per month, or approximately 27 cents per trading day. The SLCG uses this exceptionally low fee as a basis to assert that Nasdaq's \$3.50 fee for Nasdaq-listed stocks is "1,100 higher" and evidence of pricing power for Nasdaq-listed stocks. SLCG Study at 31. Yet Nasdaq's share of trading in NYSE-listed stocks is a very substantial 23%. Rather than directly reflecting the value of the data, Nasdaq's extremely low fee for NYSE-listed stocks more likely evidences Nasdaq's intense efforts to compete for order flow in NYSE-listed stocks.

³⁰⁰ 73 FR at 32765. SIFMA X repeatedly claims that the proposed NYSE Arca fees are "excessive," yet also notes that the London Stock Exchange fee for depth-of-book data is £157.5 per month for non-members. SIFMA X at 9. This fee is many times higher than the proposed NYSE Arca fees that would total \$30 per month for both members and non-members (based on a pound/dollar conversion ratio of 1.502 on November 25, 2008, the London Stock Exchange fee converts to \$236.74 per month). Indeed, the London Stock Exchange fee is much higher than the fee for any exchange depth-of-book data product in the U.S., despite the much greater trading volume and market capitalization of U.S.-listed stocks. The lower

securities firms sponsoring a non-core data initiative in the U.S.³⁰¹ As noted above, however, securities firms already have sponsored new equity trading entrants in the U.S., and DOJ – one of the U.S. antitrust authorities – cited the existence of these new entrants as support for its finding that the equity exchange markets are competitive.³⁰² If securities firms truly believe that exchanges are attempting to charge unreasonably high prices for their depth-of-book data, participating in an initiative to offer a competing source of data is a live option. Indeed, Thomson Reuters noted in its comment on the Draft Order that the ability of broker-dealers to distribute their own data “is an undeveloped but important potential source of market data” and that it is “prepared to work with the broker-dealer community to explore opportunities in the area.”³⁰³

data fees charged by U.S. exchanges is yet one more fact evidencing the significant competitive forces faced by U.S. exchanges in setting fees for their depth-of-book data products.

³⁰¹ Evans Study at 10-12. SIFMA asserted that the European example is not applicable in the U.S. because European firms are not required to give their data to exchanges for free. SIFMA IX at 21 n. 69. As discussed in the Draft Order (73 FR at 32766), however, U.S. firms are not required to provide the great majority of their orders to any exchange and, for the balance, have a choice among exchanges and FINRA. Moreover, if U.S. firms provided their non-core data without charge to a new data enterprise, it is not clear why the new enterprise would operate at a competitive disadvantage to the exchanges in distributing an alternative data product.

³⁰² See note 274 above and accompanying text.

³⁰³ Thomson Reuters Letter at 3. SIFMA X asserts that broker-dealers would be unable to create a competitive depth-of-book data product in the U.S. because, it claims, they are required to provide their data to the exchanges. SIFMA X at 9. As discussed above (text accompanying notes 236-240), the great majority of a broker-dealer’s orders need not be provided to any SRO (whether an exchange or FINRA), and the small subset of a broker-dealer’s displayable customer orders that must be provided to an SRO can be provided to FINRA, rather than an exchange.

Finally, with respect to retail investors, the SLCG Study asserts that almost 40% of their orders are for sizes greater than the displayed size at the NBBO when presented.³⁰⁴ It then presumes, without discussion, that these orders are executed at prices inferior to the NBBO and that retail investors need depth-of-book data to “see the price they are likely to receive for almost 40% of their orders.”³⁰⁵ This analysis evidences a profound misunderstanding of how retail orders are handled in today’s equity markets. In particular, the SLCG Study fails to consider the very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers. This undisplayed liquidity enables retail investors to receive executions for most of their orders at prices equal to or better than the NBBO, regardless of the displayed size at the NBBO.³⁰⁶

For example, Schwab’s public disclosures concerning its order routing practices and order execution quality provide an instructive picture of how a broker-dealer with a substantial number of retail customers handles their orders in today’s equity markets.³⁰⁷ Schwab’s Rule 606 report on order routing for the quarter ending June 30, 2008 reveals that 93% of its customer orders in U.S.-listed equities were “non-directed” – that is, the customer relied on Schwab to determine where to route the order. Schwab routed 94% of these customer orders to non-exchange trading venues, rendering it unlikely that either Schwab or its customers relied on any exchange’s depth-of-book data in making the

³⁰⁴ SLCG Study at 20-21.

³⁰⁵ SLCG Study at 21.

³⁰⁶ 73 FR at 32770.

³⁰⁷ Schwab’s disclosures are available at www.schwab.com.

routing determination for these orders.³⁰⁸ In addition, Schwab represents that 57.2% of shares in listed stocks and 61.3% of shares in Nasdaq stocks receive price improvement (an execution price better than the NBBO), and that the ratio of effective spreads to quoted spreads for customer orders is 96.5% in listed stocks and 94.7% in Nasdaq stocks (that is, customers receive prices on average that are better than the NBBO). In sum, undisplayed liquidity at non-exchange trading centers enabled Schwab customers to receive executions for their orders at much superior prices than would be indicated by any exchange's depth-of-book data. The inferior prices reflected in such data would provide a very poor basis indeed to assess whether these retail orders received best execution.

c. Efficacy of Regulatory Alternatives

A third weakness in the SLCG Study and the Evans Report is their failure to acknowledge the extent to which the current Exchange Act regulatory structure effectively promotes competition among the U.S. equity markets. They nevertheless suggest regulatory approaches that would be extraordinarily costly and difficult to implement and that would offer little chance of achieving a more efficient outcome than the market-based approach set forth in the Draft Order.

For example, both the SLCG Study and the Evans Report assert that the market shares of NYSE and NYSE Arca should be combined for purposes of analyzing market power over depth-of-book data, even though they are separately registered as national securities exchanges and operate separate liquidity pools with separate data products and

³⁰⁸ See Nasdaq III at 4 ("Rule 606 data from the second quarter of 2008 shows that a sample of major broker-dealers routed just 15% of retail orders in NASDAQ-listed stocks to an exchange.").

fees. The two economic assessments note that, because NYSE and NYSE Arca are under common control, they will have an incentive to coordinate their pricing and not compete with one another.

Exchanges under common control clearly have incentives to avoid competing with each other. Each national securities exchange, however, is subject to a comprehensive regulatory structure that is designed to address anti-competitive practices. This regulatory structure limits the potential for related exchanges to act jointly in ways that would inappropriately inhibit competition by other exchanges and trading centers with each related exchange. Section 6 of the Exchange Act requires that the rules of a national securities exchange be designed to promote a free and open market. Moreover, it prohibits a national securities exchange from adopting rules that are designed to permit unfair discrimination among its customers or that would impose an unnecessary or inappropriate burden on competition. All of these requirements are applied at the level of the individual registered securities exchange, not at the group level of exchanges that are under common control. In particular, a proposed exchange rule must stand or fall based, among other things, on the interests of customers, issuers, broker-dealers, and other persons using the facilities of that exchange. In sum, an economic analysis of jointly-controlled corporate behavior that might apply to other less regulated industries is inapplicable to equity exchanges that are subject to the pro-competitive Exchange Act regulatory structure.

For example, Section 6 and Exchange Act Rule 603(a) require NYSE Arca to distribute the ArcaBook data on terms that are not tied to other products in a way that is unfairly discriminatory or anticompetitive. Apparently unaware of these regulatory

requirements, the SLCG Study claims that the Commission “does not consider the prospect of the NYSE exercising monopoly pricing power through tying arrangements” and notes that “the NYSE has the clear incentive to force users of a product in which an exchange has monopoly pricing power to also pay for a product in which the exchange does not have monopoly pricing power.”³⁰⁹ The SLCG concerns may be applicable to firms that operate in unregulated markets, but are inapplicable to U.S. equity exchanges.

The effect of the U.S. regulatory structure is apparent when examining the respective fees for ArcaBook data and NYSE OpenBook data for NYSE-listed stocks. The Evans Report asserts that these products should not be considered as alternatives for one another, but does not address why this conclusion is valid from the standpoint of individual users of data when their use of the two products is not tied in any way.

Customers are free to purchase both, either, or neither. Each product must stand or fall on its own merits. The Evans Report asserts that the revenues of both products will be retained by the same corporate entity, yet this point is irrelevant from the standpoint of customers who might be looking for data alternatives. Indeed, if customers decide that ArcaBook is a better bargain than OpenBook, a shift between the two products would lead to a \$45 per month per customer reduction in revenues for NYSE Euronext. If customers believe that ArcaBook data is overpriced at \$15, they can purchase OpenBook alone and NYSE Euronext will have foregone an opportunity to earn greater revenues by setting a lower fee for ArcaBook data.

Although the SLCG Study and Evans Report fail to acknowledge the pro-competitive aspects of the Exchange Act regulatory structure, they nevertheless suggest

³⁰⁹ SLCG Study at 32.

alternative regulatory approaches that would be extraordinarily intrusive on competitive forces, as well as quite costly and difficult to apply in practice. For example, the Evans Report criticizes the Draft Order for not addressing whether an exchange could profitably increase the price of its depth-of-book data by 5-10 percent above a “competitive” level,³¹⁰ but offers no practical guidance for determining this hypothetical competitive level. Elsewhere, its author has noted that “it seems obvious that the ability of competition authorities and courts (or indeed of any economist) to distinguish between efficient (fair) and inefficient (unfair) prices in practice is very low.”³¹¹

For its part, the SLCG Study notes that “obtaining accurate and precise data on the marginal costs of producing a particular good or service (e.g., securities market data) is extremely difficult,” but nevertheless asserts that “there are reasonable alternatives for assessing levels and trends of marginal costs.”³¹² This statement ignores a whole host of difficulties in calculating the direct costs and common costs of market data – an endeavor that the Commission discussed at length in 1999 and will not repeat here.³¹³ Moreover,

³¹⁰ Evans Report at 4.

³¹¹ David S. Evans & A. Jorge Padilla, “Excessive Prices: Using Economics to Define Administrable Legal Rules, 1 *J. Competition L. & Econ.* 97, 118 (March 2005) (“Evans Article”); see also *id.* at 99 (“no pricing rule or benchmark can be used to distinguish effectively (i.e., without error) between competitive and excessive prices in practice”).

³¹² SLCG Study at 26. SIFMA X asserts that there are numerous choices for reviewing market data fees other than a strict cost-based analysis, but then outlines an approach that would require specialized teams of staff members and administrative hearings to adjudicate an unspecified “relationship” of a proposed fee to exchange costs. SIFMA X at 11.

³¹³ Market Data Release, 64 FR at 70627-70630. See Ordoover/Bamberger Statement at 3 n. 4 (“It is widely accepted that there is no meaningful way to allocate ‘common costs’ across different joint products. For this reason, ‘cost-based’

the SLCG Study assumes, without discussion, that marginal costs would be the efficiency-enhancing standard to assess fees for depth-of-book data. Elsewhere, however, the author of the Evans Report has noted that in “dynamic industries, where typically fixed costs are high and incremental costs are low, the ‘competitive’ price is not given by marginal costs” and that “it is impossible to define ‘competitive’ prices using only information costs.”³¹⁴ The exchange industry is highly dynamic, and exchanges are dependent on their ability to deploy cutting edge technologies. Moreover, the marginal costs of expanding the capacity of trading systems are extraordinarily low – for the most part, a trading center need only add servers and communications lines to its existing hardware and software systems.³¹⁵

In fulfilling its Exchange Act regulatory responsibilities, the Commission is faced with the pragmatic challenge of determining whether non-core market data fees are fair and reasonable. It strongly believes that the current level of competition in the U.S. equity markets provides a much more useful basis to make this determination than a regulatory attempt to measure market data costs. Although the market for distributing

regulation of the price of market data would require inherently arbitrary cost allocations.”).

³¹⁴ Evans Article at 101; see also id. at 99 (“Unfortunately, it is unclear what the appropriate competitive benchmark is in most real-life circumstances and, particularly, in dynamic industries where investment and innovation play a paramount role. Moreover, even if an appropriate benchmark could be defined, it would still remain unclear how one could, on the basis of the information typically available to policy makers and industry analysts, determine with precision whether prices are above, at, or below the competitive benchmark in practice.”).

³¹⁵ See Nasdaq III at 4 (“The business of operating a market is typified by low marginal cost for additional volume and markets operating with significant excess capacity”).

depth-of-book data may not meet all of the conditions for theoretically perfect competition, there clearly are significant competitive forces operating in the real world that constrain the exchanges in setting the terms for their data. The Commission therefore has concluded that the market-based approach outlined in the Draft Order is the most appropriate means to meet its regulatory mandate when reviewing non-core data fees.

C. Review of Terms of the Proposal

As discussed in the preceding section, NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal. The Commission therefore will approve the Proposal in the absence of a substantial countervailing basis to find that its terms nevertheless fail to meet an applicable requirement of the Exchange Act or the rules thereunder.³¹⁶ An analysis of the Proposal and of the views of commenters does not provide such a basis.

First, the proposed fees for ArcaBook data will apply equally to all professional subscribers and equally to all non-professional subscribers (subject only to the maximum monthly payment for device fees paid by any broker-dealer for non-professional subscribers). The fees therefore do not unreasonably discriminate among types of subscribers, such as by favoring participants in the NYSE Arca market or penalizing participants in other markets.

Second, the proposed fees for the ArcaBook data are substantially less than those charged by other exchanges for depth-of-book order data. For example, the NYSE charges a \$60 per month terminal fee for depth-of-book order data in NYSE-listed stocks.

³¹⁶ The Exchange Act requirements are addressed in the text accompanying notes 171-175 above.

Similarly, Nasdaq charges a \$76 per month device fee for professional subscribers to depth-of-book order data on all NMS stocks. By comparison, the NYSE Arca fee is 75% less than the NYSE fee for data in NYSE-listed stocks, and more than 60% less than the Nasdaq fee for data in all NMS stocks. It is reasonable to conclude that competitive pressures led NYSE Arca to set a substantially lower fee for its depth-of-book order data than the fees charged by other markets. If, in contrast, NYSE Arca were a monopoly data provider impervious to competitive pressures, there would be little reason for it to set significantly lower fees than other exchanges.³¹⁷

Third, NYSE Arca projects that the total revenues generated by the fee for ArcaBook data initially will amount to less than \$8 million per year,³¹⁸ and that its market data revenue as a percentage of total revenue is likely to remain close to the 2005 figure, which was approximately 17%.³¹⁹ Viewed in the context of NYSE Arca's overall

³¹⁷ See Table 1, note 210 above and accompanying text.

³¹⁸ NYSE Arca Response III at 12 n. 28. The reasonableness of this projection is supported by referring to the number of data users that have subscribed to Nasdaq's proprietary depth-of-book product for Nasdaq-listed stocks. Nasdaq reports 19,000 professional users and 12,000 non-professional users as of April 30, 2007. Nasdaq Letter at 6. If the same number of users purchased ArcaBook data for all stocks, the total revenue for NYSE Arca would be \$8,280,000 per year. As noted in Table 1, NYSE Arca has a smaller market share than Nasdaq and therefore may not attract as many subscribers to its depth-of-book product. On the other hand, NYSE Arca is charging substantially less for its data and may attract more users. In the final analysis, market forces will determine the actual revenues generated by NYSE Arca's pricing decision.

³¹⁹ NYSE Arca Response III at 12 nn. 28-29. One commenter noted that the market data revenues of the NYSE Group, which includes both NYSE and NYSE Arca, had grown by 33.7% from the third quarter of 2005 to the third quarter of 2006. See section III.A.6 above. Although correct, this figure does not demonstrate any growth in market data revenues because the 2005 figure only included the market data revenues of NYSE, while the 2006 figure included the market data revenues of both the NYSE and NYSE Arca. Using an "apples-to-apples" comparison that

funding, therefore, the fees for ArcaBook data are projected to represent a small portion of NYSE Arca's market data revenues and an even smaller portion of NYSE Arca's total revenues (using NYSE Arca's \$8 million estimate, the fees will amount to less than 12.9% of NYSE Arca's 2005 market data revenues and less than 1.6% of NYSE Arca's 2005 total revenues). In addition, NYSE Arca generated approximately \$415.4 million in revenue from equity securities transaction fees in 2005.³²⁰ These transaction fees are paid by those who voluntarily choose to submit orders to NYSE Arca for execution. The fees therefore are subject to intense competitive pressure because of NYSE Arca's need to attract order flow. In comparison, the \$8 million in projected annual fees for ArcaBook data do not appear to be inequitable, unfair, or unreasonable.

One commenter, although agreeing that exchange transaction fees are subject to intense competitive pressure, asserted that such "intermarket competition does not constrain the exchanges' pricing of market data, but it actually creates an incentive for the exchanges to increase their prices for data."³²¹ If, however, NYSE Arca were truly able to exercise monopoly power in pricing its non-core data, it likely would not choose a fee that generates only a small fraction of the transaction fees that admittedly are subject to fierce competitive forces. As discussed above, NYSE Arca was indeed subject to significant competitive forces in pricing the ArcaBook data.

includes both exchanges for both time periods, their combined market data revenues declined slightly from 2005 to 2006. NYSE Arca Response III at 20.

³²⁰ NYSE Group, Inc., Form 10-K for period ending December 31, 2005 (filed March 31, 2006), at 19.

³²¹ SIFMA V at 14-15.

Several commenters expressed concern that the Proposal would adversely affect market transparency.³²² They noted that NYSE Arca previously had distributed the ArcaBook data without charge and asserted that the new fees could substantially limit the availability of the data. The Petition, for example, stated that “the cumulative impact of [the Proposal] and other pending and recently approved market data proposals threaten to place critical data, which should be available to the general public, altogether beyond the reach of the average retail investor.”³²³

Assuring the wide availability of quotation and trade information is a primary objective of the national market system.³²⁴ With respect to non-professional users, and particularly individual retail investors, the Commission long has sought to assure that retail investors have ready access to the data they need to participate effectively in the equity markets. Indeed, the Commission’s 1999 review of market information was prompted by a concern that retail investors should have ready access to affordable market data through their on-line accounts with broker-dealers. The Concept Release on Market Information noted that, in the course of the 1999 review, the Networks had reduced by up to 80% the fees for non-professional subscribers to obtain core data with the best-priced quotations and most recent last sale prices.³²⁵ It also emphasized the importance of such affordable data for retail investors:

³²² Financial Services Roundtable Letter at 3; Schwab Letter at 5.

³²³ Petition at 3.

³²⁴ Section 11A(a)(1)(C)(iii) of the Exchange Act.

³²⁵ Market Information Concept Release, 64 FR at 70614. Since 1999, the Network data fees applicable to retail investors have either remained the same or been further reduced. Currently, nonprofessional investors can obtain unlimited

One of the most important functions that the Commission can perform for retail investors is to ensure that they have access to the information they need to protect and further their own interests. Communications technology now has progressed to the point that broad access to real-time market information should be an affordable option for most retail investors, as it long has been for professional investors. This information could greatly expand the ability of retail investors to monitor and control their own securities transactions, including the quality of execution of their transactions by broker-dealers. The Commission intends to assure that market information fees applicable to retail investors do not restrict their access to market information, in terms of both number of subscribers and quality of service. In addition, such fees must not be unreasonably discriminatory when compared with the fees charged to professional users of market information.³²⁶

The Commission appreciates the efforts of the Petitioner and other commenters in advocating the particular needs of users of advertiser-supported Internet Web sites, a great many of whom are likely to be individual retail investors. The Commission believes that the exchanges and other entities that distribute securities market information will find business-justified ways to attend to the needs of individual investors and, as markets evolve, develop innovative products that meet the needs of these users and are affordable in light of the users' economic circumstances. In this respect, it recognizes the exchange initiatives to distribute new types of data products specifically designed to meet the needs of Internet users for reference data on equity prices.³²⁷

The Commission does not believe, however, that the Proposal will significantly detract from transparency in the equity markets. Of course, any increase in fees can lower the marginal demand for a product. To assess an effect on transparency, however,

amounts of core data for no more than \$1 per month each for Network A, B, and C stocks. See SIFMA III, Appendix A.

³²⁶ Market Information Concept Release, 64 FR at 70614.

³²⁷ See note 19 above (NYSE Real-Time Reference Prices and Nasdaq Last Sale Data Feeds).

the relevant question is whether the fees for a particular product deter a significant number of market participants from obtaining the market data they need because the fees are not affordable given their economic circumstances.³²⁸ Market transparency does not require that the same products be made available to all users on the same terms and conditions. Such a one-size-fits-all approach would ignore the important differences among data users in terms of both their needs and their economic circumstances. Most importantly, such an approach would fail to address the particular needs of individual retail investors.

With respect to professional data users (i.e., those who earn their living through the markets), the Commission believes that competitive forces, combined with the heightened ability of professional users to advance their own interests, will produce an appropriate level of availability of non-core data. With respect to non-professional users, as well, the Commission believes that the ArcaBook fees will not materially affect their access to the information they need to participate effectively in the equity markets.³²⁹ The ArcaBook data likely is both too narrow and too broad to meet the needs of most retail investors. It likely is too narrow for most retail investors when they make their trading and order-routing decisions. The best prices quoted for a stock in the ArcaBook

³²⁸ See Market Information Concept Release, 64 FR at 70630 (“[T]he relevant Exchange Act question is whether the fees for particular classes of subscribers, given their economic circumstances and their need for and use of real-time information, are at a sufficiently high level that a significant number of users are deterred from obtaining the information or that the quality of their information services is reduced.”)

³²⁹ See NYSE Arca Response III at 18 (“The overwhelming majority of retail investors are unaffected by the inter-market competition over proprietary depth-of-book products. For them, the consolidated top-of-book data that the markets make available under the NMS Plans provides adequate information on which they can base trading decisions.”).

data reflect only the NYSE Arca market. Other markets may be offering substantially better prices. It is for this reason that Rule 603(c) of Regulation NMS requires broker-dealers and vendors to provide their customers with a consolidated display of core data in the context of trading and order-routing decisions. A consolidated display includes the national best bid and offer for a stock, as well as the most recent last sale for such stock reported at any market. This consolidated display thereby gives retail investors a valuable tool for ascertaining the best prices for a stock.

Two commenters stated that the average retail order is 1000 or more shares and is larger than the size typically reflected in the consolidated quotation in core data.³³⁰ This issue was raised, however, when the Commission was formulating its approach to non-core data in 2005. It noted that the average execution price for small market orders (the order type typically used by retail investors) is very close to, if not better than, the NBBO.³³¹ In addition, a study by the Commission's Office of Economic Analysis of quoting in 2003 in 3,429 Nasdaq stocks found that the average displayed depth of quotations at the NBBO was 1,833 shares -- greater than the size of the average order cited by commenters.³³²

Some commenters suggested that the core data provided by the Networks disadvantaged retail investors because it was not distributed as fast as the depth-of-book

³³⁰ Schwab Letter at 1-2; SIFMA IV at 14.

³³¹ Regulation NMS Release, 70 FR at 37567. Most retail investors receive order executions at prices equal to or better than the NBBO that is disseminated in core data. See also Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS, 70 FR 37636 (estimating that between 98% and 99% of all trades did not trade through better-priced bids or offers).

³³² 70 FR at 37511 n. 108.

order data obtained directly from an exchange.³³³ The central processors of core data must first obtain data from each SRO and then consolidate it into a single data feed for distribution to the public. While exchanges are prohibited from providing their data to direct recipients any sooner than they provide it to the Network central processor,³³⁴ the additional step of transmitting data to the central processor inevitably means that a direct data feed can be distributed faster to users than the Network data feed. The size of this time latency, however, is extremely small in absolute terms. For example, a technology upgrade by the central processor for Network A and Network B has reduced the latency of the core data feed to approximately 3/100ths of a second.³³⁵ The Commission does not believe that such a small latency under current market conditions disadvantages retail investors in their use of core data, but rather would be most likely relevant only to the most sophisticated and active professional traders with state-of-the-art systems.

Moreover, outside of trading contexts, the ArcaBook data will be far broader than individual investors typically need. The ArcaBook data encompasses all quotations for a stock at many prices that are well away from the current best prices. For retail investors that are not trading but simply need a useful reference price to track the value of their

³³³ Schwab Letter at 4; SIFMA III at 6 n. 11.

³³⁴ Regulation NMS Release, 70 FR at 37567.

³³⁵ NYSE Arca Response III at 21. The upgrade was completed in April 2007. See Securities Industry Automation Corporation, Notice to CTA Recipients, "Reminder Notice – CQS Unix Activation – New Source IP Addresses" (April 27, 2007) (available at www.nysedata.com). This major upgrade of the CTA data feed runs contrary to the concern of one commenter on the Draft Order that exchanges would have little incentive to maintain the quality of core data. NSX II at 5-6.

portfolio and monitor the market, the enormous volume of data regarding trading interest outside the best prices is not needed.³³⁶

Some commenters asserted that the Proposal failed to satisfy the requirements of Exchange Act Rule 19b-4 and Form 19b-4.³³⁷ Form 19b-4 requires, among other things, that SROs provide a statement of the purpose of the proposed rule change and its basis under the Exchange Act. The statement must be sufficiently detailed and specific to support a finding that the proposed rule change meets the requirements of the Exchange Act, including that the proposed rule change does not unduly burden competition or efficiency, does not conflict with the securities laws, and is not inconsistent with the public interest or the protection of investors. The NYSE Arca Proposal met these requirements. Among other things, the Proposal noted that the proposed fees compared favorably to the fees that other competing markets charge for similar products, including those of other exchanges that previously had been approved by the Commission.³³⁸

One commenter argued that NYSE Arca should have addressed a number of specific points that it raised in opposition to the Proposal, such as including a statement

³³⁶ See NYSE Arca Response II at 2 (“during the first ten months of 2005 the number of messages processed by the Exchanged greatly increased from approximately 9,800 MPS [messages per second] to 14,100 MPS”).

³³⁷ See section III.A.3 above. In their comments on the Draft Order, commenters claimed that it in effect would amend Rule 19b-4 without following required agency rulemaking procedures. NetCoalition V at 7; SIFMA IX at 20. Rule 19b-4, however, merely sets forth requirements for SROs to follow in preparing their proposed rule changes. It does not address the substantive nature of Commission review of proposed rule changes, which necessarily will vary widely depending on the particular issues raised by the SRO proposal.

³³⁸ See Proposal, 71 FR at 33499.

of costs to produce the ArcaBook data.³³⁹ The purpose of Form 19b-4, however, is to elicit information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether the proposed rule change is consistent with the requirements of the Exchange Act and the rules thereunder.³⁴⁰ The Proposal met these objectives. Although Form 19b-4 requires that a proposed rule change be accurate, consistent, and complete, including the information necessary for the Commission's review, the Form does not require SROs to anticipate and respond in advance to each of the points that commenters may raise in opposition to a proposed rule change. With this Order, the Commission has determined that the points raised by the commenter do not provide a basis to decline to approve the Proposal.

Finally, commenters raised concerns regarding the contract terms that will govern the distribution of ArcaBook data.³⁴¹ In particular, one notes that NYSE Arca has not filed its vendor distribution agreement with the Commission for public notice and comment and Commission approval.³⁴²

NYSE Arca has stated, however, that it plans to use the vendor and subscriber agreements used by CTA and CQ Plan Participants (the "CTA/CQ Vendor and Subscriber Agreements") to govern the distribution of NYSE Arca Data. According to

³³⁹ SIFMA III at 11-12.

³⁴⁰ Section B of the General Instructions for Form 19b-4.

³⁴¹ See section III.A.7 above.

³⁴² SIFMA I at 7. In this regard, the commenter states that, procedurally, the Exchange "is amending and adding to the CTA vendor agreement without first submitting its contractual changes through the CTA's processes, which are subject to industry input through the new Advisory Committee mandated by Regulation NMS." SIFMA I at 8.

the Exchange, the CTA/CQ Vendor and Subscriber Agreements “are drafted as generic one-size-fits all agreements and explicitly apply to the receipt and use of certain market data that individual exchanges make available in the same way that they apply to data made available under the CTA and CQ Plans,” and the contracts need not be amended to cause them to govern the receipt and use of the Exchange’s data.³⁴³ The Exchange maintains that because “the terms and conditions of the CTA/CQ contracts do not change in any way with the addition of the Exchange’s market data . . . there are no changes for the industry or Commission to review.”³⁴⁴

The Commission believes that the Exchange may use the CTA/CQ Vendor and Subscriber Agreements to govern the distribution of NYSE Arca Data.³⁴⁵ It notes that the NYSE used the CTA Vendor Agreement to govern the distribution of its OpenBook and Liquidity Quote market data products.³⁴⁶ Moreover, the Exchange represents that, following consultations with vendors and end-users, and in response to client demand:

³⁴³ NYSE Arca Response I at 3.

³⁴⁴ NYSE Arca Response I at 3 (emphasis in original).

³⁴⁵ The Commission is not approving the CTA/CQ Vendor and Subscriber Agreements, which the CTA and CQ Plan Participants filed with the Commission as amendments to the CTA and CQ Plans that were effective on filing with the Commission pursuant to Rule 608(b)(3)(iii) of Regulation NMS (previously designated as Exchange Act Rule 11Aa3-2(c)(3)(iii)). See, e.g., Securities Exchange Act Release No. 28407 (September 6, 1990), 55 FR 37276 (September 10, 1990) (File No. 4-2811) (notice of filing and immediate effectiveness of amendments to the CTA Plan and the CQ Plan). Rule 608(b)(3)(iii) of Regulation NMS (previously designated as Exchange Act Rule 11Aa3-2(c)(3)(iii)) allows a proposed amendment to a national market system plan to be put into effect upon filing with the Commission if the plan sponsors designate the proposed amendment as involving solely technical or ministerial matters.

³⁴⁶ Securities Exchange Act Release Nos. 53585 (March 31, 2006), 71 FR 17934 (April 7, 2006) (order approving File Nos. SR-NYSE-2004-43 and NYSE-2005-32) (relating to OpenBook); and 51438 (March 28, 2005), 70 FR 17137 (April 4,

[The Exchange] chose to fold itself into an existing contract and administration system rather than to burden clients with another set of market data agreements and another market data reporting system, both of which would require clients to commit additional legal and technical resources to support the Exchange's data products.³⁴⁷

In addition, the Exchange has represented that it is "not imposing restrictions on the use or display of its data beyond those set forth" in the existing CTA/CQ Vendor and Subscriber Agreements.³⁴⁸ The Commission therefore does not believe that the Exchange is amending or adding to such agreements.

A commenter also stated that the Exchange has not recognized the rights of a broker or dealer, established in Regulation NMS, to distribute its order information, subject to the condition that it does so on terms that are fair and reasonable and not unreasonably discriminatory.³⁴⁹ In response, the Exchange states that the CTA/CQ Vendor and Subscriber Agreements do not prohibit a broker-dealer member of an SRO participant in a Plan from making available to the public information relating to the orders and transaction reports that it provides to the SRO participant.³⁵⁰ Accordingly, the Commission believes that the Exchange has acknowledged the rights of a broker or

2005) (order approving File No. SR-NYSE-2004-32) (relating to Liquidity Quote). For the both the OpenBook and Liquidity Quote products, the NYSE attached to the CTA Vendor Agreement an Exhibit C containing additional terms governing the distribution of those products, which the Commission specifically approved. NYSE Arca is not including additional contract terms in the Proposal.

³⁴⁷ NYSE Arca Response I at 4.

³⁴⁸ NYSE Arca Response I at 3.

³⁴⁹ SIFMA I at 7.

³⁵⁰ NYSE Arca Response I at 4.

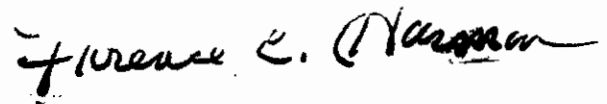
dealer to distribute its market information, subject to the requirements of Rule 603(a) of Regulation NMS.

A commenter also stated that the Exchange has failed to consider the administrative burdens that the proposal would impose, including the need for broker-dealers to develop system controls to track ArcaBook access and usage.³⁵¹ In response, the Exchange represents that it has communicated with its customers to ensure system readiness and is using "a long-standing, well-known, broadly-used administrative system" to minimize the amount of development effort required to meet the administrative requirements associated with the proposal.³⁵² Accordingly, the Commission believes that NYSE Arca has reasonably addressed the administrative requirements associated with the Proposal.

VII. Conclusion

It is therefore ordered that the earlier action taken by delegated authority, Securities Exchange Act Release No. 54597 (October 12, 2006) 71 FR 62029 (October 20, 2006), is set aside and, pursuant to Section 19(b)(2) of the Exchange Act, the Proposal (SR-NYSEArca-2006-21) is approved.

By the Commission.



Florence E. Harmon
Acting Secretary

³⁵¹ SIFMA I at 8.

³⁵² NYSE Arca Response I at 4-5.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59047 / December 3, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2904 / December 3, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11582

In the Matter of Gary L. Seidelman, CPA	:	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT RESPONSIBLE FOR THE PREPARATION OR REVIEW OF FINANCIAL STATEMENTS REQUIRED TO BE FILED WITH THE COMMISSION
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On August 11, 2004, Gary L. Seidelman, CPA ("Seidelman") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Seidelman pursuant to Rule 102(e) of the Commission's Rules of Practice.¹ Seidelman consented to the entry of the order without admitting or denying the findings therein. This order is issued in response to Seidelman's application for reinstatement to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

From the first quarter of 1998 through the first quarter of 2000, certain of Anicom, Inc.'s ("Anicom") officers and employees engaged in improper earnings management techniques that inflated Anicom's revenues by over \$38 million and net income by over \$20 million. During this period, Seidelman served as the engagement partner for PricewaterhouseCoopers LLP's audits and interim reviews of the financial statements of Anicom. The Commission found that Seidelman engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice in connection with PwC's 1999 audit and first quarter 2000 interim review of Anicom's financial statements. The Commission additionally found that Seidelman violated Section 10A(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act") and that Seidelman caused Anicom's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

¹ See Accounting and Auditing Enforcement Release No. 2078 dated August 11, 2004. Seidelman was permitted, pursuant to the order, to apply for reinstatement after three years upon making certain showings.

In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Seidelman attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity. Seidelman is not, at this time, seeking to appear or practice before the Commission as an independent accountant. If he should wish to resume appearing and practicing before the Commission as an independent accountant, he will be required to submit an application to the Commission showing that he has complied and will comply with the terms of the original suspension order in this regard. Therefore, Seidelman's denial of the privilege of appearing or practicing before the Commission as an independent accountant continues in effect until the Commission determines that a sufficient showing has been made in this regard in accordance with the terms of the original suspension order.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."² This "good cause" determination is necessarily highly fact specific.

On the basis of information supplied, representations made, and undertakings agreed to by Seidelman, it appears that he has complied with the terms of the August 11, 2004 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Seidelman, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, has shown good cause for reinstatement. Therefore, it is accordingly,

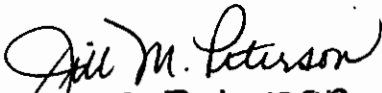
² Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

1
ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Gary L. Seidelman, CPA is hereby reinstated to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 59056/December 4, 2008

ORDER GRANTING REGISTRATION OF EGAN-JONES RATING COMPANY TO
ADD TWO ADDITIONAL CLASSES OF CREDIT RATINGS

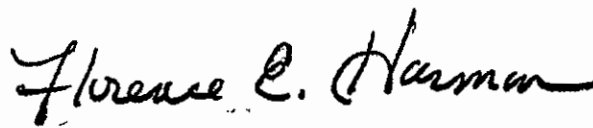
Egan-Jones Rating Company, a nationally recognized statistical rating organization ("NRSRO"), furnished to the Securities and Exchange Commission ("Commission") an application under Section 15E of the Securities Exchange Act of 1934 ("Exchange Act") to register for the two classes of credit ratings described in clauses (iv) and (v) of Section 3(a)(62)(B) of the Exchange Act. The Commission finds that the application furnished by Egan-Jones Rating Company is in the form required by Exchange Act Section 15E, Exchange Act Rule 17g-1 (17 CFR 240.17g-1), and Form NRSRO (17 CFR 249b.300).

Based on the application, the Commission finds that the requirements of Section 15E of the Exchange Act are satisfied.

Accordingly,

IT IS ORDERED, under paragraph (a)(2) of Section 15E of the Exchange Act, that the registration of Egan-Jones Rating Company with the Commission for the classes of credit ratings described in clauses (iv) and (v) of Section 3(a)(62)(B) of the Exchange Act is granted.

By the Commission.



Florence E. Harmon
Acting Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59058 / December 4, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2906 / December 4, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11150

In the Matter of

Kenneth Wilchfort, CPA

:
: ORDER GRANTING APPLICATION FOR
: REINSTATEMENT TO APPEAR AND PRACTICE
: BEFORE THE COMMISSION AS AN ACCOUNTANT
:

On June 4, 2003, Kenneth Wilchfort ("Wilchfort") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Wilchfort pursuant to Rule 102(e) of the Commission's Rules of Practice.¹ Wilchfort consented to the entry of the June 4, 2003 order without admitting or denying the findings therein. This order is issued in response to Wilchfort's application for reinstatement to practice before the Commission as an accountant.

On April 30, 2003, a final judgment was entered by consent against Wilchfort, permanently enjoining him from aiding and abetting violations of Section 13(a) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1 and 13a-13 thereunder. The Commission's complaint alleged that Wilchfort, as the audit engagement partner and Senior Advisory Partner for Ernst & Young LLP's audits of certain financial statements filed by CUC International Inc. ("CUC") and Cendant Corporation ("Cendant"), improperly failed to detect that CUC and Cendant's financial statements were not presented in conformity with generally accepted accounting principles. The Commission further alleged that Wilchfort had a duty to withhold his firm's audit report containing an unqualified opinion and take appropriate steps to prevent these financial statements from being filed with the Commission. By failing to do so, Wilchfort aided and abetted CUC's and Cendant's violations of the reporting provisions of the federal securities laws.

¹ See Accounting and Auditing Enforcement Release No. 1795 dated June 4, 2003. Wilchfort was permitted, pursuant to the order, to apply for reinstatement after four years upon making certain showings.

Wilchfort has met all of the conditions set forth in the original order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to all requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Wilchfort attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."² This "good cause" determination is necessarily highly fact specific.

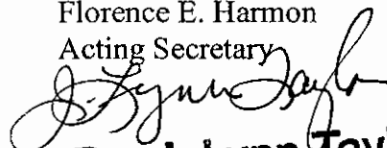
On the basis of the information supplied, representations made, and undertakings agreed to by Wilchfort, it appears that he has complied with the terms of the June 4, 2003 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Wilchfort, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Wilchfort, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Kenneth Wilchfort, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Florence E. Harmon

Acting Secretary



By: J. Lynn Taylor

Assistant Secretary

² Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59057 / December 4, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2905 / December 4, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11149

In the Matter of

Marc Rabinowitz, CPA

:
:
:
: ORDER GRANTING APPLICATION FOR
:
:
: REINSTATEMENT TO APPEAR AND PRACTICE
:
:
: BEFORE THE COMMISSION AS AN ACCOUNTANT
:
:

On June 4, 2003, Marc Rabinowitz ("Rabinowitz") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Rabinowitz pursuant to Rule 102(e) of the Commission's Rules of Practice.¹ Rabinowitz consented to the entry of the June 4, 2003 order without admitting or denying the findings therein. This order is issued in response to Rabinowitz's application for reinstatement to practice before the Commission as an accountant.

On April 30, 2003, a final judgment was entered by consent against Rabinowitz, permanently enjoining him from aiding and abetting violations of Section 13(a) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1 and 13a-13 thereunder. The Commission's complaint alleged that Rabinowitz, as the engagement partner for Ernst & Young's audits of certain financial statements filed by CUC International Inc. ("CUC") and Cendant Corporation ("Cendant"), improperly failed to detect that CUC and Cendant's financial statements were not presented in conformity with generally accepted accounting principles. The Commission further alleged that Rabinowitz had a duty to withhold his firm's audit report containing an unqualified opinion and take appropriate steps to prevent these financial statements from being filed with the Commission. By failing to do so, Rabinowitz aided and abetted CUC's and Cendant's violations of the reporting provisions of the federal securities laws.

¹ See Accounting and Auditing Enforcement Release No. 1794 dated June 4, 2003. Rabinowitz was permitted, pursuant to the order, to apply for reinstatement after four years upon making certain showings.

Rabinowitz has met all of the conditions set forth in the original order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to all requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Rabinowitz attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."² This "good cause" determination is necessarily highly fact specific.

On the basis of the information supplied, representations made, and undertakings agreed to by Rabinowitz, it appears that he has complied with the terms of the June 4, 2003 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Rabinowitz, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Rabinowitz, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Marc Rabinowitz, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Florence E. Harmon

Acting Secretary

By: J. Lynn Taylor
Assistant Secretary

² Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-59062; File No. S7-21-08]

RIN 3235-AK20

Amendment to Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to a rule under the Securities Exchange Act of 1934 ("Exchange Act") relating to municipal securities disclosure. This final rule amends certain requirements regarding the information that the broker, dealer, or municipal securities dealer acting as an underwriter in a primary offering of municipal securities must reasonably determine that an issuer of municipal securities or an obligated person has undertaken, in a written agreement or contract for the benefit of holders of the issuer's municipal securities, to provide. Specifically, the amendments require the broker, dealer, or municipal securities dealer to reasonably determine that the issuer or obligated person has agreed: to provide the information covered by the written agreement to the Municipal Securities Rulemaking Board ("MSRB" or "Board"), instead of to multiple nationally recognized municipal securities information repositories ("NRMSIRs") and state information depositories ("SIDs"); and to provide such information in an electronic format and accompanied by identifying information as prescribed by the MSRB. The Commission's rulemaking is intended to improve the availability of information about municipal securities to investors, market professionals, and the public generally. Concurrently, we have approved a companion proposal by the MSRB relating to its Electronic Municipal Market Access

("EMMA") system for municipal securities disclosures. Finally, we are withdrawing proposed amendments to the Rule, issued in 2006, that would have eliminated the MSRB as a location to which issuers could submit certain municipal disclosure documents.

EFFECTIVE DATE: July 1, 2009.

FOR FURTHER INFORMATION CONTACT: Martha Mahan Haines, Assistant Director and Chief, Office of Municipal Securities, at (202) 551-5681; Nancy J. Burke-Sanow, Assistant Director, Office of Market Supervision, at (202) 551-5620; Mary N. Simpkins, Senior Special Counsel, Office of Municipal Securities, at (202) 551-5683; Rahman J. Harrison, Special Counsel, Office of Market Supervision, at (202) 551-5663; David J. Michehl, Special Counsel, Office of Market Supervision, at (202) 551-5627; and Steven Varholik, Attorney, Office of Market Supervision, at (202) 551-5615, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Rule 15c2-12¹ under the Exchange Act.²

I. Executive Summary

On August 7, 2008, the Commission published for comment amendments to Rule 15c2-12 to provide for a single centralized repository for the electronic collection and availability of information about municipal securities outstanding in the secondary market.³ The comment period for the proposed amendments expired on September 22, 2008. The proposed amendments would require the Participating Underwriter to reasonably determine that the issuer or obligated

¹ 17 CFR 240.15c2-12.

² 15 U.S.C. 78a *et seq.*

³ See Securities Exchange Act Release No. 58255 (July 30, 2008), 73 FR 46138 (August 7, 2008) ("Proposing Release").

person has undertaken in its continuing disclosure agreement to provide continuing disclosure documents: (1) solely to the MSRB; and (2) in an electronic format and accompanied by identifying information, as prescribed by the MSRB. We received twenty-three comment letters in response to our proposed amendments from a wide range of commenters.⁴ The respondents included an issuer; a mutual fund complex; NRMSIRs; SIDs; the MSRB; trade organizations representing broker-dealers, investment advisors, financial analysts, government financial officials, and bond lawyers; and individual investors. The majority of commenters supported the proposed amendments and believed that the Commission's proposal would help improve disclosure for municipal securities, protect investors, restore confidence in the market, assist investors in making informed investment decisions, and make it easier for issuers and other obligated persons to comply with their continuing disclosure agreements. Of the comment letters we received, twenty expressed their support of the proposed amendments,⁵ two NRMSIRs opposed the amendments⁶ and one commenter neither expressed its support of nor opposition to the proposed amendments.⁷ In addition, a number of commenters offered suggestions relating to the implementation and operation of the proposed disclosure system.⁸

⁴ Exhibit A, which is attached to this release, contains the full title of each comment letter cited herein and the citation key for these letters. Copies of all comments received on the proposed amendments are available on the Commission's Internet Web site, located at <http://www.sec.gov/comments/s7-21-08/s72108.shtml>, and in the Commission's Public Reference Room at its Washington, DC headquarters.

⁵ See Busby Letter, GFOA Letter, Vanguard Letter, SIFMA Letter, MSRB Letter, NABL Letter, IAA Letter, Treasurer of the State of Connecticut Letter, e-certus Letter, Texas MAC Letter, NASACT Letter, OMAC Letter, ICI Letter, NAHEFFA Letter, Multiple-Markets Letter, NFMA Letter, EDGAR Online Letter, Dickman Letter, Mooney Letter, Grant Letter.

⁶ See SPSE Letter and DPC DATA Letter.

⁷ See DAC Letter.

⁸ See, e.g., GFOA Letter, NABL Letter, IAA Letter, e-certus Letter, NAHEFFA Letter, Multiple-Markets Letter, NFMA Letter, and EDGAR Online Letter.

In general, commenters supported the use of a single repository for receiving continuing disclosures and believed that such an arrangement would be more efficient than the current decentralized system.⁹ Commenters generally expressed their support for the MSRB as the single repository and believed that the MSRB would be a logical operator of the proposed disclosure system.¹⁰ Commenters also expressed their support for the use of an entirely electronic format for submissions to the single repository, with some commenters stating that paper copies should not be permitted.¹¹ In addition, commenters supported the indexing of information to be submitted to the single repository but had a variety of opinions on the scope of the information to be included in such indexing.¹² Some commenters expressed concern about access to information submitted to the single repository and the fees that could result from the use of such repository,¹³ with some commenters opposing a system that would impose fees on issuers, obligated persons or investors.¹⁴ One commenter believed that the exemptive provision in paragraph (d)(2) of the Rule, which generally is used by smaller issuers, should be retained in

⁹ See, e.g., OMAC Letter, NFMA Letter, and Treasurer of the State of Connecticut Letter.

¹⁰ See, e.g., GFOA Letter, Vanguard Letter, SIFMA Letter, NASACT Letter, ICI Letter, and NFMA Letter.

¹¹ See, e.g., Vanguard Letter, at 3, and Multiple-Markets Letter, at 2.

¹² See, e.g., GFOA Letter, Vanguard Letter, ICI Letter, OMAC Letter, NAHEFFA Letter, Multiple-Markets Letter, NFMA Letter, Edgar Online Letter, and DAC Letter. Neither the proposed nor the final Rule 15c2-12 amendments address the specific information to be indexed. Indexing information is addressed in the MSRB's proposed rule change and the Commission's approval order relating to the EMMA system and is considered separately. See Securities Exchange Act Release Nos. 58256 (July 30, 2008), 73 FR 46161 (August 7, 2008) (SR-MSRB-2008-05) ("MSRB EMMA Proposal") and 59061 (December 5, 2008)(order approving MSRB EMMA Proposal) ("MSRB Approval Order").

¹³ See, e.g., NFMA Letter, GFOA Letter, Vanguard Letter, IAA Letter, ICI Letter, and SPSE Letter.

¹⁴ See, e.g., GFOA Letter, Vanguard Letter, IAA Letter, ICI Letter, and NAHEFFA Letter.

its current form.¹⁵ A number of comment letters addressed both the proposed amendments and the MSRB's companion proposal to establish a continuing disclosure service within its EMMA system.¹⁶ This release describes and addresses only those portions of the comment letters that are relevant to the proposed amendments; the portions of the comment letters pertaining to the continuing disclosure component of the MSRB's EMMA system are considered separately in the Commission's order approving the MSRB's proposal, which we also are issuing today.¹⁷

We have carefully considered all the comments we received regarding the proposed amendments and, as discussed below, are adopting the amendments, as proposed. In adopting these amendments, we are furthering our intent to deter fraud and manipulation in the municipal securities market by improving the availability of information about municipal securities outstanding in the secondary market.

II. Background

A. History of Rule 15c2-12

We have long been concerned with improving the quality, timing, and dissemination of disclosure in the municipal securities markets. In an effort to improve the transparency of the municipal securities market, in 1989, we adopted Rule 15c2-12 ("Rule" or "Rule 15c2-12") and an accompanying interpretation modifying a previously published interpretation of the legal obligations of underwriters of municipal securities.¹⁸ At the time of its adoption in 1989, Rule 15c2-12 required, and still requires, an underwriter acting in a primary offering of municipal securities of \$1,000,000 or more: (1) to obtain and review an official statement "deemed final"

¹⁵ See NABL Letter, at 2.

¹⁶ See MSRB EMMA Proposal, supra note 12.

¹⁷ See MSRB Approval Order, supra note 12.

¹⁸ See Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (July 10, 1989) ("1989 Adopting Release").

by an issuer of the securities, except for the omission of specified information, prior to making a bid, purchase, offer, or sale of municipal securities; (2) in non-competitively bid offerings, to send, upon request, a copy of the most recent preliminary official statement (if one exists) to potential customers; (3) to send, upon request, a copy of the final official statement to potential customers for a specified period of time; and (4) to contract with the issuer to receive, within a specified time, sufficient copies of the final official statement to comply with the Rule's delivery requirement, and the requirements of the rules of the MSRB.¹⁹

While the availability of primary offering disclosure significantly improved following the adoption of Rule 15c2-12, there was a continuing concern about the adequacy of disclosure in the secondary market.²⁰ To enhance the quality, timing, and dissemination of disclosure in the secondary municipal securities market, in 1994 we adopted amendments to Rule 15c2-12.²¹

¹⁹ 17 CFR 240.15c2-12.

²⁰ In 1993, the Commission's Division of Market Regulation (n/k/a the Division of Trading and Markets) conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure ("1993 Staff Report"). Findings in the 1993 Staff Report highlighted the need for improved disclosure practices in both the primary and secondary municipal securities markets. The 1993 Staff Report found that investors need sufficient current information about issuers and significant obligors to better protect themselves from fraud and manipulation, to better evaluate offering prices, to decide which municipal securities to buy, and to decide when to sell. Moreover, the 1993 Staff Report found that the growing participation of individuals as both direct and indirect purchasers of municipal securities underscored the need for sound recommendations by brokers, dealers, and municipal securities dealers. See Securities and Exchange Commission, Division of Market Regulation (n/k/a Division of Trading and Markets), Staff Report on the Municipal Securities Market (September 1993) (available at <http://www.sec.gov/info/municipal.shtml>).

²¹ See Securities Exchange Act Release No. 34961 (November 10, 1994), 59 FR 59590 (November 17, 1994) ("1994 Amendments").

In light of the growing volume of municipal securities offerings, as well as the growing ownership of municipal securities by individual investors, in March 1994, the Commission published the Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others. See Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994). The Commission

Among other things, the 1994 Amendments placed certain requirements on brokers, dealers, and municipal securities dealers ("Dealers" or, when used in connection with primary offerings, "Participating Underwriters"). In adopting the 1994 Amendments, we intended "to deter fraud and manipulation in the municipal securities market" by prohibiting the underwriting and subsequent recommendation of transactions in municipal securities for which adequate information was not available on an ongoing basis.²²

Specifically, under the 1994 Amendments, Participating Underwriters are prohibited, subject to certain exemptions, from purchasing or selling municipal securities covered by the Rule in a primary offering, unless the Participating Underwriter has reasonably determined that an issuer of municipal securities or an obligated person²³ has undertaken in a written agreement or contract for the benefit of holders of such securities ("continuing disclosure agreement") to provide specified annual information and event notices to certain information repositories. The information to be provided consists of: (1) certain annual financial and operating information and audited financial statements ("annual filings");²⁴ (2) notices of the occurrence of any of eleven specific events ("material event notices");²⁵ and (3) notices of the failure of an issuer or

intended that its statement of views with respect to disclosures under the federal securities laws in the municipal market would encourage and expedite the ongoing efforts by market participants to improve disclosure practices, particularly in the secondary market, and to assist market participants in meeting their obligations under the antifraud provisions. *Id.*

²² See 1994 Amendments, *supra* note 21.

²³ Obligated persons include persons, including the issuer, committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities to be sold in an offering. See 17 CFR 240.15c2-12(f)(10).

²⁴ 17 CFR 240.15c2-12(b)(5)(i)(A) and (B).

²⁵ 17 CFR 240.15c2-12(b)(5)(i)(C). The following events, if material, require notice: (1) principal and interest payment delinquencies; (2) non-payment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties;

other obligated person to make a submission required by a continuing disclosure agreement ("failure to file notices").²⁶ The 1994 Amendments require the Participating Underwriter to reasonably determine that an issuer of municipal securities or an obligated person has undertaken in the continuing disclosure agreement to provide: (1) annual filings to each NRMSIR; (2) material event notices and failure to file notices either to each NRMSIR or to the MSRB; and (3) in the case of states that established SIDs, all continuing disclosure documents to the appropriate SID. Finally, the 1994 Amendments revise the definition of "final official statement" to include a description of the issuer's or obligated person's continuing disclosure undertakings for the securities being offered, and of any instances in the previous five years in which the issuer or obligated person failed to comply, in all material respects, with undertakings in previous continuing disclosure agreements.

B. Disclosure Practices in the Secondary Market and Need for Improved Availability to Continuing Disclosure

Since the adoption of Rule 15c2-12 in 1989 and its subsequent amendment in 1994, the size of the municipal securities market has grown considerably.²⁷ There were over \$2.6 trillion

(5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of the security; (7) modifications to rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities; and (11) rating changes.

In addition, Rule 15c2-12(d)(2) provides an exemption from the application of paragraph (b)(5) of the Rule with respect to primary offerings if, among other things, the issuer or obligated person has agreed to a limited disclosure obligation, including sending certain material event notices to each NRMSIR or the MSRB, as well as the appropriate SID. See 17 CFR 240.15c2-12(d)(2).

²⁶ 17 CFR 240.15c2-12(b)(5)(i)(D). Annual filings, material event notices, and failure to file notices are referred to collectively herein as "continuing disclosure documents."

²⁷ According to statistics assembled by SIFMA, the amount of outstanding municipal securities grew from \$1.2616 trillion in 1996 to \$2.617.4 trillion at the end of 2007. See SIFMA "Outstanding U.S Bond Market Debt" (available at http://www.sifma.org/research/pdf/Overall_Outstanding.pdf).

of municipal securities outstanding at the end of 2007.²⁸ Notably, at the end of 2007, retail investors held approximately 35% of outstanding municipal securities directly and up to another 36% indirectly through money market funds, mutual funds, and closed end funds.²⁹ There is also substantial trading volume in the municipal securities market. According to the MSRB, more than \$6.6 trillion of long and short term municipal securities were traded in 2007 in more than 9 million transactions.³⁰ Further, the municipal securities market is extremely diverse, with more than 50,000 state and local issuers of these securities.³¹

Currently, there are four NRMSIRs³² and three SIDs.³³ Each of the NRMSIRs utilizes the information obtained from continuing disclosure documents to create proprietary information products that are primarily sold to and used by dealers, institutional investors and other market participants who subscribe to such products. With respect to the availability of municipal securities information to retail investors, each of the NRMSIRs also makes continuing disclosure documents available for sale to non-subscribers.³⁴

²⁸ See SIFMA "Outstanding U.S. Bond Market Debt" (available at http://www.sifma.org/research/pdf/Overall_Outstanding.pdf).

²⁹ See SIFMA "Holders of U.S. Municipal Securities" (available at http://www.sifma.org/research/pdf/Holders_Municipal_Securities.pdf).

³⁰ See MSRB's Real-Time Transaction Reporting Statistical Information, Monthly Summaries 2007 (available at http://www.msrb.org/msrb1/TRSweb/MarketStats/statistical_patterns_in_the_muni.htm).

³¹ See Securities Exchange Act Release No. 33741, *supra* note 21.

³² The four NRMSIRs are the Bloomberg Municipal Repository, DPC DATA, Interactive Data Pricing and Reference Data, Inc., and SPSE.

³³ The three SIDs are the Municipal Advisory Council of Michigan, Texas MAC, and OMAC.

³⁴ See <http://www.bloomberg.com/markets/rates/municontracts.html> (Bloomberg Municipal Repository); <http://www.munifilings.com/help/help.cfm> (DPC DATA); http://www.interactivedata-prd.com/07company_info/about_us/MN/NRMSIR.shtml (Interactive Data Pricing and Reference Data, Inc.); and <http://www.disclosuredirectory.standardandpoors.com/> (SPSE).

Although the existing practice for the collection and availability of municipal securities disclosures has substantially improved the availability of information to the market, we believe that improvements could achieve more efficient, effective, and wider availability of municipal securities information to market participants.³⁵ Among other things, improvements in information availability may allow investors to obtain information more readily and may help them to make more informed investment decisions. Specifically, we believe that municipal securities disclosure documents should be made more readily and more promptly available to the public and that all investors should have better access to important market information that may affect the price of a municipal security, such as information in financial statements and notices regarding defaults and changes in ratings, credit enhancement provider, and tax status.

Furthermore, we believe that improved access to the information in continuing disclosure documents not only would provide the investing public with important information regarding municipal securities, both during offerings and on an ongoing basis, but also would help fulfill the regulatory and information needs of municipal market participants, including Dealers, Participating Underwriters, mutual funds, and others. For example, many mutual funds include

³⁵ The Commission notes that the aspects of the Rule that relate to the provision of continuing disclosure documents to multiple locations (*i.e.*, to each NRMSIR and SID) may have engendered certain inefficiencies in the current system. See 17 CFR 240.15c2-12(b)(5)(i)(A) through (D). For instance, there have been reports that NRMSIRs may not receive continuing disclosure documents concurrently, resulting in the uneven availability of documents from the various NRMSIRs for some period of time. There also have been reports of inconsistent document collections among NRMSIRs, possibly due to the failure of some issuers or obligated persons to provide continuing disclosure documents to each NRMSIR. Finally, there have been reports indicating possible weaknesses in document retrieval at the NRMSIRs. See, *e.g.*, Troy L. Kilpatrick and Antonio Portuondo, Is This the Last Chance for the Muni Industry to Self-Regulate?, The Bond Buyer, August 6, 2007, and comments made at the 2001 Municipal Market Roundtable - "Secondary Market Disclosure for the 21st Century" held November 14, 2001 ("2001 Roundtable"), and the 2000 Municipal Market Roundtable held October 12, 2000 (available at <http://www.sec.gov/info/municipal/roundtables/thirdmuniround.htm> and <http://www.sec.gov/info/municipal/roundtables/2000participants.htm>, respectively).

municipal securities in their portfolios that they routinely monitor for regulatory and other reasons.³⁶ They do so by reviewing annual filings, as well as material event notices and failure to file notices, obtained from NRMSIRs and SIDs.³⁷ In addition, the MSRB requires Dealers to disclose to a customer at the time of trade all material facts about a transaction known by the Dealer.³⁸ Further, the MSRB requires a Dealer to disclose material facts about a security when such facts are reasonably accessible to the market.³⁹ Accordingly, a Dealer is responsible for disclosing to a customer any material fact concerning a municipal security transaction made publicly available through sources such as NRMSIRs, the MSRB's Municipal Securities Information Library ("MSIL") system,⁴⁰ the MSRB's Real-Time Transaction Reporting System

³⁶ For example, Rule 2a-7 under the Investment Company Act of 1940 specifies the characteristics of investments that may be purchased and held by money market funds. Among other requirements, Rule 2a-7 requires a money market fund to limit its portfolio investments to those securities that the fund's board of directors determines present minimal credit risks (including factors in addition to any assigned rating). See Rule 2a-7(c)(3), 17 CFR 270.2a-7(c)(3).

³⁷ See, e.g., the comments of Leslie Richards-Yellen, Principal, The Vanguard Group, at the 2001 Roundtable, supra note 35.

³⁸ See MSRB "Interpretive Notice Regarding Rule G-17 on Disclosure of Material Facts" (March 20, 2002) (available at <http://www.msrb.org/msrb1/rules/notg17.htm>). See also Securities Exchange Act Release No. 45591 (March 18, 2002), 67 FR 13673 (March 25, 2002) (SR-MSRB-2002-01) (order approving MSRB's proposed interpretation of the duty to deal fairly set forth in MSRB Rule G-17).

³⁹ Id.

⁴⁰ Municipal Securities Information Library and MSIL are registered trademarks of the MSRB. The Official Statement and Advance Refunding Document ("OS/ARD") system of the MSIL system was initially approved by the Commission in 1991 and was amended in 2001 to establish the MSRB's current optional electronic system for underwriters to submit official statements and advance refunding documents. See Securities Exchange Act Release Nos. 29298 (June 13, 1991), 56 FR 28194 (June 19, 1991) (File No. SR-MSRB-90-2) (order approving MSRB's proposal to establish and operate the OS/ARD of the MSIL system, through which information collected pursuant to MSRB Rule G-36 would be made available electronically to market participants and information vendors) and 44643 (August 1, 2001), 66 FR 42243 (August 10, 2001) (File No. SR-MSRB-2001-03) (order approving MSRB's proposal to amend the OS/ARD system to establish an

("RTRS"), rating agency reports and other sources of information relating to the municipal securities transaction generally used by Dealers that effect transactions in the type of municipal securities at issue.⁴¹ Dealers use the information contained in the continuing disclosure documents to carry out these obligations. Therefore, improving access to information in the continuing disclosure documents would help facilitate and simplify the process of gathering the necessary information to carry out their obligations. For these reasons, we proposed, and are now adopting, amendments to Rule 15c2-12 that, in our view, will provide municipal market participants with more efficient access to information in continuing disclosure documents to satisfy their regulatory requirements and informational needs.

C. The MSRB's Electronic Systems

In 2006, the Commission published for comment proposed amendments to Rule 15c2-12 in response to a petition from the MSRB⁴² that would permit the MSRB to close its Continuing Disclosure Information Net ("CDINet") system, thereby eliminating the MSRB as a location to which issuers could submit material event notices and failure to file notices.⁴³ In the 2006 Proposed Amendments, we indicated our belief that, given the limited usage of the MSRB's

optional procedure for electronic submissions of required materials under MSRB Rule G-36).

⁴¹ See supra note 38.

⁴² See Letter from Diane G. Klink, General Counsel, MSRB, to Jonathan G. Katz, Secretary, Commission, dated September 8, 2005 ("MSRB Petition") (File No. 4-508).

⁴³ See Securities Exchange Act Release No. 54863 (December 4, 2006), 71 FR 71109 (December 8, 2006) ("2006 Proposed Amendments"). According to the MSRB Petition, the CDINet system was designed to permit issuers to satisfy their undertakings to provide material event notices through a single submission to the MSRB, rather than through separate submissions to each of the NRMSIRs. The MSRB stated that relatively few issuers had opted to use the CDINet system, and, in recent years, usage of the CDINet system had diminished. See MSRB Petition, supra note 42.

CDINet system, among other things, the proposed elimination of the provision in Rule 15c2-12 that allows the filing of material event notices with the MSRB was warranted.⁴⁴

We recently approved the MSRB's proposed rule change, filed under Section 19(b) of the Exchange Act,⁴⁵ to establish a pilot program for an Internet-based public access portal ("pilot portal") for the consolidated availability of primary offering information about municipal securities that currently is made available in paper form, subject to copying charges, at the MSRB's public access facility, and electronically by paid subscription on a daily over-night basis and by purchase of annual back-log collections.⁴⁶ The MSRB has implemented the pilot portal as a service of its new Internet-based public access system, which it designated as the EMMA system, as a pilot facility within the MSIL system.

In the course of developing the primary offering information component of the EMMA system, the MSRB determined that it could incorporate in the EMMA system the collection and availability of continuing disclosure documents, thus eliminating the need for the Commission to adopt its proposed changes to Rule 15c2-12 to remove the MSRB as a repository of material event notices.⁴⁷ As a result, the MSRB submitted to the Commission a proposed rule change, filed under Section 19(b) of the Exchange Act,⁴⁸ to expand the EMMA system to accommodate the collection and availability of annual filings, material event notices and failure to file

⁴⁴ See 2006 Proposed Amendments, *supra* note 43.

⁴⁵ 15 U.S.C. 78s(b).

⁴⁶ See Securities Exchange Act Release No. 57577 (March 28, 2008), 73 FR 18022 (April 2, 2008) (File No. SR-MSRB-2007-06) (order approving the pilot portal). Primary offering information consists of the official statement and the advance refunding document that Participating Underwriters are required to send to the MSRB under MSRB Rule G-36.

⁴⁷ See MSRB EMMA Proposal, *supra* note 12.

⁴⁸ 15 U.S.C. 78s(b).

notices.⁴⁹ We published the MSRB's proposal to incorporate continuing disclosure documents in the EMMA system simultaneously with the proposed amendments to Rule 15c2-12 that we are adopting today.⁵⁰ While the MSRB still intends to propose to terminate its CDINet System, subject to Commission approval,⁵¹ the MSRB's subsequent decision to file a proposed rule change to expand the EMMA system to accommodate annual filings, material event notices, and failure to file notices⁵² has led it to withdraw the MSRB Petition.⁵³ In the Proposing Release, we noted that, in light of our most recent proposed amendments, we were considering whether to withdraw our 2006 Proposed Amendments.⁵⁴ We received no comments regarding our proposed withdrawal of the 2006 Proposed Amendments. Therefore, in conjunction with the Commission's proposal today to amend Rule 15c2-12, the Commission is withdrawing its 2006 Proposed Amendments.

III. Discussion of Amendments and Comments Received

A. Amendments to Rule 15c2-12

We are adopting, without change, our proposed amendments to the Rule, which facilitate the collection and availability of information about outstanding municipal securities. For the reasons discussed in this release and the Proposing Release, we believe that the amendments are consistent with the Commission's mandate to, among other things, adopt rules reasonably designed to prevent fraud in the municipal securities market.

⁴⁹ See MSRB EMMA Proposal, supra note 12.

⁵⁰ Id.

⁵¹ Id.

⁵² Id.

⁵³ See letter to Florence E. Harmon, Acting Secretary, Commission, from Ernesto A. Lanza, General Counsel, MSRB, dated October 22, 2008.

⁵⁴ See Proposing Release, supra note 3, 73 FR at 46141.

In summary, we are amending paragraph (b)(5) of Rule 15c2-12, which relates to a Participating Underwriter's obligation under the Rule to reasonably determine that issuers or obligated persons have contractually agreed to provide specified documents, in connection with primary offerings subject to the Rule. The final amendments require a Participating Underwriter to reasonably determine that the issuer or obligated person has agreed at the time of a primary offering: (1) to provide the continuing disclosure documents to the MSRB instead of to each NRMSIR and the appropriate SID, if any; and (2) to provide the continuing disclosure documents in an electronic format and accompanied by identifying information as prescribed by the MSRB.⁵⁵ In addition, the final amendments make comparable changes to paragraph (d)(2) of the Rule, which provides for a limited exemption from Rule 15c2-12(b)(5) as long as specified conditions are met. We also are making revisions to other provisions of Rule 15c2-12 to reflect that the MSRB will be the sole repository and we are providing for a transition mechanism to accommodate existing continuing disclosure agreements that refer to NRMSIRs. As noted above, the rule amendments as adopted are identical to the proposed amendments.

1. Use of a Single Repository

We are adopting amendments to Rule 15c2-12 to provide for a single centralized repository that will receive submissions in an electronic format. These amendments are expected to encourage a more efficient and effective process for the submission and availability of continuing disclosure documents. In our view, a single repository that receives submissions electronically should assist in facilitating and simplifying the process of submitting continuing disclosure documents under the Rule. Issuers and obligated persons will be able to comply with

⁵⁵ We note that, as part of its EMMA proposal filed with the Commission under Section 19(b) of the Exchange Act, the MSRB set forth the electronic format it proposes to use. See MSRB EMMA Proposal, supra note 12.

their undertakings by submitting their continuing disclosure documents only to one repository, as opposed to multiple repositories.

We also believe that having a centralized repository that receives submissions in an electronic format will help provide ready and prompt access to continuing disclosure documents by investors and other municipal securities market participants. Rather than having to approach multiple locations, investors and other market participants will be able to go solely to one location to retrieve continuing disclosure documents, thereby allowing for a more convenient means to obtain such information. Moreover, we believe that having one repository electronically collect and make available all continuing disclosure documents will increase the likelihood that investors and other market participants will obtain complete information about a municipal security or its issuer, since the information will not be distributed across multiple repositories. In addition, we expect that the consistent availability of municipal secondary market disclosures from a single source can simplify compliance with regulatory requirements by Participating Underwriters and others, such as mutual funds and Dealers. Information vendors (including NRMSIRs and SIDs) and others also will have ready access to continuing disclosure documents from a single source for use in their value-added products.

We have long been interested in improving the availability of disclosure in the municipal securities market. At the time we adopted Rule 15c2-12 and amended it in 1994, disclosure documents were submitted in paper form. We believed that, in such an environment where document retrieval would be handled manually, the establishment of one or more repositories could be beneficial in widening the retrieval and availability of information in the secondary market, since the public could obtain the disclosure documents from multiple locations. Our objective of encouraging greater availability of municipal securities information remains

unchanged. However, as indicated above, there have been significant inefficiencies in the current use of multiple repositories that likely have impacted the public's ability to retrieve continuing disclosure documents.⁵⁶ Although in the 1989 Adopting Release we supported the development of an information linkage among the repositories, none was established to help broaden the availability of the disclosure information. Since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems, including the use of the Internet, to provide information quickly and inexpensively to market participants and investors. In this regard, we believe that the use of a single repository to receive, in an electronic format, and make available continuing disclosure documents, in an electronic format, will substantially and effectively increase the availability of information about municipal issues, thereby preventing fraud, and enhance the efficiency of the secondary trading market.

In the Proposing Release, we requested comment on whether we should amend Rule 15c2-12 as proposed, or whether it would be preferable to continue to have multiple sources for such information. In addition, with respect to the transition to a sole repository for continuing disclosure documents, we requested comment on whether commenters foresee any differences that could occur between the existing structure of multiple NRMSIRs and one repository regarding the scope, quantity, and continuity of information.

Many commenters supported amending the Rule to provide for only one repository instead of multiple repositories for the submission of, and access to, continuing disclosure documents.⁵⁷ Generally, commenters expressed the view that the creation of a single repository

⁵⁶ See supra note 35.

⁵⁷ See, e.g., GFOA Letter, at 1, Vanguard Letter, at 1, SIFMA Letter, at 1, MSRB Letter, at 1, Treasurer of the State of Connecticut Letter, at 1, IAA Letter, at 1-2, Texas MAC

would be a significant step forward in making municipal disclosure more transparent in its scope,⁵⁸ more efficient in its delivery,⁵⁹ more consistent⁶⁰ and comparable⁶¹ across issuers, and more accessible for investors,⁶² particularly individual investors, and others – enhancing the overall efficiency of the secondary trading market for municipal securities.⁶³ As discussed below, two commenters objected to the establishment of a single repository.⁶⁴

In response to our question about whether having one repository instead of multiple repositories for the submission of, and access to, continuing disclosure documents would improve access to secondary market disclosure for investors and municipal securities market participants, commenters expressed the expectation that allowing only one entity to serve as the repository for continuing disclosure documents would greatly streamline the current system and resolve previous accessibility and consistency issues that resulted from submissions to several different information repositories.⁶⁵ In addition, commenters noted that having a single repository for secondary market disclosures would benefit investors by allowing them to obtain

Letter, at 1, NAHEFFA Letter, at 1, NFMA Letter, at 1, NASACT Letter, at 1, and Multiple-Markets Letter, at 1.

⁵⁸ See Treasurer of the State of Connecticut Letter, at 1, Mooney Letter, at 1, IAA Letter, at 1, and Multiple-Markets Letter, at 1.

⁵⁹ See Treasurer of the State of Connecticut Letter, at 1, Texas MAC Letter, and Multiple-Markets Letter, at 1.

⁶⁰ See Treasurer of the State of Connecticut Letter, at 1.

⁶¹ See Treasurer of the State of Connecticut Letter, at 1, and EDGAR Online Letter.

⁶² See GFOA Letter, at 2, Vanguard Letter, at 2, SIFMA Letter, at 2, MSRB Letter, at 3, Treasurer of the State of Connecticut Letter, at 2-3, IAA Letter, at 1, NASACT Letter, at 1, and ICI Letter, at 3.

⁶³ See Treasurer of the State of Connecticut Letter, at 1, EDGAR Online Letter, SIFMA Letter, at 1, IAA Letter, at 3, and NASACT Letter at 1.

⁶⁴ See SPSE Letter and DPC DATA Letter.

⁶⁵ See Treasurer of the State of Connecticut Letter, at 1, EDGAR Online Letter, SIFMA Letter, at 1, IAA Letter, at 3, and NASACT Letter at 1.

complete information without having to search for disclosures in multiple locations.⁶⁶ One commenter stated that its members reported that it is rare for municipal securities disclosure information currently to be found in one location.⁶⁷ This commenter expressed the view that a single repository would significantly improve information availability by allowing investors to obtain information more readily, increasing the likelihood that investors can obtain more complete information and enabling them to better protect themselves from misrepresentation or other fraudulent activities, and would assist investors in making more informed investment decisions.⁶⁸ Another commenter echoed this concern when, in discussing the discrepancies that currently exist, it stated that it is not reasonable to expect an investor to have to search multiple locations for the same information.⁶⁹ One commenter – a financial information disseminator – noted that it is not feasible under the current system for it to have access to municipal bond disclosures for the purpose of redistribution to investors because it would have to either: (1) obtain disclosures individually from each of 50,000 different issuers; or (2) pay a NRMSIR an annual subscription fee or a \$25 per document fee, in which case it would still be unable to redistribute the disclosures because the NRMSIRs have copyrighted the documents by categorizing and reformatting the documents into a proprietary format.⁷⁰ This commenter further noted that obtaining what it referred to as a “fundamental database” of municipal disclosures is currently problematic because the disclosures are difficult to locate, financial

⁶⁶ See ICI Letter, at 3, and SIFMA Letter, at 2.

⁶⁷ See ICI Letter, at 3.

⁶⁸ Id.

⁶⁹ See Treasurer of the State of Connecticut Letter, at 1.

⁷⁰ See EDGAR Online Letter, at 2.

reporting between municipalities differs greatly, and the volume of documents is too great.⁷¹ Another commenter also supported the replacement of the current system and agreed with the Commission that a centralized location for the collection of information would eliminate the problem of an issuer failing to provide certain information to every repository, resulting in one repository not having a complete set of information.⁷² In addition, a single source of secondary market information was anticipated by some commenters to reduce the costs incurred by market participants as a result of the existing fragmented system, which forces investors and others to seek information from multiple sources.⁷³ Furthermore, it was suggested that, as with the Commission's EDGAR system for reporting issuers, the establishment of a single repository for municipal information would encourage links with other information delivery sources that the investing public could access, such as free websites, subscriptions, or brokerage services, which would promote greater familiarity and usage and a more transparent and efficient market.⁷⁴

We also requested comment on whether the availability of such information from a single source would simplify compliance with regulatory requirements by Participating Underwriters and others. Commenters anticipated that having a single site for continuing disclosure information would assist dealers in meeting their obligation to obtain the information necessary to establish a reasonable basis for making investment recommendations, improve the due diligence activities of underwriters of new offerings, and assist mutual funds in carrying out their regulatory obligations.⁷⁵ Some commenters indicated a belief that a single repository would

⁷¹ See EDGAR Online Letter, at 4.

⁷² See IAA Letter, at 2.

⁷³ See ICI Letter, at 3, and SIFMA Letter, at 2.

⁷⁴ See Treasurer of the State of Connecticut Letter, at 1-2.

⁷⁵ See SIFMA Letter, at 2, and ICI Letter, at 3.

simplify the manner in which municipal issuers, obligated persons and their agents make filings, and promote full compliance by issuers and obligated persons with the filing requirements contained in continuing disclosure agreements.⁷⁶

Two commenters that are NRMSIRs opposed having a single repository.⁷⁷ Both commenters stated that the proposed amendments would not accomplish the Commission's information goals because the amendments do not address the root cause of current municipal disclosure problems, such as issuers who file late or fail to file.⁷⁸ One commenter stated the Commission's information goals would not be accomplished because of the absence of uniform accounting and financial reporting standards for issuers in the municipal market.⁷⁹ One commenter was of the opinion that the proposed amendment "does nothing to improve the overall continuing disclosure regime, except to make the filing materials available free of charge to the public."⁸⁰ This commenter further stated that many problems with the present system of municipal continuing disclosure would "remain unaddressed in the proposed rule change, as do other publicly described and measured problems such as the significant level of municipal continuing disclosure delinquency" and that the "proposed rule change has no substantive benefit to offer."⁸¹ Another commenter, while noting that numerous inefficiencies exist within the current NRMSIR system, indicated that a single repository system still would depend on if, how, and when an issuer submits information.⁸² The Commission understands that the proposed

⁷⁶ See GFOA Letter, at 1, and SIFMA Letter, at 2.

⁷⁷ See SPSE Letter and DPC DATA Letter.

⁷⁸ See SPSE Letter, at 8, and DPC DATA Letter, at 1.

⁷⁹ See SPSE Letter, at 8.

⁸⁰ See DPC DATA Letter, at 1.

⁸¹ Id.

⁸² See DAC Letter, at 3.

amendments will not necessarily solve every problem found in the current system based on NRMSIRs and SIDs. Under the current system, it is not possible to determine with certainty whether gaps in the continuing disclosure document collections of NRMSIRs are the result of failures by issuers to provide continuing disclosure documents as provided in their continuing disclosure agreements or failures of NRMSIRs to maintain accurate indices or adequate document retrieval systems. The Commission believes that the use of a single repository will make it easier for investors and others to identify issuers who fail to file. The Commission expects that, with the rule amendments, investors will be able to make better informed investment decisions and Participating Underwriters and Dealers will be able to fulfill their regulatory responsibilities more easily and accurately. At the same time, the Commission believes that the use of a single venue, from which all continuing disclosure documents will be available to the general public immediately upon being filed, will provide a comprehensive source of information to NRMSIRs and other vendors to utilize in their value added products.

One commenter, who opposed the amendments, suggested the use of a "central post office" approach whereby all filings would be supplied to a single location for immediate redistribution to all NRMSIRs and SIDs and an index of filings would be available to the general public at no charge.⁸³ Another commenter, who supported a single repository, requested that, in the event the Commission determines not to adopt the proposed amendments, it consider the establishment of a "central post office" facility.⁸⁴ One commenter, which currently operates such a "central post office" facility, also supported having of a single repository operated by the MSRB and indicated its belief that a single repository would be more efficient than the current

⁸³ See SPSE Letter, at 2.

⁸⁴ See GFOA Letter, at 2.

decentralized system.⁸⁵ The Commission has considered a “central post office” approach. However, while a central post office may benefit NRMSIRs by providing a comprehensive source of continuing disclosure documents in an electronic format, it would not result in such documents being made available to the public at no charge. The Commission believes that direct access to such information from a single repository, without charge, will benefit investors, particularly individual investors, while providing a comprehensive source of continuing disclosure documents to information vendors and others who may wish to obtain all filings or a subset thereof, such as filings related to issuers and obligated persons in a single state.

One commenter noted that having a single repository might cause investors and broker-dealers unduly to rely on the repository’s contents, which it believed would create a risk of undermining the purpose of protecting investors against fraud.⁸⁶ This commenter provided no reason for its view that documents supplied to the MSRB would be less reliable than those supplied to NRMSIRs and SIDs directly or through a “central post office.”

While we acknowledge that today’s amendments do not address all of the information challenges of the municipal market, we nonetheless believe that they will be a significant step forward in improving the availability of, and access to, secondary market municipal disclosures. As noted above, the vast majority of commenters on the proposed amendments believed that the adoption of the rule amendments will simplify and improve the current system. The Commission also believes that this will be the case. With respect to comments favoring a “central post office,” we believe that this approach would fail to achieve the benefits of the amendments. For example, with a central post office, there would continue to be no single location to which investors, particularly individuals, could turn for free access to information

⁸⁵ See Texas MAC Letter.

⁸⁶ See SPSE Letter, at 2.

regarding municipal securities. Instead, individuals or entities that wish to obtain such information would find it necessary first to access the central post office to find out what documents might be available from NRMSIRs and SIDs and then to contact one or more NRMSIRs or SIDs and pay applicable fees to obtain the document or documents they seek. This would be a less efficient process than that contemplated by the final amendments, in which interested persons could directly access, view and print for free continuing disclosure documents from one place – the MSRB's Internet site.

Moreover, a "central post office" would not, to the same extent as the Commission's amendments, simplify compliance with regulatory requirements by Participating Underwriters, Dealers and others. This is because they would have to first access the "central post office" to determine what documents are available and then contact one or more NRMSIRs or SIDs to obtain these documents. In fact, one commenter that supported the proposed amendments indicated that the proposal, along with the MSRB EMMA Proposal, "takes the notion of a central post office one step further by streamlining the process and removing the necessity and inefficiency of forwarding filings to several NRMSIRs and SIDs."⁸⁷ We therefore anticipate that public access to all continuing disclosure documents on the Internet, as provided by the amendments, will promote market efficiency and deter fraud by improving the availability of information to all investors.

2. MSRB as the Sole Repository

In the Proposing Release, we sought comment concerning whether the MSRB should be the sole repository included in Rule 15c2-12 or whether another entity, such as a private vendor, should be the sole repository, instead of the MSRB, and requested that commenters provide

⁸⁷ See NASACT Letter, at 1.

reasons for their viewpoints. As proposed, we are revising Rule 15c2-12 to delete all references to NRMSIRs and SIDs and in their place refer solely to the MSRB.

Twelve commenters supported and two commenters opposed our proposal for the MSRB to be the single repository for secondary market disclosure.⁸⁸ Commenters favoring the MSRB as the sole repository expressed a belief that the Commission's oversight of the MSRB as a self-regulatory organization ("SRO") and the MSRB's experience with the complexities of municipal securities and the municipal securities markets and the MSRB's direct experience in developing and maintaining electronic information systems for the municipal securities market (such as its MSIL and RTRS systems) would provide significant value to the framework of the proposed repository.⁸⁹ The two commenters that opposed having the MSRB as the sole repository believed that the current system should be retained and that they and other vendors of municipal information would be at a competitive disadvantage if the MSRB became the sole repository.⁹⁰

Comment also was solicited regarding whether the MSRB's status as an SRO would be an advantage or disadvantage to its serving as the sole repository. Three commenters stated a belief that having the MSRB serve as the sole repository is reasonable because, as an SRO, it is subject to oversight by the Commission.⁹¹ One of these commenters also noted that, as a result, a rule change relevant to the continuing disclosure service of EMMA would be subject to public

⁸⁸ See GFOA Letter, Vanguard Letter, SIFMA Letter, MSRB Letter, Texas MAC Letter, NASACT Letter, OMAC Letter, ICI Letter, NAHEFFA Letter, Multiple-Markets Letter, NFMA Letter, and EDGAR Online Letter (each supporting the MSRB as the single repository). See also SPSE Letter and DPC DATA Letter (each opposing the MSRB as the single repository).

⁸⁹ See SIFMA Letter, NFMA Letter, and ICI Letter.

⁹⁰ See SPSE Letter, at 2, 7 and DPC DATA Letter, at 2.

⁹¹ See Vanguard Letter, SIFMA Letter, and ICI Letter.

comment and Commission approval.⁹² However, a commenter that opposed the proposed amendments suggested that naming the MSRB to be the sole repository would not be appropriate because the MSRB would be reimbursed through mandatory fees assessed against broker-dealers rather than users.⁹³ This commenter expressed a belief that such costs ultimately would be passed along by broker-dealers to their customers.⁹⁴

We also sought comment on whether the MSRB would be an appropriate operator of a centralized repository for the collection and availability of continuing disclosure information about municipal securities, and whether there is a more appropriate location or means through which such information could be made readily available to the public without charge. Some commenters noted that one benefit of having the MSRB act as sole repository would be the accessibility of comprehensive information regarding municipal securities, including official statements, continuing disclosure documents and pricing information, without charge at one location.⁹⁵ However, one commenter suggested that, by analogy to our EDGAR system, the Commission might be a more appropriate party to operate such a repository than the MSRB, which represents only one segment of the market (*i.e.*, brokers, dealers and municipal securities dealers).⁹⁶ In addition, one of the existing NRMSIRs indicated its view that it is inappropriate for a quasi-governmental entity such as the MSRB to operate a facility that would compete with private business.⁹⁷ Two commenters indicated an overall preference for maintenance of the

⁹² See SIFMA Letter, at 3.

⁹³ See SPSE Letter, at 11.

⁹⁴ *Id.*

⁹⁵ See, *e.g.*, SIFMA Letter, at 2, and NASACT Letter, at 1.

⁹⁶ See Treasurer of the State of Connecticut Letter, at 2.

⁹⁷ See DPC DATA Letter, at 2. See discussion below in Section III.A.3.

existing structure of the Rule – pursuant to which private entities, not the MSRB, provide locations or means through which such information is made available to the public.⁹⁸

We agree with the many commenters who believed that the MSRB is the appropriate entity to serve as the single repository. Established pursuant to an act of Congress⁹⁹ as an SRO for brokers, dealers and municipal securities dealers engaged in transactions in municipal securities, the MSRB is subject to Commission oversight, as provided by the Exchange Act. As an SRO, the MSRB is required to file its rules and changes to those rules with the Commission for notice and comment under Section 19(b) of the Exchange Act.¹⁰⁰ Pursuant to Section 15B(b)(2)(C) of the Exchange Act, the MSRB's rules are required to be designed, in part, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, ... to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest."¹⁰¹ The MSRB's existing RTRS and MSIL systems, and the primary offering information component of the EMMA system that has been approved by the Commission (relating to the submission of official statements and advance refunding documents),¹⁰² were subject to notice and comment and Commission review. Similarly, the MSRB's proposal to establish a continuing disclosure component within the EMMA system was subject to notice and comment under Section 19(b) of

⁹⁸ See SPSE Letter and DPC DATA Letter.

⁹⁹ 15 U.S.C. 78o-4.

¹⁰⁰ 15 U.S.C. 78s(b).

¹⁰¹ 15 U.S.C. 78o-4(b)(2)(C).

¹⁰² See Securities Exchange Act Release No. 57577, supra note 46.

the Exchange Act, as would as any future changes to the system.¹⁰³ Further, we believe that, in addition to being subject to Commission oversight as an SRO, the MSRB is both familiar with the complexities of municipal securities and the municipal securities market and has experience in developing and maintaining electronic information systems for that market.¹⁰⁴ Collectively, these factors lead us to adopt amendments to Rule 15c2-12 to provide that the MSRB be the centralized location for collecting (in an electronic format) and making information about municipal securities available to the public at no cost.

Although two commenters opposed the proposal for the MSRB to be the sole repository,¹⁰⁵ the Commission believes that the MSRB's status as an SRO and experience with municipal market disclosure make it appropriate for the MSRB to be the sole repository. Moreover, as discussed in detail throughout the Proposing Release as well as this release, the Commission believes that the current NRMSIR model of disclosure needs to be improved. Many commenters agreed with this view.¹⁰⁶ Although one commenter suggested that the Commission should be the repository,¹⁰⁷ we believe that the MSRB, in light of its experience with municipal disclosure and its status as an SRO, will be in a better position to act as the repository more quickly and efficiently.

As discussed below, with respect to the comment that it is inappropriate for a quasi-governmental entity such as the MSRB to operate a facility that would compete with private

¹⁰³ See MSRB EMMA Proposal, *supra* note 12.

¹⁰⁴ For example, the MSRB is experienced with operating CDINet, the MSIL system, and the RTRS system.

¹⁰⁵ See SPSE Letter, at 2, DPC DATA Letter, at 3.

¹⁰⁶ See, e.g., Vanguard Letter, at 2, NASACT Letter, at 1, ICI Letter, at 3, IAA Letter, at 1, and NFMA Letter, at 1.

¹⁰⁷ See Treasurer of the State of Connecticut Letter, at 2.

business, the Commission believes that any competitive impact that may result from the MSRB's status as the sole repository is justified by the benefits that such status is expected to provide to investors, broker-dealers, mutual funds, vendors of municipal information, municipal security analysts, other market professionals, and the public generally.¹⁰⁸ Further, as discussed in Section III.A.3. below, we believe that having the MSRB serve as the repository for the electronic submission and availability of continuing disclosure documents could foster competition for value-added products and services and thus it is not anti-competitive for the MSRB to serve as the repository.

With respect to the statement that broker-dealers would pass on fees to their customers to support the EMMA system, the Commission notes that the MSRB, as an SRO, would have to file any fees relating to the use of EMMA with the Commission under Section 19(b) of the Exchange Act.¹⁰⁹ The Commission further notes that broker-dealers currently are charged fees for access to disclosure documents obtained from the NRMSIRs that they currently may or may not pass on to their customers. According to the MSRB, it presently anticipates no increase in fees on brokers, dealers, and municipal securities dealers who effect transactions in municipal securities to establish and operate the EMMA system.¹¹⁰ The MSRB has indicated that it has funds on

¹⁰⁸ See discussion above regarding the MSRB's status as an SRO and resulting Commission oversight, infra Section III.A.3.

¹⁰⁹ 15 U.S.C. 78s(b). Under Section 15B(b)(2)(J) of the Exchange Act, 15 U.S.C. 78o-4(b)(2)(J), among other requirements, any fees charged by the MSRB must be reasonable.

¹¹⁰ Telephone conversation between Earnesto Lanza, General Counsel, MSRB, and Martha Mahan Haines, Chief of the Office of Municipal Securities and Assistant Director, Division of Trading and Markets, October 22, 2008.

hand that, together with amounts it will collect in the future under its current fee schedule, it believes will be sufficient to establish and operate the EMMA system.¹¹¹

Indeed, we anticipate that the accessibility of documents through the repository will greatly benefit dealers in satisfying their obligation to have a reasonable basis for investment recommendations and other regulatory responsibilities, in addition to investors and other market participants who seek information about municipal securities. All commenters who addressed this issue supported this conclusion.¹¹²

3. Competitive Concerns with a Single Repository

In the Proposing Release, we discussed the competitive implications generally of having a single repository for continuing disclosure documents and specifically of having the MSRB serve as the sole repository and sought commenters' views on potential competition issues. With respect to the Exchange Act goal of promoting competition, we note that, when we adopted Rule 15c2-12 in 1989, we strongly supported the development of one or more central repositories for municipal disclosure documents.¹¹³ We "recognize[d] the benefits that may accrue from the creation of competing private repositories," and indicated that "the creation of central sources for municipal offering documents is an important first step that may eventually encourage widespread use of repositories to disseminate annual reports and other current information about issuers to the secondary markets."¹¹⁴ Further, when we adopted the 1994 Amendments, we

¹¹¹ Id.

¹¹² See SIFMA Letter, at 2, ICI Letter, at 3, Dickman Letter, Grant Letter, and Mooney Letter.

¹¹³ See 1989 Adopting Release at 54 FR 28807, supra note 18. See also Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759 (March 17, 1994) (File No. S7-5-94) (proposing release for the 1994 Amendments) ("1994 Proposing Release").

¹¹⁴ See 1989 Adopting Release, supra note 18. See also 1994 Proposing Release, supra note 113.

stated that the "requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allay[ed] the anti-competitive concerns raised by the creation of a single repository."¹¹⁵

Since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems that allow market participants and investors, both retail and institutional, easily, quickly, and inexpensively to obtain information through electronic means. The exponential growth of the Internet and the capacity it affords to investors, particularly individual investors, to obtain, compile and review information has likely helped to keep investors better informed. In addition to the Commission's EDGAR system, which contains filings by public companies required to file periodic reports and by mutual funds, we have increasingly encouraged and, in some cases required, the use of the Internet and websites by public reporting companies and mutual funds to provide disclosures and communicate with investors.¹¹⁶

Our adoption of the proposed amendments, which provide for having a single repository for the electronic collection and availability of continuing disclosure documents, will help further the Exchange Act objective of promoting competition because information about municipal securities will be more widely available to market professionals, investors, information vendors, and others as a result of the final amendments. For example, we believe that competition among vendors can increase because vendors can utilize this information to provide value-added

¹¹⁵ See 1994 Amendments, *supra* note 21.

¹¹⁶ See, e.g., Securities Exchange Act Release Nos. 52056 (July 19, 2005), 70 FR 44722 (August 3, 2005) (File No. S7-38-04) (adopting amendments to encourage and, in some cases, mandate the use of an Internet site in securities offering); 56135 (July 26, 2007), 72 FR 42222 (August 1, 2007) (File No. S7-03-07) (adopting amendments to the proxy rules under the Exchange Act requiring issuers and other soliciting persons to post their proxy materials on an Internet Web site and providing shareholders with a notice of the Internet availability of the materials); and 58288 (August 1, 2008), 73 FR 45862 (August 7, 2008) (File No. S7-23-08) (interpretative release providing guidance on the use of company Web sites).

services to municipal market participants. The rule amendments also may promote competition in the purchase and sale of municipal securities because the greater availability of information, delivered electronically through a single repository, may instill greater investor confidence in the municipal securities market. Moreover, this greater availability of information also may encourage improvement in the completeness and timeliness of disclosures by issuers and obligated persons and may foster interest in municipal securities by retail and institutional customers. As a result, more investors may be attracted to this market sector and broker-dealers may compete for their business.

In the Proposing Release, we acknowledged that adoption of the proposed amendments potentially could have an adverse impact on one or more existing NRMSIRs, especially if their business models depended on their status as a NRMSIR. Moreover, since NRMSIRs have received compensation for providing copies of continuing disclosure documents to persons who request them, we noted that one or more NRMSIRs possibly could be adversely affected by the rule amendments, if they no longer have available to them a steady flow of funds from providing for a fee copies of continuing disclosure documents to persons who request them. As a result of the final amendments, a NRMSIR could find that it would have to revise its current manner of doing business or face a significant downturn in its business operations. Vendors of information about municipal securities, other than NRMSIRs, also could be affected by the final amendments because the MSRB proposes to provide information electronically free of charge.

In addition, because there would be just one repository, in lieu of the four NRMSIRs, the Proposing Release noted that the proposed amendments could reduce competition with respect to services provided by NRMSIRs as information vendors. In addition to supplying municipal disclosure documents upon request, NRMSIRs also provide value-added market data services to

municipal investors that incorporate continuing disclosure information. We noted in the Proposing Release that, if NRMSIRs are adversely affected by the proposed amendments, it is possible that there could be a reduction in these value-added market data services relating to municipal securities or a loss of innovation in offering competing information services regarding municipal securities.

We received comment letters from two NRMSIRs that raised concerns about the competitive effects of the proposed amendments.¹¹⁷ The primary concerns, raised by both commenters, relate to the MSRB's role as the sole repository of continuing disclosure documents and the competitive effects that this would have on existing vendors of municipal disclosure information. One commenter stated that the Commission's proposal "would allow the MSRB to impose restrictions on municipal issuers and obligated persons by limiting the filings to a single, electronic format."¹¹⁸ In addition, this commenter noted that the Commission's proposal would place the MSRB "in direct competition with commercial vendors who have served the market as practical implementers of Rule 15c2-12 without any subsidy for more than a decade."¹¹⁹ This commenter also expressed concern that the MSRB would unfairly discriminate against private vendors by controlling their access to information through fee structures and dissemination of information.¹²⁰ The Commission acknowledges that the existing NRMSIR system was an improvement over the disclosure regime that was in place prior to its creation. However, we believe that there have been significant improvements in technology that will allow for increased access to municipal disclosure information to investors and others for free via the Internet. This

¹¹⁷ See DPC DATA Letter and SPSE Letter.

¹¹⁸ See DPC DATA Letter, at 1.

¹¹⁹ See DPC DATA Letter, at 2.

¹²⁰ Id.

supports having the MSRB serve as the sole repository. We continue to believe that our rule amendments being adopted today are a significant step forward in fostering greater availability of municipal disclosures to a broad range of market participants, investors, and other individuals and entities, thereby preventing fraud. Moreover, we note that a majority of commenters recognized there were inefficiencies with respect to the current municipal disclosure system and supported the proposed amendments.¹²¹

Another commenter echoed similar sentiments as the commenter above and cited to the Commission's statements in adopting Rule 15c2-12 in 1989 and amendments to the Rule in 1994, which discussed possible anti-competitive concerns regarding the use of a single repository.¹²² This commenter noted that eliminating the NRMSIR function would upset the balance of its current business model and have an impact on its ability to provide value-added products and services.¹²³ The commenter disputed that the potential burdens on competition would be justified by the proposed amendments' adoption because, in its view, the current issues with municipal disclosure lie in the quality and timeliness of the information that is filed.¹²⁴ This commenter also urged the Commission to adopt an alternative approach.¹²⁵ Under this commenter's proposal, the MSRB would not be the sole repository for municipal disclosure information.¹²⁶ Instead, this commenter proposed having an unspecified entity serve as a central electronic post office for municipal disclosure information where "issuers and obligors would file documents through a single electronic format" and such entity "would then forward the

¹²¹ See supra notes 57-64 and accompanying text.

¹²² See SPSE Letter, at 5-7.

¹²³ See SPSE Letter, at 7.

¹²⁴ See SPSE Letter, at 7-8.

¹²⁵ See SPSE Letter, at 3-5.

¹²⁶ See SPSE Letter, at 4.

centrally-filed documents in real time to the NRMSIRs.”¹²⁷ The commenter expressed no opinion regarding the identity of the entity that should serve as the central electronic post office or how such entity would be chosen.¹²⁸

Although two commenters questioned whether the proposed amendments would benefit competition,¹²⁹ the Commission continues to believe that having a single repository will provide the benefits discussed throughout the release and will not have a significant adverse effect on the ability or willingness of private information vendors to compete to create and market value-added data products. Commercial vendors will be able to readily access the information made available by the MSRB to re-disseminate it or use it in whatever value-added products they may wish to provide.¹³⁰ In fact, we believe a single repository in which documents are submitted in an electronic format could encourage the private information vendors to disseminate municipal securities information by reducing the cost of entry into the information services market. We also believe that existing vendors may need to make some adjustments to their infrastructure, facilities, or services offered. However, we believe that some vendors could determine that they no longer will need to invest in the infrastructure and facilities necessary to collect and store continuing disclosure documents, and new entrants into the market will not need to obtain the information from multiple locations, but rather could readily access such information from one

¹²⁷ See SPSE Letter, at 2. See discussion above in Section III.A.1.

¹²⁸ Id.

¹²⁹ See DPC DATA Letter, at 2, and SPSE Letter, at 6-8.

¹³⁰ In addition to making available such information on the MSRB's Web site through EMMA, the MSRB has indicated that it will make continuing disclosure documents available by subscription for a fee to information vendors and other bulk data users on terms that will promote the development of value-added services by subscribers for use by market participants. See MSRB EMMA Proposal, 73 FR at 46163. The fees for this subscription service will be subject to a proposed rule change to be filed with the Commission under Section 19(b) of the Exchange Act.

centralized source. Thus, we believe that all vendors should be able to obtain easily continuing disclosure documents and should be able to compete in providing value-added services.

We previously stated that we would specifically consider the competitive implications of the MSRB becoming a repository.¹³¹ In addition, we stated that if we were to conclude that the MSRB's status as a repository might have adverse competitive implications, we would consider whether we should take any action to address these effects.¹³² As noted earlier, we recognize that competition with respect to certain information services regarding municipal securities that are provided by the existing NRMSIRs could decline should the MSRB become the central repository. Two commenters suggested in their comment letters that a decrease in competition could occur as a result of the Commission's rulemaking.¹³³ As discussed in more detail above and in the Proposing Release, circumstances have changed since we last considered Rule 15c2-12 amendments in 1994. For example, technology developments have facilitated access to information and access to municipal information typically is subject to a fee and can be difficult for individuals to obtain. Further, the NRMSIRs did not develop a system of linkages with each other. We continue to believe that one of the benefits in having the MSRB as the sole repository will be the MSRB's ability to provide a ready source of continuing disclosure documents to other information vendors who wish to use that information for their products. Private vendors could utilize the MSRB in its capacity as a repository as a means to collect information from the continuing disclosure documents to create value-added products for their customers.¹³⁴

¹³¹ See Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333 (June 7, 1990) (File No. SR-MSRB-89-9).

¹³² Id.

¹³³ See DPC DATA Letter and SPSE Letter.

¹³⁴ The Commission notes that two commenters raised concerns with the potential subscription fees associated with having the MSRB as the single repository. The

With respect to concerns that the MSRB could control private vendors' access to information through unfair fee structures and biased dissemination of information, we note that, as an SRO, the MSRB will need to file its fee changes and rule proposals relating to its EMMA system with the Commission under Section 19(b) of the Exchange Act. When the Commission publishes any such proposed rule changes, interested parties will have the opportunity to comment and bring to our attention any potential issues that they discern.

We do not believe that there are competitive implications that would uniquely apply to the MSRB in its capacity as the sole repository. As we have noted, we believe the MSRB's status as an SRO will provide an additional level of Commission oversight since changes to its rules relating to continuing disclosure documents will have to be filed for Commission consideration as a proposed rule change under Section 19(b) of the Exchange Act. Accordingly, we believe that any competitive impact that may result from the MSRB's status as the sole repository is justified by the benefits that such status is expected to provide to investors, broker-dealers, mutual funds, vendors of municipal information, municipal security analysts, other market professionals, and the public generally.

4. Electronic Document Submission

Because the current environment differs markedly from the time when Rule 15c2-12 was adopted in 1989 and subsequently amended in 1994, we believe that it is appropriate to adopt an approach that utilizes the significant technological advances, such as the development and use of various electronic formats, which have occurred in the intervening years. Thus, we are adopting

Commission notes that the MSRB will be required to file a proposed rule change with the Commission pursuant to Section 19(b) of the Exchange Act regarding any subscription fees for a data stream that it proposes as well as any changes to those fees.

the proposed amendments that specify that continuing disclosure documents must be provided to the MSRB in an electronic format as specified by the MSRB.¹³⁵

We believe that this method of submission will better enable the information to be promptly posted by the single repository and made available to the public without charge. Electronic submission also will eliminate the need for manual handling of paper documents, which can be a less efficient and more costly process. For instance, the submission of paper documents would require the repository to manually review, sort and store such documents. There is also a potential for a less complete record of continuing disclosure documents at the repository if such documents are submitted in paper to the repository and, for instance, are misplaced or misfiled. The Commission believes that submissions in an electronic format will not be burdensome on issuers or other obligated persons, since many continuing disclosure documents already are being created in an electronic format and, as a result, are readily transmitted by electronic means.

We requested comment on the proposed amendments to provide continuing disclosure documents in an electronic format, including whether submitting continuing disclosure documents in an electronic format would increase the efficiency of submission and availability of continuing disclosure documents, and whether submitting the documents in an electronic format would facilitate wider availability of the information. Furthermore, we requested comment concerning whether the proposed amendments should allow for the submission of paper documents and, if so, whether any conditions should be imposed in connection with paper

¹³⁵ We note that the MSRB will be required to file a proposed rule change with the Commission pursuant to Section 19(b) of the Exchange Act regarding the electronic format that it wishes to prescribe as well as any changes to that format. In fact, the MSRB prescribed the format for submissions of continuing disclosure documents in a recent filing with the Commission. See MSRB EMMA Proposal, supra note 12.

submissions. Comments also were requested on whether the proposed amendments should allow for the availability of paper copies upon request from the central repository.

The commenters who addressed this topic supported the proposal that, under continuing disclosure agreements, continuing disclosure documents must be provided in an electronic format.¹³⁶ These commenters generally expressed the opinion that the current disclosure system, which relies on paper-based filings, should be updated in light of today's use of, and advances in, technology and that the electronic submission of documents would better enable the information to be promptly submitted, categorized, and posted on the Internet for investor use. In addition, one commenter noted that "the proposed amendments provide for necessary flexibility in changes to technology by delegating to the MSRB the authority to determine electronic formatting and identifying information."¹³⁷ Further, one commenter mentioned that, while some issuers, especially smaller issuers, may have to purchase new software in order to submit electronic documents, the overall long-term savings that an electronic-based central repository would provide would benefit state and local governments and authorities.¹³⁸ However, as discussed in Section III.A.6. below, two commenters expressed the opinion that smaller issuers may need additional time to adapt to the need to obtain documents in an electronic format.¹³⁹ No commenters suggested that the MSRB should accept paper documents.

Two commenters¹⁴⁰ urged the implementation of an interactive data format (i.e., XBRL) for EMMA. In the Proposing Release, we noted that the availability of audited financial

¹³⁶ See Vanguard Letter, IAA Letter, e-certus Letter, NASACT Letter, ICI Letter, Multiple-Markets Letter, NFMA Letter, EDGAR Online Letter, SPSE Letter and DAC Letter.

¹³⁷ See SIFMA Letter, at 3.

¹³⁸ See GFOA Letter, at 2.

¹³⁹ See NASACT Letter, at 2, and GFOA Letter, at 2.

¹⁴⁰ See e-certus Letter, at 2, and EDGAR Online Letter, at 6.

statements and other financial and statistical data in an electronic format by issuers and obligated persons could encourage the establishment of the necessary taxonomies and permit states and local governments and other obligated persons to make use of XBRL in the future, should they wish to do so.¹⁴¹ The final amendments to the Rule do not designate the electronic format or formats that EMMA will accept; instead, they provide that the MSRB will prescribe the format, which will be subject to the Section 19(b) rule filing process. Nevertheless, we note that this provision allows flexibility for future implementation of improved methods for the electronic presentation of information.

One commenter stated that the design of the electronic filing format should be entrusted to a joint industry committee.¹⁴² This commenter further noted its belief that the notice and comment process would not be an adequate substitute for a joint industry working group because it would not permit ongoing dialogue.¹⁴³ While we do not believe that a joint industry committee is the only method by which the electronic filing format could be determined, we do believe that the notice and comment process is necessary to allow issuers, obligated persons and others a method for providing input in the determination of the electronic filing format. The Commission notes that our rule amendments do not preclude the formation of a joint industry committee that would be able to work with the MSRB in designing the electronic filing format. In addition, we expect that the MSRB would welcome an ongoing dialogue with those industry participants that wish to provide input on the electronic filing format and any other aspects of the continuing disclosure component of the EMMA system.

¹⁴¹ See Proposing Release, 73 FR at 46144 n.64.

¹⁴² See SPSE Letter, at 9.

¹⁴³ Id.

5. Identifying Information

To enable the continuing disclosure documents to be identified and retrieved accurately, we are adopting new subparagraph (b)(5)(iv) of Rule 15c2-12, as proposed to be amended, to require Participating Underwriters to reasonably determine that the issuer or obligated person has undertaken in writing to accompany continuing disclosure documents submitted to the MSRB with identifying information as prescribed by the MSRB. Similarly, the Commission is adopting a conforming change to subparagraph (d)(2)(ii)(C) of the Rule, relating to the limited undertaking set forth in Rule 15c2-12(d)(2)(ii), to specify that continuing disclosure agreements provide that the relevant continuing disclosure documents shall be provided to the MSRB and shall be accompanied by identifying information as prescribed by the MSRB.¹⁴⁴

We believe that providing identifying information with each submitted document will permit the repository to sort and categorize the document efficiently and accurately. We also anticipate that the inclusion with each submission of the basic information needed to accurately identify the document will facilitate the ability of investors, market participants, and others to reliably search for and locate relevant disclosure documents. Facilitation of the efficient retrieval of information is designed to decrease the possibilities for fraudulent practices. Furthermore, we expect that there will be a minimal burden on Participating Underwriters to comply with this requirement because the only change is that they would need to determine reasonably that issuers and obligated persons have contractually agreed to supply the identifying information prescribed by the MSRB. On the other hand, there will be a significant benefit to investors and other

¹⁴⁴ The MSRB proposed certain identifying information to be required in the MSRB EMMA Proposal, which the Commission is also approving. See *supra* note 12. We note that the MSRB would be required to file a proposed rule change with the Commission pursuant to Section 19(b) of the Exchange Act regarding any additional identifying information and any changes to that information that it wishes to prescribe.

municipal market participants as a result of this amendment because they will be able to more easily retrieve from the MSRB the information that they seek. Indeed, issuers and other obligated persons that choose to submit continuing disclosure documents through some existing dissemination agents and document delivery services already are supplying identifying information with their submissions.¹⁴⁵

The Proposing Release also requested comments regarding supplying identifying information as prescribed by the MSRB and regarding alternative methods that would assist investors and municipal market participants in locating specific information about a municipal security that is submitted under the Rule.

Commenters generally supported requiring Participating Underwriters to reasonably determine that the issuer or obligated person has undertaken in writing to accompany all documents submitted to the MSRB with identifying information as prescribed by the MSRB.¹⁴⁶ In addition, one commenter did not believe that this determination would impose an unreasonable burden on underwriters.¹⁴⁷ The need for such information was generally perceived as essential to permit investors and others to access continuing disclosure documents from the

¹⁴⁵ The commitment by an issuer to provide identifying information exists only if it were included in a continuing disclosure agreement. As a result, issuers submitting continuing disclosure documents pursuant to the terms of undertakings that were entered into prior to the effective date of the final amendments and that did not require identifying information will be able to submit documents without supplying identifying information. Nevertheless, we encourage such issuers to include identifying information when they or their agent submit continuing disclosure documents to the repository. See also Section III.C., infra discussing transition issues.

¹⁴⁶ See, e.g., GFAO Letter, at 2, Vanguard Letter, at 4, SIFMA Letter, at 2, Texas MAC Letter, OMAC Letter, ICI Letter, at 5, Multiple-Markets Letter, at 2-3, NFMA Letter, at 1, and Edgar Online Letter, at 3.

¹⁴⁷ See SIFMA Letter, at 2.

MSRB.¹⁴⁸ Two commenters observed that in order for the EMMA system to sort and categorize disclosure documents efficiently and accurately, submissions to EMMA should include specific identifying information.¹⁴⁹ Two other commenters noted that the need for identifying information is essential.¹⁵⁰ The Commission believes that it is in the interest of issuers and obligated persons to provide accurate indexing information. Moreover, under rule changes in this release and the MSRB Approval Order, identifying information will be required by Commission and MSRB rules. Several commenters suggested specific items of identifying information that should be prescribed by the MSRB or sought clarification about such items.¹⁵¹ Because these comments are pertinent to the MSRB's EMMA proposal, and not to the Commission's adoption of these amendments, they are addressed in the Commission order approving the continuing disclosure document component of the EMMA system.¹⁵²

6. Exemptive Provision

We are amending Rule 15c2-12(d)(2)(ii), as proposed, which provides for a limited exemption from the requirements of paragraph (b)(5) of the Rule, as long as the conditions specified in paragraph (d)(2) are met. The exemption in Rule 15c2-12(d)(2) provides that paragraph (b)(5) of the Rule, which relates to the submission of continuing disclosure documents pursuant to continuing disclosure agreements, does not apply to a primary offering if three conditions are met. These conditions are: (i) the issuer or the obligated person has less than or

¹⁴⁸ See, e.g., Vanguard Letter, at 4, Texas MAC Letter, NFMA Letter, at 2, and ICI Letter, at 5.

¹⁴⁹ See Vanguard Letter, at 4, and NFMA Letter, at 1.

¹⁵⁰ See Texas MAC Letter and OMAC Letter.

¹⁵¹ See, e.g., Edgar Online Letter, at 3, DAC Letter, at 6, Multiple-Markets Letter, at 3, NFMA Letter, at 2, and NAHEFFA Letter, at 2.

¹⁵² See MSRB Approval Order, supra note 12.

equal to \$10 million of debt outstanding;¹⁵³ (ii) the issuer or obligated person has undertaken in a written agreement or contract ("limited undertaking") to provide: (A) upon request to any person or at least annually to the appropriate SID, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available,¹⁵⁴ and (B) to each NRMSIR or to the MSRB, and to the appropriate SID, if any, material event notices;¹⁵⁵ and (iii) the final official statement identifies by name, address and telephone numbers the persons from which the foregoing information, data and notices can be obtained.¹⁵⁶ The rule amendments revise the limited undertaking set forth in 15c2-12(d)(2)(ii)(A) and (B) by deleting references to NRMSIRs and SIDs, and by solely referencing the MSRB.¹⁵⁷ Accordingly, under the amendment to Rule 15c2-12(d)(2)(ii), a Participating Underwriter will be exempt from its obligations under paragraph (b)(5) of the Rule if an issuer or obligated person has agreed in its limited undertaking to provide annual financial information, operating data and material event notices to the MSRB in an electronic format as prescribed by the MSRB, and the exemption's other conditions are met.

¹⁵³ 17 CFR 240.15c2-12(d)(2)(i).

¹⁵⁴ 17 CFR 240.15c2-12(d)(2)(ii)(A).

¹⁵⁵ 17 CFR 240.15c2-12(d)(2)(ii)(B).

¹⁵⁶ Although this provision provides an exemption for Participating Underwriters in a primary offering of municipal securities, as long as its conditions are satisfied, it is commonly referred to as the "small issuer exemption."

¹⁵⁷ See Section III.A.7. infra for a discussion of the deletion from the Rule of references to SIDs.

One commenter stated that the practical effect of the proposed amendments would be the repeal of the small issuer exemption.¹⁵⁸ The commenter stated that, while small issuers receive few requests for continuing disclosure documents from investors, many of these issuers are subject to public disclosure laws and make financial information and operating data publicly available that exceeds that which would be included in an official statement or required of other issuers pursuant to a continuing disclosure agreement under Rule 15c2-12(b)(5). The commenter believed that the practical effect of this proposal would be to cause small issuers to incur increased costs associated with filing such information electronically because they believed that the information may be considerably more extensive than that submitted by other issuers. The commenter suggested that the Commission either retain the small issuer exemption in its current form or delete paragraph (d)(2) of Rule 15c2-12 altogether.

We recognize that one effect of the amendments will be that some small issuers will submit annual financial information and operating data to the MSRB when currently they do not regularly submit such disclosures to any repository. We do not believe that electronically formatting information a small issuer already has and makes publicly available will be a significant burden. Further, we do not believe that the final amendments would result in small issuers providing the voluminous filings the commenter suggests. This amendment does not affect the nature of a Participating Underwriter's obligation to reasonably determine that a small issuer has undertaken to deliver continuing disclosure documents to fulfill the conditions of the exemption; rather, it affects what the Participating Underwriter needs to determine regarding the undertaking with respect to the location where such documents are to be sent. Specifically, the final amendments do not revise the provision limiting the commitment to provide annual

¹⁵⁸ See NABL Letter, at 2.

financial or operating data only if such information is customarily prepared by such obligated person and is publicly available. Furthermore, if a small issuer customarily prepares and makes publicly available information that is more extensive than that provided in the final official statement, the Participating Underwriter may rely on an undertaking that is limited to providing the information that would comprise annual financial information for non-exempt offerings.¹⁵⁹

Under our amendments, a condition of the exemption available to Participating Underwriters now will require the undertaking to provide that annual financial information or operating data, if customarily prepared and publicly available, will be submitted to the MSRB, rather than being supplied only upon request to any person or at least annually to the appropriate SID, if any.¹⁶⁰ Participating Underwriters seeking an exemption from subparagraph (b)(5) would no longer need to reasonably determine that small issuers will provide annual financial information or operating data to any person, upon request, pursuant to the small issuer's undertaking. If such requests are received, small issuers will be able to refer investors or others to the MSRB to obtain the information. Nevertheless, we recognize that today some small issuers that reside in a state without a SID and that historically receive no requests from investors or others for such annual financial information are not obligated by their continuing disclosure agreement to provide this information to each NRMSIR, the MSRB, or any other entity.¹⁶¹ In contrast, as a condition of the exemption, the final amendments will provide that a Participating

¹⁵⁹ See response to question 18 in letter to John S. Overdorff, Chair, and Gerald J. Laporte, Vice-Chair, of the Securities Law and Disclosure Committee of NABL, from Robert L.D. Colby, Deputy Director, Division of Market Regulation, dated June 23, 1995, 1995 SEC No-Act. LEXIS 563.

¹⁶⁰ See Section V.B., *infra* for a discussion of the costs small issuers may incur in connection with submitting continuing disclosure documents to the MSRB.

¹⁶¹ We understand that, in some cases, state laws may provide for the public availability or distribution of such information. However, these requirements vary widely.

Underwriter must reasonably determine that a small issuer undertakes to provide annual financial information, to the extent the issuer prepares it and makes it publicly available, to the MSRB in an electronic format.

At this time, we believe that our proposed amendment of the small issuer exemption is preferable to the commenter's alternative suggestion to eliminate the small issuer exemption altogether.¹⁶² We note that the final amendments do not alter the provision that specifies that the undertaking by small issuers to provide annual financial information or operating data need be satisfied only to the extent that such information is customarily prepared by the obligated person and is publicly available.¹⁶³ We understand that most small governmental issuers prepare and make publicly available annual financial statements or other financial and operating data as a matter of course. For such issuers, we recognize that the difference between our amendment to the exemption and elimination of the exemption entirely, as a practical matter, may be minimal. However, we note that small obligated persons, such as private conduit borrowers, also benefit from the small issuer exemption. Such obligated persons and some small issuers may not customarily prepare financial and operating data for public availability. We believe that it is preferable to take a measured approach and observe the actual impact of the final amendments before considering elimination of the small issuer exemption entirely. Accordingly, the Commission has determined not to eliminate at this time the small issuer exemption as the commenter suggested.¹⁶⁴

¹⁶² See NABL Letter, at 2.

¹⁶³ 17 CFR 15c2-12(d)(2)(ii)(A).

¹⁶⁴ It is possible that this provision could provide a disincentive to an obligated person to prepare the information and make it publicly available. As noted above, we understand that most small governmental issuers routinely prepare and make publicly available annual financial statements or other financial and operating data, although some small

We believe that the exemptive provision of the amended Rule - that paragraph (b)(5) of the Rule will not apply under the revised conditions described above - is justified despite the increased burden on some small issuers by the amended Rule's objective that this information be more widely available to investors, market professionals, and others. The availability of this information should help brokers to fulfill their obligations and investors to make better informed investment decisions regarding municipal securities, thereby helping to deter fraud in the municipal securities market.

7. SIDs

We are amending subparagraphs (A) through (D) of Rule 15c2-12(b)(5)(i), as proposed to be amended, to delete references to SIDs, in addition to references to each NRMSIR. Thus, Participating Underwriters no longer will need to reasonably determine that issuers or obligated persons have agreed in continuing disclosure agreements to provide continuing disclosure documents to the appropriate SID, if any. We also are revising paragraph (d)(2) of the Rule, which provides for an exemption from paragraph (b)(5) of the Rule if specified conditions are met.¹⁶⁵ The final amendments revise the limited undertaking set forth in Rule 15c2-12(d)(2)(ii) by deleting references to each NRMSIR and the appropriate SID, if any, and solely referencing the MSRB and specifying that the financial information, operating data, and material event notices are to be provided to the MSRB in an electronic format and accompanied by identifying information as prescribed by the MSRB. As noted above, under paragraph (d)(2) of the Rule,

obligated persons, such as private conduit borrowers, may not prepare this information and make it publicly available. We will monitor the extent to which the exemption as currently crafted fosters a disincentive to preparing annual financial information and operating data and making it publicly available and will consider whether any further amendment to the small issuer exemption is warranted.

¹⁶⁵ See Section III.A.6. supra for a discussion of the exemptive provision contained in Rule 15c2-12(d)(2).

Participating Underwriters will be exempt from their obligation under paragraph (b)(5) of the Rule if the issuer or obligated person has agreed in its limited undertaking to provide financial information, operating data, and material event notices to the MSRB in an electronic format and accompanied by identifying information as prescribed by the MSRB, and if the provision's other conditions are met.

We requested comment on the proposal to omit references to the SIDs in the Rule. In particular, comment was requested concerning the impact of removing the references to the SIDs in the Rule, including the impact of this proposal on the obligations of Participating Underwriters, issuers and obligated persons. We also requested comment on the effect of the proposed amendment on SIDs and on their role in the collection and disclosure of continuing disclosure documents.

Five commenters addressed the proposed removal of references to SIDs from the Rule.¹⁶⁶ Four of the commenters stated that the MSRB should provide a data feed to SIDs of documents related to issuers in their states so that those issuers that may be required by their states to send continuing disclosure documents to a SID need not provide them to both the MSRB and a SID.¹⁶⁷ They believed that this approach would be more efficient for both issuers and SIDs and result in more complete and consistent data availability of information from the MSRB and SIDs. Furthermore, two of these commenters expressly indicated that there should be no charge to SIDs to receive such a data feed.¹⁶⁸ One commenter supported the proposal to remove

¹⁶⁶ See GFOA Letter, SIFMA Letter, Texas MAC Letter, OMAC Letter, and Multiple-Markets Letter.

¹⁶⁷ See GFOA Letter, at 3, Texas MAC Letter, OMAC Letter, and Multiple-Markets Letter, at 2.

¹⁶⁸ See GFOA Letter, at 3, and Multiple-Markets Letter, at 3.

references to SIDs from the Rule, noting that there are just three SIDs and that the ease of public access to the MSRB's EMMA system renders specific reference to SIDs, unnecessary.¹⁶⁹

Because we are amending the Rule to provide for a single repository for the electronic collection and availability of continuing disclosure documents that, in our view, will efficiently and effectively improve disclosure in the municipal securities market, we believe that it is no longer necessary to specifically require in the Rule that Participating Underwriters reasonably determine that issuers and obligated persons have contractually agreed to provide continuing disclosure documents to the SIDs or that the provision that provides an exemption from this requirement refer to SIDs. Nevertheless, the amendments will not affect the legal obligation of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, as required under the appropriate state law. In addition, the amendments will have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to the effective date of the amendments to the Rule to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that may be required under the appropriate state law. We agree with the opinions of those commenters who underscored the importance for the document collections of the MSRB and SIDs to be consistent to avoid uneven access to information that otherwise might result. However, the commenters' suggestions relating to data feeds, including free access to such feeds, relate to the operation of the MSRB's continuing disclosure component of the

¹⁶⁹ See SIFMA Letter, at 3.

EMMA system, rather than to the instant rulemaking and therefore are addressed in connection with the MSRB Approval Order.¹⁷⁰

8. Other Amendments

We are adopting a change to Rule 15c2-12(b)(4)(ii), as proposed, which currently refers to a NRMSIR with respect to the time period in which the Participating Underwriter must send the final official statement to any potential customer. Specifically, under Rule 15c2-12(b)(4), from the time the final official statement becomes available until the earlier of: (1) ninety days from the end of the underwriting period; or (2) the time when the official statement is available to any person from a NRMSIR, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in a primary offering is required to send to any potential customer, upon request, the final official statement. We are amending the language in Rule 15c2-12(b)(4)(ii), as proposed, to refer to the MSRB instead of to a NRMSIR.

Accordingly, Participating Underwriters will have the time period from when the final official statement becomes available until the earlier of: (1) ninety days from the end of the underwriting period; or (2) the time when the official statement is available to any person from the MSRB, but in no case less than twenty-five days following the end of the underwriting period, to send the final official statement to a potential customer, upon request.

In addition, we are adopting similar changes to Rule 15c2-12(f)(3) and (f)(9), as proposed, which define the terms “final official statement” and “annual financial information,” respectively. Rule 15c2-12(f)(3) defines the term “final official statement” to mean a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter and that sets forth information

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As noted above, the MSRB is required to file any new fees or changes to its fees with the Commission under Section 19(b) of the Exchange Act.

concerning, among other things, financial information or operating data concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the offering. Rule 15c2-12(f)(9) defines the term "annual financial information" to mean financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Both definitions allow for financial information or operating data to be set forth in the document or set of documents, or be included by specific reference to documents previously provided to each NRMSIR, and to a SID, if any, or filed with the Commission. We are amending Rule 15c2-12(f)(3) and (f)(9), as proposed, to replace references to each NRMSIR and the appropriate SID, if any, with references to the MSRB's Internet Web site. Accordingly, the amendments to paragraphs (f)(3) and (f)(9) of the Rule will allow issuers to reference financial information or operating data set forth in specified documents available to the public from the MSRB's Internet web site (or filed with the Commission) as part of the final official statements and annual financial information, instead of referencing specific documents previously provided to each NRMSIR and SID.

We received one comment letter that addressed the proposed amendment to the definition of "final official statement."¹⁷¹ The commenter expressed technical concerns regarding the first sentence of paragraph (f)(3), noting that issuers obligated by undertakings made before the

¹⁷¹ See NABL Letter, at 2-3.

effective date of the final amendments would not have entered into a "written contract or agreement specified in paragraph (b)(5)(i)" (because paragraph (b)(5)(i) currently requires different terms of the continuing disclosure undertaking). However, we have not made the change suggested in the comment letter because we do not believe that it is necessary. We believe that the amendment as adopted makes clear that, in reporting any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of the Rule failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of the Rule, a final official statement must include any such failures over such period with respect to both written contracts or agreements entered into in conformance with paragraph (b)(5)(i) of the Rule prior to the effective date of the amendments and written contracts or agreements entered into in conformance with paragraph (b)(5)(i) of the Rule as amended.

B. Other Comments

Two commenters¹⁷² questioned the Commission's authority to adopt the proposed amendments in light of the provisions of Section 15B(d) of the Exchange Act, commonly referred to as the "Tower Amendment."¹⁷³ One of the commenters stated its belief that the

¹⁷² See SPSE Letter, at 12-15, and DPC DATA Letter, at 1.

¹⁷³ The so-called "Tower Amendment," added Section 15B(d), 15 U.S.C. 78o-4(d) to the Exchange Act. It states: "(1) Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities. (2) The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: Provided, however, That the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers

Tower Amendment prohibits federal regulation of state issuers; the proposed amendments place “de facto regulatory power in the hands of a federal regulatory body;” and “the body in whose hands regulatory power is placed is a group constituted of those who stand to profit from underwriting of state-issued securities.”¹⁷⁴ The other commenter stated that the proposed amendments, in combination, with the MSRB’s EMMA Proposal, go further than the 1994 Amendments into the area protected by the Tower Amendment, because they establish, as the sole repository, a single Commission-supervised body, the MSRB, that is also subject to the Tower Amendment.¹⁷⁵ In addition, this commenter stated a belief that because the proposed amendments and the MSRB’s related rule filing “are akin to a joint initiative between the SEC and the MSRB,” they should be subject to the limits of both provisions of Section 15B(d). Because the commenter questions whether the Commission’s and MSRB’s proposals would in fact improve the availability of municipal securities disclosure, it believed that it is “even harder to link the [proposed amendments and related MSRB rule filing] to preventing fraud, which is the basis for the Commission’s authority.”¹⁷⁶

Three commenters that supported the proposed amendments expressed their concern about any actions that would allow the Commission to impose disclosure requirements on issuers.¹⁷⁷ One of these commenters, however, expressly noted that “the proposal’s sole purpose

or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title.” 15 U.S.C. 78o-4(d).

¹⁷⁴ See DPC DATA Letter, at 1.

¹⁷⁵ See SPSE Letter, at 14.

¹⁷⁶ See SPSE Letter, at 14.

¹⁷⁷ See GFOA Letter, at 1, NASACT Letter, at 2, and NAHEFFA Letter, at 2.

of having the MSRB operate a system to accept and post disclosure documents does not violate the Tower Amendment.”¹⁷⁸

As we have noted in the past,¹⁷⁹ with the passage of the Securities Acts Amendments of 1975 (“1975 Amendments”), Congress provided for a limited regulatory scheme for municipal securities.¹⁸⁰ Prior to the passage of the 1975 Amendments, municipal issuers were exempt from the registration and continuous reporting provisions of both the Securities Act of 1933¹⁸¹ and the Exchange Act. While municipal issuers continued to be exempt from all but the antifraud provisions of the federal securities laws, the 1975 Amendments required the registration of municipal securities brokers and dealers,¹⁸² and established the MSRB,¹⁸³ granting it the authority to promulgate rules governing the sale of municipal securities effected by brokers, dealers and municipal securities dealers.

While narrowly tailoring the authority of the MSRB to require that disclosure documents be provided to investors, Congress was careful to preserve the authority of the Commission under Section 15(c)(2) of the Exchange Act.¹⁸⁴ Section 15B(d)(2) expressly indicates that “[n]othing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title.”¹⁸⁵ Thus, while prohibiting the Commission from requiring

¹⁷⁸ See GFOA Letter, at 3.

¹⁷⁹ See 1994 Proposing Release, *supra* note 113.

¹⁸⁰ The Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (June 4, 1975).

¹⁸¹ 15 U.S.C. 77a *et seq.*

¹⁸² 15 U.S.C. 78o-4(a)(1).

¹⁸³ 15 U.S.C. 78o-4(b)(1).

¹⁸⁴ 15 U.S.C. 78o(c)(2).

¹⁸⁵ 15 U.S.C. 78o-4(d)(2).

municipal issuers to file reports or documents prior to issuing securities in Section 15B(d)(1),¹⁸⁶ Congress expanded the Commission's authority to adopt rules reasonably designed to prevent fraud. The Commission does not believe the amendments to Rule 15c2-12 are inconsistent with the limitations in Exchange Act Section 15B(d). As discussed in detail throughout this release, as well as the Proposing Release, the Commission believes that the amendments to Rule 15c2-12 are consistent with its Congressional mandate to, among other things, adopt rules reasonably designed to prevent fraud in the municipal securities market.¹⁸⁷ It is important for investors, market professionals, analysts, and others to have access to complete and timely descriptive information about municipal securities and municipal securities issuers. The proposed amendments are expected to improve access to information about municipal securities for those who effect transactions in the municipal markets. Better access to the disclosure is designed to allow them to compare that information against any other information disseminated with respect to municipal securities. In furtherance of the fundamental purpose of Rule 15c2-12, this accessibility should allow these market participants to more easily detect potentially fraudulent information. Finally, we do not believe that this Commission rulemaking implicates Section 15B(d)(2), which applies only to the MSRB. Indeed, this rulemaking comports with Section 15B(d)(2)'s explicit reservation of the Commission's authority under the Exchange Act to, among other things, promulgate regulations reasonably designed to prevent fraud, thereby protecting investors and preserving the integrity of the market for municipal securities.

¹⁸⁶ 15 U.S.C. 78o-4(d)(1).

¹⁸⁷ Rule 15c2-12 was adopted under a number of Exchange Act provisions, including Section 15(c); 15 U.S.C. 78o(c).

C. Transition

The amendments to Rule 15c2-12 will require Participating Underwriters to reasonably determine whether continuing disclosure agreements for primary offerings occurring on or after the effective date of the amendments comply with the provisions of the amendments, including containing a specific reference to the MSRB as the sole repository to receive an issuer's or obligated person's continuing disclosure documents. Commenters generally confirmed that an issue exists with respect to the handling of continuing disclosure documents submitted under continuing disclosure agreements entered into by issuers and obligated persons prior to the effective date of the final rule amendments.¹⁸⁸ To address issues that may arise if continuing disclosure documents submitted pursuant to existing continuing disclosure agreements must be filed in different locations from those documents submitted in connection with offerings occurring on or after the amendments' effective date, we requested comment on directing Commission staff to withdraw the "no action" letters provided to the current NRMSIRs and designating the MSRB as the sole NRMSIR.¹⁸⁹

While some commenters¹⁹⁰ supported this approach, others advocated various alternative transition processes.¹⁹¹ For example, one commenter suggested that the Commission could require any continuing disclosure made pursuant to the amended Rule provide that issuers make filings with the MSRB electronically with respect to new undertakings and all undertakings

¹⁸⁸ See, e.g., ICI Letter, at 4, NABL Letter, at 1-2, SPSE Letter, at 15, and Vanguard Letter, at 3.

¹⁸⁹ See Proposing Release, 73 FR at 46146.

¹⁹⁰ See SIFMA Letter, at 3-4, ICI Letter, at 3-4, and Vanguard Letter, at 2-3.

¹⁹¹ See GFOA Letter, at 3, NABL Letter, at 1-2, NASACT Letter, at 2, and NFMA Letter, at 1.

previously entered into by such issuers.¹⁹² In the alternative, this commenter suggested that the Commission issue an interpretive letter stating that an issuer that chooses to satisfy existing undertakings (namely, that documents be provided to NRMSIRs and SIDs) by transmitting them to the MSRB would be acting in a manner consistent with the Rule as amended.¹⁹³ Another commenter supported the proposed alternative approaches.¹⁹⁴ The Commission observes that under the commenter's primary suggestion, the Commission in effect would mandate the amendment of existing contracts without the parties' consent. We do not believe that it would be appropriate to interfere with the terms of existing contracts, which were the subject of negotiation among the parties. In addition, we note that the submission to the MSRB of continuing disclosure documents for past offerings would not occur until a subsequent offering occurs. As many issuers and obligated persons do not offer securities annually – many do so only occasionally – there would be a potentially lengthy period during which some issuers would supply continuing disclosure documents to the MSRB, while others would continue to supply them to the NRMSIRs and SIDs under existing continuing disclosure agreements. The commenter's suggested alternative, that the Commission issue an interpretive letter stating that an issuer or obligated person that chooses to satisfy an existing undertaking by transmitting documents to the MSRB would be acting in a manner consistent with the Rule, as amended, would also be inappropriate because it would ignore the plain meaning of those existing contracts that require continuing disclosure documents to be provided to NRMSIRs and SIDs.

We believe that it would be inefficient, confusing and burdensome for issuers to submit continuing disclosure documents for offerings that occurred prior to the effective date of the final

¹⁹² See NABL Letter, at 1-2.

¹⁹³ Id.

¹⁹⁴ See GFOA Letter, at 3.

amendments to different locations than for offerings occurring afterwards. Moreover, having such a bifurcated system would not be in the best interests of investors and others who seek information about municipal issuers because it could result in the MSRB collecting only a portion of new information. We believe that one commenter's suggestion that new continuing disclosure agreements amend all prior disclosure agreements of the same issuer would incorporate existing continuing disclosure into the new centralized system only if and when an issuer returns to the market, and therefore is not as effective a transition mechanism as the Commission's approach.

We believe that it will be more efficient and effective to implement a sole repository expeditiously. In our view, this can best be accomplished by creating a mechanism by which issuers or obligated persons may comply with their existing undertakings by submitting their continuing disclosure documents to one location, thereby providing investors and municipal market participants with prompt and easy access to continuing disclosure documents at no charge. Our proposed approach to withdraw the "no action" letters to the existing NRMSIRs and have the MSRB be the sole NRMSIR for the submission of continuing disclosure documents pursuant to continuing disclosure agreements entered into prior to the effective date of the final amendments was supported by a number of commenters who addressed this issue.¹⁹⁵ We believe that, given the MSRB's proposal to implement the continuing disclosure feature of its EMMA system that we are approving today, it is reasonable and sensible for the MSRB also to serve as the sole NRMSIR.

¹⁹⁵ See ICI Letter, at 4, SIFMA Letter, at 4, and Vanguard Letter, at 3.

Accordingly, the Commission has determined to implement the approach that it outlined in the Proposing Release.¹⁹⁶ We hereby direct Commission staff to withdraw all “no action” letters recognizing existing NRMSIRs¹⁹⁷ as of 12:00 midnight (ET) of the day preceding the effective date of the final amendments to Rule 15c2-12. In addition, by amending Rule 15c2-12, we are designating the MSRB as the sole NRMSIR. Consequently, beginning on the effective date of the final amendments, continuing disclosure documents that are provided pursuant to existing continuing disclosure agreements – i.e., those agreements entered into prior to the effective date of the final amendments (which typically reference the NRMSIRs as locations to which a submission should be made) – should be provided to the MSRB in its capacity as the sole NRMSIR.¹⁹⁸ Providing all submissions – for both past and future offerings – to the same location is expected to be less confusing to, and is expected to simplify the submission process for, issuers and other obligated persons subject to continuing disclosure agreements, as well as to investors and others who wish to obtain such information.¹⁹⁹

¹⁹⁶ See Proposing Release, 73 FR at 46146.

¹⁹⁷ See Letters from Brandon Becker, Director, Division of Market Regulation (n/k/a Division of Trading and Markets), Commission, to: Michael R. Bloomberg, President, Bloomberg L.P., dated June 26, 1995, and Aaron L. Kaplow, Vice President, Kenny S&P Information Services, dated June 26, 1995; and Letters from Robert L.D. Colby, Deputy Director, Division of Market Regulation (n/k/a Division of Trading and Markets), Commission, to: Peter J. Schmitt, President, DPC DATA, dated June 23, 1997, and John King, Chief Operating Officer, Interactive Data, dated December 21, 1999.

¹⁹⁸ Issuers or obligated persons with existing limited undertakings under Rule 15c2-12(d)(2)(ii)(B) that reference the MSRB rather than the NRMSIRs as the location to submit material event notices would not be affected by this approach because they would continue to submit such notices to the MSRB as stated in their limited undertaking. However, issuers or obligated persons with existing limited undertakings that reference the NRMSIRs as the location to submit material event notices would provide such notices to the MSRB in its capacity as the sole NRMSIR.

¹⁹⁹ We note that this approach will result in issuers located in the three states with SIDs providing continuing disclosure documents for undertakings entered into prior to the effective date of the final amendments to both the MSRB and the appropriate SID. This

To assist issuers and obligated persons during the period between the date the Commission adopts the amendments and their effective date, municipal advisers and lawyers may wish to consider noting to their clients that the MSRB will become the only NRMSIR on the effective date and that all continuing disclosure documents should thereafter be provided to the MSRB alone. We note that the MSRB has indicated plans for an extensive outreach program to educate issuers and other obligated persons regarding use of its EMMA system's continuing disclosure service and to assist filers who have been accustomed to providing paper documents, which should help further alleviate the potential for transitional problems.²⁰⁰

In determining that the MSRB should become the sole NRMSIR on the effective date of the final amendments, we considered the continued accessibility to the public of the documents provided to the existing NRMSIRs. In the Proposing Release, we sought comment on whether there are concerns that the NRMSIRs would not retain the historical continuing disclosure documents and whether commenters anticipate any problems in obtaining such documents from the current NRMSIRs, if they were no longer recognized as such. In addition, we requested that, if commenters foresaw any such problems, they suggest alternative approaches for the retention of and access to historical information.

One NRMSIR requested that, in the event that the Commission determined no longer to designate it as a NRMSIR, it not have any continuing obligation to serve as a NRMSIR for existing documents and historical documents.²⁰¹ However, other commenters expressed a

situation is unavoidable even though SIDS no longer will be referenced in the Rule as amended, because the obligation to provide documents to the appropriate SID under existing agreements is not being affected as a result of our direction to withdraw outstanding "no action" letters to the NRMSIRs and designating the MSRB as the sole NRMSIR for purposes of outstanding continuing disclosure agreements.

²⁰⁰ See MSRB EMMA Proposal, *supra* note 12, 73 FR at 46165.

²⁰¹ See SPSE Letter, at 15.

concern that such documents might not remain accessible.²⁰² The Commission understands that each NRMSIR is an information vendor that has been in that business for a number of years.²⁰³ While Rule 15c2-12, as amended, will no longer contemplate use of the current NRMSIRs for future continuing disclosure documents from issuers and obligated persons after the effective date of the final amendments, the Commission believes that the current NRMSIRs could determine it is in their interest to continue to provide public access to the continuing disclosure documents they obtained while serving as NRMSIRs, in order to be able to earn revenue from their respective collections. As a practical matter, requests for such documents from the NRMSIRs by those who are not already subscribers to their services may be expected to decline over time, because more current continuing disclosure documents will become available without charge from the MSRB.

We also requested comment on any issues or problems that could arise if investors seek to obtain and compare information from multiple repositories -- e.g., historical continuing disclosure documents from the NRMSIRs and current continuing disclosure documents from the MSRB-- and whether there are any alternative methods that would allow them to obtain complete information about municipal securities, including obtaining historical information. Two commenters, however, favored transferring continuing disclosure information to the MSRB if the NRMSIRs do not retain historical documents.²⁰⁴

We note that transitional issues regarding access to continuing disclosure documents generally are time limited. Investors presumably desire to obtain information for only the most recent years. Further, since final official statements of offerings subject to the Rule must

²⁰² See Vanguard Letter, at 3, and ICI Letter, at 4.

²⁰³ See supra note 197.

²⁰⁴ See ICI Letter, at 4, and Vanguard Letter, at 3.

disclose the failures of an issuer or obligated person to comply with continuing disclosure undertakings only for the previous five years,²⁰⁵ Participating Underwriters presumably do not desire access to older information. The Commission believes that the benefits that it anticipates in connection with the final amendments justify the transitory challenges of the Rule's conversion from the NRMSIR model to a model in which the MSRB will be the sole repository.

Some commenters advocated a short transition period²⁰⁶ whereas other commenters stressed that the Commission should allow sufficient time to allow small issuers to prepare for an electronic-only process.²⁰⁷ We have established July 1, 2009 as the effective date of these amendments.²⁰⁸ We believe that the approximately eight month period will be adequate to address commenters' concerns regarding the need for adequate time for issuers to become informed about the MSRB's new role as the only NRMSIR; become familiar with the continuing disclosure component of EMMA; arrange to obtain necessary documents in or convert such documents into the electronic format designated by the MSRB; and generally adapt their policies and procedures for providing continuing disclosure documents.

IV. Paperwork Reduction Act

The Rule, as amended, contains "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").²⁰⁹ In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission submitted revisions to the currently approved

²⁰⁵ See Rule 15c2-12(f)(3), 17 CFR 15c2-12(f)(3).

²⁰⁶ See NFMA Letter, at 1, and Vanguard Letter, at 3.

²⁰⁷ See GFOA Letter, at 2, and NASACT, at 2.

²⁰⁸ Because commenters also addressed the proper length of the transition period in the context of the MSRB EMMA Proposal, we also are addressing the issue in the MSRB Approval Order, supra note 12.

²⁰⁹ 44 U.S.C. 3501 et. seq.

collection of information titled "Municipal Securities Disclosure" (17 CFR 240.15c2-12) (OMB Control No. 3235-0372) to the Office of Management and Budget ("OMB"). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. In the Proposing Release, the Commission solicited comments on the collection of information requirements. The Commission noted that the estimates of the effect that the proposed amendments to the Rule would have on the collection of information were based on data from various sources, including the most recent PRA submission for Rule 15c2-12, the MSRB, and municipal industry participants. Although the Commission received twenty-three comment letters on the proposed rulemaking, none of the commenters addressed the estimates regarding its collection of information aspects. After further consideration, the Commission has refined the cost estimate that issuers could incur to obtain technology resources. The Commission continues to believe that all other burden estimates provided in the Proposing Release are appropriate.

A. Summary of Collection of Information

Prior to these amendments, under paragraph (b) of Rule 15c2-12, a Participating Underwriter is required: (1) to obtain and review an official statement "deemed final" by an issuer of the securities, except for the omission of specified information, prior to making a bid, purchase, offer, or sale of municipal securities; (2) in non-competitively bid offerings, to send, upon request, a copy of the most recent preliminary official statement (if one exists) to potential customers; (3) to send, upon request, a copy of the final official statement to potential customers for a specified period of time; (4) to contract with the issuer to receive, within a specified time, sufficient copies of the final official statement to comply with the Rule's delivery requirement, and the requirements of the rules of the MSRB; and (5) before purchasing or selling municipal

securities in connection with an offering, to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of holders of such municipal securities, to provide annual filings, material event notices, and failure to file notices (i.e., continuing disclosure documents) to each NRMSIR (or, alternatively, to the MSRB in the case of material event notices and failure to file notices).²¹⁰ Under the Rule, as amended, Participating Underwriters will be required to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide continuing disclosure documents to the MSRB, in an electronic format and accompanied by identifying information, in each case as prescribed by the MSRB. The final rule amendments will not substantively change any of the current obligations of Participating Underwriters, except to the extent that Participating Underwriters will have to reasonably determine that the issuer or obligated person has agreed in the continuing disclosure agreement to provide continuing disclosure documents to a single repository, i.e., the MSRB, instead of to multiple NRMSIRs.

The final amendments also will revise Rule 15c2-12(d)(2)(ii), which is part of an exemptive provision from the requirements of Rule 15c2-12(b)(5). Prior to the amendments adopted today, the exemption in Rule 15c2-12(d)(2) provided that paragraph (b)(5) of the Rule, which relates to the submission of continuing disclosure documents pursuant to continuing disclosure agreements, would not apply to a primary offering if three conditions were met: (1) the issuer or the obligated person has \$10 million or less of debt outstanding;²¹¹ (2) the issuer or obligated person has undertaken in a written agreement or contract to provide: (A) financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, including financial information and

²¹⁰ 17 CFR 240.15c2-12(b).

²¹¹ 17 CFR 240.15c2-12(d)(2)(i).

operating data which is customarily prepared by such obligated person and is publicly available, upon request to any person or at least annually to the appropriate SID,²¹² and (B) material event notices to each NRMSIR or the MSRB, as well as the appropriate SID;²¹³ and (3) the final official statement identifies by name, address and telephone number the persons from which the foregoing information, data and notices can be obtained. The final amendments revise the limited undertaking set forth in 15c2-12(d)(2)(ii)(A) and (B) by deleting references to the NRMSIRs and SIDs and solely referencing the MSRB. Accordingly, under the amendment to Rule 15c2-12(d)(2)(ii), a Participating Underwriter will be exempt from its obligations under paragraph (b)(5) of the Rule if an issuer or obligated person has agreed in its limited undertaking to provide financial information, operating data and material event notices to the MSRB in an electronic format as prescribed by the MSRB, and the exemption's other conditions are met.

B. Use of Information

The final amendments will provide for a single repository that receives submissions in an electronic format to encourage a more efficient and effective process for the collection and availability of continuing disclosure documents. The final amendments are intended to improve the availability of continuing disclosure documents that provide current information about municipal issuers and their securities. As a result, investors and other municipal securities market participants should be able to have ready and prompt access to the continuing disclosure documents of municipal securities issuers. This information could be used by retail and institutional investors; underwriters of municipal securities; other market participants, including broker-dealers and municipal securities dealers; municipal securities issuers; vendors of

²¹² 17 CFR 240.15c2-12(d)(2)(ii)(A).

²¹³ 17 CFR 240.15c2-12(d)(2)(ii)(B).

information regarding municipal securities; the MSRB and its staff; Commission staff; and the public generally.

C. Respondents

The final amendments require that a Participating Underwriter in a primary offering of municipal securities reasonably determine that the issuer or an obligated person has undertaken in a continuing disclosure agreement to submit specified continuing disclosure documents to the MSRB in an electronic format and accompanied by identifying information, as prescribed by the MSRB. In the Proposing Release, we estimated that the respondents impacted by the paperwork collection associated with the Rule would consist of: 250 broker-dealers, 10,000 issuers, and the MSRB. The Commission included this estimated number of respondents in the Proposing Release and received no comments on this estimate. The Commission continues to believe that these estimates are appropriate.

D. Total Annual Reporting and Recordkeeping Burden

We estimate the aggregate information collection burden for the amended Rule to consist of the following:

1. Broker-Dealers

We estimate that the Rule, as amended, will impose a paperwork collection burden for 250 broker-dealers and will require each of these broker-dealers an average burden of one hour per year to comply with the Rule. This burden accounts for the time it will take a broker-dealer to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of holders of such municipal securities, to provide annual filings, material event notices, and failure to file notices (i.e., continuing disclosure documents) to the MSRB.

In addition, we estimate that a broker-dealer will incur a one-time paperwork burden to have its internal compliance attorney prepare and issue a notice advising its employees who work on primary offerings of municipal securities about the final amendments to Rule 15c2-12. We estimate that it will take the internal compliance attorney approximately 30 minutes to prepare a notice describing the broker-dealer's obligations in light of the revisions to the Rule. The task of preparing and issuing a notice advising the broker-dealer's employees about the adopted amendments is consistent with the type of compliance work that a broker-dealer typically handles internally. Accordingly, we estimate that 250 broker-dealers each will incur a one-time, first-year burden of 30 minutes to prepare and issue a notice to its employees regarding the broker dealer's obligations under the adopted amendments.

Therefore, under the final amendments, the total burden on broker-dealer respondents will be 375 hours for the first year²¹⁴ and 250 hours for each subsequent year.²¹⁵ The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

2. Issuers

The Commission believes that issuers prepare annual filings and material event notices as a usual and customary practice in the municipal securities market. Issuers' undertakings regarding the submission of annual filings, material event notices, and failure to file notices that are set forth in continuing disclosure agreements contemplated by the Rule impose a paperwork burden on issuers of municipal securities. We estimate that, in connection with the final

²¹⁴ (250 (maximum estimate of broker-dealers impacted by the final amendments) x 1 hour) + (250 (maximum estimate of broker-dealers impacted by the final amendments) x .5 hour (estimate for one-time burden to issue notice regarding broker-dealer's obligations under the final amendments)) = 375 hours.

²¹⁵ 250 (maximum estimate of broker-dealers impacted by the final amendments) x 1 hour = 250 hours.

amendments to the Rule, 10,000 municipal issuers with continuing disclosure agreements will prepare approximately 12,000 to 15,000 annual filings yearly.²¹⁶

The Rule, as amended, provides that, under continuing disclosure agreements, continuing disclosure documents are to be submitted electronically to the MSRB, but does not revise the categories of persons who can submit the documents. Issuers can continue to submit continuing disclosure documents directly to the repository or can do so indirectly through an indenture trustee or a designated agent. An issuer might engage the services of a designated agent as a matter of convenience to advise it of the timing and type of continuing disclosure documents that need to be submitted to the repository. We estimate that approximately 30% of issuers will utilize the services of a designated agent to submit disclosure documents to the MSRB.

We estimate that, under the final amendments, an issuer will take approximately 45 minutes to submit an annual filing to the MSRB in an electronic format and accompanied by identifying information. This estimate includes approximately 30 minutes to prepare the annual filing, which is consistent with the prior paperwork collection associated with the Rule, plus a new burden of an additional 15 minutes to convert the information into an electronic format and add any identifying information that the repository may prescribe. Therefore, under the final amendments, the total burden on issuers of municipal securities to submit 15,000 annual filings to the MSRB is estimated to be 11,250 hours.²¹⁷

We estimate that, under the final amendments, the MSRB annually will receive approximately 50,000 to 60,000 notices of the occurrence of a material event.²¹⁸ We also

²¹⁶ The estimate for the number of annual filings includes the submission of annual financial information or operating data described in Rule 15c2-12(d)(2)(ii)(A).

²¹⁷ 15,000 (maximum estimate of annual filings) x 45 minutes = 11,250 hours.

²¹⁸ This estimate for material event notices includes the submission of material event notices described in Rule 15c2-12(d)(2)(ii)(B).

estimate that, under the final amendments, an issuer will take approximately 45 minutes to submit a material event notice to the MSRB in an electronic format and accompanied by identifying information. This estimate includes approximately 30 minutes to prepare the material event notice, which is consistent with the prior paperwork collection associated with the Rule, plus an additional 15 minutes to convert the information into an electronic format and add any identifying information that the repository may prescribe. Therefore, under the final amendments, the total burden on issuers to submit material event notices to the MSRB will require 45,000 hours.

We estimate that, under the final amendments, the MSRB annually will receive approximately 1,500 to 2,000 failure to file notices. We also estimate that, under the final amendments, an issuer will take approximately 30 minutes to submit a failure to file notice to the MSRB in an electronic format and accompanied by identifying information. This estimate includes approximately 15 minutes to prepare the failure to file notice, plus an additional 15 minutes to convert the information into an electronic format and add any identifying information that the repository would prescribe. Therefore, under the adopted amendments, the total burden on issuers to prepare and submit failure to file notices to the MSRB will be 1,000 hours.²¹⁹ Thus, the estimated 1,000 hours to prepare and submit failure to file notices to the MSRB represents a new paperwork burden of 1,000 hours.

Accordingly, under the final amendments, the total burden on issuers to submit annual filings, material event notices and failure to file notices to the MSRB would be 57,250 hours.²²⁰

²¹⁹ 2,000 (maximum estimate of failure to file notices) x 30 minutes = 1,000 hours.

²²⁰ 11,250 hours (estimated burden for issuers to submit annual filings) + 45,000 hours (estimated burden for issuers to submit material event notices) + 1,000 hours (estimated burden for issuers to submit failure to file notices) = 57,250 hours.

The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

3. The MSRB

Under the final amendments, the MSRB will be the sole repository and will receive disclosure documents in an electronic, rather than paper, format. We estimate that the burden on the MSRB to collect, index, store, retrieve, and make available the pertinent documents would be the number of hours that its employees would be assigned to the system for collecting, storing, retrieving, and making available the documents. In the Proposing Release, we noted that the MSRB advised that three full-time employees and one half-time employee would be assigned to these tasks and that each full-time employee would spend approximately 2,000 hours per year working on these tasks. Therefore, under the final amendments, the total burden on the MSRB to collect, store, retrieve, and make available the disclosure documents covered by the amendments will be 7,000 hours per year.²²¹ The Commission included this estimate in the Proposing Release and received no comments on it. The Commission continues to believe that this estimate is appropriate.

4. Annual Aggregate Burden for Proposed Amendments

Accordingly, we estimate that the ongoing annual aggregate information collection burden for the amended Rule will be 64,500 hours.²²² The Commission included this estimate in the Proposing Release and received no comments on it. The Commission continues to believe that this estimate is appropriate.

²²¹ 2,000 hours x 3.5 (3 full time employees and 1 half-time employee) = 7,000 hours.

²²² 250 hours (total estimated burden for broker-dealers) + 57,250 hours (total estimated burden for issuers) + 7,000 hours (total estimated burden for MSRB) = 64,500 hours. The initial first-year burden would be 64,625 hours: 375 hours (total estimated burden for broker-dealers in the first year) + 57,250 hours (total estimated burden for issuers) + 7,000 hours (total estimated burden for MSRB) = 64,625 hours.

E. Total Annual Cost Burden

1. Issuers

The Commission expects that some issuers may be subject to some costs associated with the electronic submission of annual filings, material event notices and failure to file notices, particularly if they (or their agent) were submitting paper copies of these documents to the repositories. It is likely, however, that many issuers of municipal securities currently have the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB. For issuers that currently have such capability, the start-up costs to provide continuing disclosure documents to the MSRB will be minimal because they already possess the necessary resources internally. Some issuers may have the necessary computer equipment to transmit documents electronically to the MSRB, but may need to upgrade or obtain the software necessary to submit documents to the MSRB in the electronic format that it prescribes. For these issuers, the start-up costs will be the costs of upgrading or acquiring the necessary software. Issuers that presently do not provide their annual filings, material event notices and/or failure to file notices in an electronic format and that are currently sending paper copies of their documents to the repositories pursuant to their continuing disclosure agreements (or only providing disclosures upon request) may incur some costs to obtain electronic copies of such documents if they are prepared by a third party (e.g., accountant or attorney) or, alternatively, to have a paper copy converted into an electronic format. These costs can vary depending on how the issuer elects to convert its continuing disclosure documents into an electronic format. An issuer may elect to have a third-party vendor transfer its paper continuing disclosure documents into the appropriate

electronic format. An issuer also may decide to undertake the work internally, and its costs will vary depending on the issuer's current technology resources.

The cost for an issuer to have a third-party vendor transfer its paper continuing disclosure documents into an appropriate electronic format can vary depending on what resources are required to transfer the documents into the appropriate electronic format. One example of such a transfer is the scanning of paper-based continuing disclosure documents into an electronic format. We estimate that the cost for an issuer to have a third-party vendor scan documents will be \$6 for the first page and \$2 for each page thereafter. We estimate that material event and failure to file notices consist of one to two pages, while annual filings range from eight to ten pages to several hundred pages, but average about 30 pages in length. Accordingly, the approximate cost for an issuer to use a third party vendor to scan a material event notice or failure to file notice will be \$8 each, and the approximate cost to scan an average-sized annual financial statement will be \$64. We further estimate that an issuer will submit one to five continuing disclosure documents annually. We included these estimates in the Proposing Release and received no comments on them. We continue to believe that these estimates are appropriate.

Alternatively, an issuer that currently does not have the appropriate technology can elect to purchase the resources to electronically format the disclosure documents on its own.²²³ We

²²³ Generally, the technology resources necessary to transfer a paper document into an electronic format are a computer, scanner and possibly software to convert the scanned document into the appropriate electronic document format. Most scanners include a software package that is capable of converting scanned images into multiple electronic document formats. An issuer will need to purchase software only if the issuer (1) has a scanner that does not include a software package that is capable of converting scanned images into the appropriate electronic format, or (2) purchases a scanner that does not include a software package capable of converting documents into the appropriate electronic format.

estimate that an issuer's initial cost to acquire these technology resources could range from \$750 to \$4,300.²²⁴ Some issuers may have the necessary hardware to transmit documents electronically to the MSRB, but may need to upgrade or obtain the software necessary to submit documents to the MSRB in the electronic format that it prescribes. We estimate that an issuer's cost to update or acquire this software can range from \$50 to \$300.²²⁵ We included these estimates in the Proposing Release and received no comments on them. We continue to believe that these estimates are appropriate.

In addition, issuers without direct Internet access may incur some costs to obtain such access to submit the documents. However, Internet access is now broadly available to and utilized by businesses, governments, organizations and the public, and we expect that most issuers of municipal securities currently have Internet access. In the event that an issuer does not have Internet access, we estimate the cost of such access to be approximately \$50 per month. Otherwise, there are multiple free or low cost locations that an issuer can utilize, such as various commercial sites, which could help an issuer to avoid the costs of maintaining continuous Internet access solely to submit documents to the MSRB.

Accordingly, the Commission estimates that the costs to some issuers to submit continuing disclosure documents to a single repository in electronic format includes: (1) an approximate cost of \$8 per notice to use a third party vendor to scan a material event notice or failure to file notice, and an approximate cost of \$64 to use a third party vendor to scan an

²²⁴ The estimated cost for an issuer to upgrade or acquire the necessary technology to transfer its paper continuing disclosure documents into an electronic format is based on the following estimates for purchasing the necessary equipment from a commercial vendor: (1) \$500 to \$3,000 for a computer; (2) \$200 to \$1,000 for a scanner; and (3) \$50 to \$300 for software to submit documents in an electronic format.

²²⁵ Issuers that need solely to upgrade existing software may incur costs closer to the lower end of this estimate, while those issuers that need to purchase completely new software packages may incur costs closer to the higher end of this estimate.

average-sized annual financial statement; (2) an approximate cost ranging from \$750 and \$4,300 to acquire technology resources to convert continuing disclosure documents into an electronic format; (3) an approximate cost ranging from \$50 to \$300 solely to upgrade or acquire the software to submit documents in an electronic format; and (4) approximately \$50 per month to acquire Internet access.

For an issuer that does not have Internet access and elects to have a third party convert continuing disclosure documents into an electronic format ("Category 1 issuers"), the total maximum external estimated cost such issuer will incur is \$752 per year.²²⁶ For an issuer that does not have Internet access and elects to acquire the technological resources to convert continuing disclosure documents into an electronic format internally ("Category 2 issuers"), the total maximum external estimated cost such issuer will incur is \$4,900 for the first year and \$600 per year thereafter.²²⁷ As noted in the Proposing Release, the estimated total cost for issuers, if they all were classified as Category 1 issuers, is \$7,520,000 per year, and the estimated total cost for issuers, if they all were classified as Category 2 issuers, is \$49,000,000 for the first year and

²²⁶ $[\$64 \text{ (cost to have third party convert annual filing into an electronic format)} \times 2 \text{ (maximum estimated number of annual filings filed per year per issuer)}] + [\$8 \text{ (cost to have third party convert material event notice or failure to file notice into an electronic format)} \times 3 \text{ (maximum estimated number of material event or failure to file notices filed per year per issuer)}] + [\$50 \text{ (estimated monthly Internet charge)} \times 12 \text{ months}] = \$752.$ We estimate that an issuer would file one to five continuing disclosure documents per year. These documents generally consist of no more than two annual filings and three material event or failure to file notices.

²²⁷ $[\$4,300 \text{ (maximum estimated one-time cost to acquire technology to convert continuing disclosure documents into an electronic format)}] + [\$50 \text{ (estimated monthly Internet charge)} \times 12 \text{ months}] = \$4,900.$ After the initial year, issuers who acquire the technology to convert continuing disclosure documents into an electronic format internally only will have the cost of securing Internet access. $\$50 \text{ (estimated monthly Internet charge)} \times 12 \text{ months} = \$600.$

\$6,000,000 per year thereafter.²²⁸ We included these cost estimates in the Proposing Release and received no comments on them.

After further consideration, we believe that the actual total costs that are likely to be incurred by issuers to convert continuing disclosure documents into an electronic format will be less than the estimated maximum external costs described above. We note that these total annual cost estimates are based on the assumption that all issuers subject to continuing disclosure agreements would have to acquire technology resources necessary to submit continuing disclosure documents in an electronic format to the MSRB. In the Proposing Release, we noted our belief that this was a conservative estimate, and that in all likelihood, many issuers either currently submit continuing disclosure documents in an electronic format or currently have the necessary technology resources to submit continuing disclosure documents in an electronic format.

In this regard, we noted in the Proposing Release that approximately 30% of issuers currently utilize the services of a designated filing agent to submit documents electronically to NRMSIRs. Moreover, all NRMSIRs currently allow electronic filing of continuing disclosure documents. We further note that it was reported in 2002 that approximately 89% of all municipal governments in New York, Pennsylvania and West Virginia had access to computer technology and used it in their operations.²²⁹

²²⁸ Total cost for Category 1 issuers: 10,000 issuers x \$752 (annual cost per issuer to have a third party convert continuing disclosure documents into an electronic format and for Internet access) = \$7,520,000. Total cost for Category 2 issuers: 10,000 issuers x \$4,900 (one-time cost to acquire technology to convert continuing disclosure documents into an electronic format and annual cost for Internet access) = \$49,000,000. 10,000 issuers x \$600 (annual cost per issuer for Internet access) = \$6,000,000.

²²⁹ See Timothy M. Kelsey, Michael J. Dougherty and Michael Hattery, Information Technology Use by Local Governments in the Northeast: Assessment and Needs, 40

Finally, even if all issuers currently lack the necessary technology, we assume that they would be more likely to choose the lower cost option, *i.e.*, Category 1 with an estimated annual cost of \$7,520,000. To be conservative for purposes of the PRA, however, the Commission estimates that the annual costs for those issuers that need to acquire technology resources to submit documents to the MSRB will be approximately \$9,800,000²³⁰ for the first year after the adoption of the final amendments and approximately \$1,200,000²³¹ for each year thereafter.

Alternatively, an issuer may elect to use the services of a designated agent to submit continuing disclosure documents to the MSRB. As noted above, we believe that approximately 30% of municipal issuers that submit continuing disclosure documents today rely on the services of a designated agent. Generally, when issuers utilize the services of a designated agent, they enter into a contract with the designated agent for a package of services, including the submission of continuing disclosure documents, for a single fee. As noted in the Proposing Release, it is anticipated that five of the largest designated agents will submit documents electronically to the MSRB via a direct computer-to-computer interface. We estimate that the start-up cost for an entity to develop a direct computer-to-computer interface with the MSRB will range from approximately \$69,360 to \$138,720.²³² Thus, the maximum estimated total

Journal of Extension 5, October 2002 (available at <http://www.joe.org/joe/2002october/a4.shtml>) ("Journal of Extension").

²³⁰ 2,000 (Category 2 issuers) x \$4,900 = \$9,800,000. This estimate assumes 20% of issuers incur Category 2 costs at \$4,900 per issuer. To be conservative, we are using a number approximately double the percentage of issuers estimated in the Journal of Extension article. We acknowledge that this estimate yields a sum greater than the total Category 1 cost.

²³¹ 2,000 (Category 2 issuers) x \$600 = \$1,200,000.

²³² As noted in the Proposing Release, the MSRB estimated that it would take an entity approximately 240 to 480 hours of computer programming to develop the computer-to-computer interface with the MSRB. \$289 (hourly wage for a senior programmer) x 240 hours = \$69,360. \$289 (hourly wage for a senior programmer) x 480 hours = \$138,720.

start-up cost of developing a direct computer-to-computer interface by each of the five designated agents for the submission of continuing disclosure documents to the MSRB is \$693,600. The Commission included these cost estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

The Commission believes that, in light of the estimated cost to develop and implement a computer-to-computer interface with the MSRB, it is unlikely that issuers will elect to proceed with this approach given the availability of less expensive alternatives to submitting continuing disclosure documents electronically to the MSRB. However, some issuers may choose to submit their continuing disclosure documents to the MSRB through a designated agent. A designated agent may submit continuing disclosure documents along with identifying information to the MSRB on behalf of numerous issuers. Depending on its business model, a designated agent may submit continuing disclosure documents along with identifying information to the MSRB via the Internet or through a direct computer-to-computer interface. In either case, the issuer will incur a cost associated with the designated agent's electronic submission of the pertinent continuing disclosure document and any identifying information to the MSRB. We estimate that this cost is approximately \$16 per continuing disclosure document.²³³ We continue to believe that this estimate is appropriate.

The \$289 per hour estimate for a senior programmer is from SIFMA's Office Salaries in the Securities Industry 2007, modified by Commission staff to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

²³³ This estimate includes the cost of having the designated agent's compliance clerk submit electronically the pertinent continuing disclosure document and any identifying information to the MSRB. 15 minutes (.25 hours) (estimated time per document to gather identifying information) x \$62 (hourly wage for a compliance clerk) = \$15.50 (approximately \$16). The \$62 per hour estimate for a compliance clerk is from SIFMA's

2. MSRB

The MSRB will incur costs to develop the computer system to allow it to collect, store, process, retrieve, and make available continuing disclosure documents furnished to it by issuers of municipal securities. The MSRB's start-up costs associated with developing the portal for continuing disclosure documents, including hardware, an additional hosting site, and software licensing and acquisition costs, is estimated to be approximately \$1,000,000. In addition, the MSRB's annual operating costs for this system, excluding salary and other costs related to employees, is estimated to be approximately \$350,000. Accordingly, we estimate that the total costs for the MSRB is \$1,350,000 for the first year and \$350,000 per year thereafter, exclusive of salary and other costs related to employees.²³⁴ The Commission included these cost estimates in the Proposing Release and did not receive any comments on them. The Commission continues to believe that these estimates are appropriate.

F. Retention Period of Recordkeeping Requirements

The final amendments to the Rule do not contain any recordkeeping requirements.

However, as an SRO subject to Rule 17a-1 under the Exchange Act,²³⁵ the MSRB is required to

Office Salaries in the Securities Industry 2007, modified to account for an 1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

²³⁴ \$1,000,000 (cost to establish computer system) + \$350,000 (annual operation costs for computer system, excluding salary and other related costs for employees) = \$1,350,000 (first year cost to MSRB). After the first year, the only cost would be the annual operation cost of \$350,000. These costs do not include the salary and other overhead costs related to the employees who would maintain the system. The Proposing Release noted that MSRB staff advised Commission staff that the personnel costs associated with operating the portal for continuing disclosure documents will be approximately \$400,000 per year.

²³⁵ 17 CFR 240.17a-1.

retain records of the collection of information for a period of not less than five years, the first two years in an easily accessible place.

G. Collection of Information Is Mandatory

The collection of information pursuant to the Rule, as amended, is a mandatory collection of information.

H. Responses to Collection of Information Will Not Be Kept Confidential

The collection of information pursuant to the Rule, as amended, will not be confidential and will be publicly available.

V. Costs and Benefits of Proposed Amendments to Rule 15c2-12

In the Proposing Release the Commission considered certain costs and benefits of the amendments to Rule 15c2-12. As noted below, the Commission received a few general comments relating to the costs or benefits of the proposed amendments. As discussed below, the Commission is refining its cost analysis relating to the costs that issuers could incur to obtain technology resources. Other than this cost revision, the Commission is not modifying its costs and benefits analysis from that presented in the Proposing Release.

A. Benefits

Under the Rule, as amended, a Participating Underwriter will be prohibited from purchasing or selling municipal securities covered by the Rule in a primary offering, unless it has reasonably determined that the issuer of a municipal security has undertaken in a continuing disclosure agreement to provide continuing disclosure documents to the MSRB.²³⁶ The

²³⁶ Under the adopted amendments to paragraph (d)(2)(ii) of the Rule, a Participating Underwriter would be exempt from its obligations under paragraph (b)(5) of the Rule as long as an issuer or obligated person has agreed in its limited undertaking that the publicly available financial information or operating data described in paragraph (d)(2)(ii)(A) of the Rule would be submitted to the MSRB annually, instead of upon

Commission believes that providing for a single repository that receives submissions in an electronic format, rather than multiple repositories, will encourage a more efficient and effective process for the collection and availability of continuing disclosure information. In the Commission's view, a single electronic point of collection and accessibility of continuing disclosure documents can assist issuers and obligated persons in complying with their undertakings. Submission of continuing disclosure documents to one repository only rather than multiple repositories will reduce the resources issuers and obligated persons need to devote to the process of gathering and submitting continuing disclosure documents. Because the final amendments will provide for the electronic submission and availability of continuing disclosure documents, the costs to issuers and obligated persons of gathering and submitting this information ultimately could be reduced because these entities no longer will have to gather and submit documents in a paper format.

Most commenters were supportive of the proposed amendments and believed that a single repository for the collection, storage, and dissemination of continuing disclosure documents would greatly benefit investors and other municipal market participants.²³⁷ Commenters indicated that the benefits of the proposed amendments include: (1) increased transparency of municipal securities disclosure;²³⁸ (2) simplifying and improving the efficiency

request to any person or at least annually to the appropriate SID, if any, and that the material event notices described in paragraph (d)(2)(ii)(B) of the Rule would be submitted to the MSRB, instead of to each NRMSIR or the MSRB and to the appropriate SID, if any, and as long as the other conditions of the exemption are met.

²³⁷ See GFOA Letter, Vanguard Letter, SIFMA Letter, MSRB Letter, Treasurer of the State of Connecticut Letter, IAA Letter, NASACT Letter, EDGAR Online Letter, NFMA Letter, NAHEFFA Letter, ICI Letter, Texas Mac Letter, and Multiple-Markets Letter.

²³⁸ See Treasurer of the State of Connecticut Letter, at 1, and IAA Letter, at 1.

of filing municipal disclosure information;²³⁹ (3) improved accessibility to municipal disclosure information for investors and other market participants;²⁴⁰ (4) assisting broker-dealers and mutual funds in meeting their regulatory obligations;²⁴¹ and (5) reducing the potential for fraudulent activities.²⁴² In addition, commenters noted that the submission of municipal disclosure information in an electronic format with indexing information would: (1) make finding and using municipal disclosure information easier for investors and other municipal market participants;²⁴³ and (2) help facilitate the creation of new value-added services by municipal disclosure vendors.²⁴⁴

As described more fully in Section IV. above, we estimate that the ongoing annual information collection burden under the adopted amendments will be 64,500 hours.²⁴⁵ This represents a reduction of 59,350 burden hours from the immediately preceding collection of information.²⁴⁶ This overall reduction in the Rule's paperwork burden - and the costs associated with that burden - principally will benefit issuers or obligated persons.

The Commission also believes that having a single repository that receives and makes available submissions in an electronic format will provide ready and prompt access to this information by investors and municipal securities market participants. Investors and market

²³⁹ See Texas MAC Letter, at 1, and IAA Letter, at 2.

²⁴⁰ See SIFMA Letter, at 2, NASACT Letter, at 1, and ICI Letter, at 3.

²⁴¹ See SIFMA Letter, at 2, and ICI Letter, at 3.

²⁴² See ICI Letter, at 3.

²⁴³ See ICI Letter, at 3, and IAA Letter, at 3.

²⁴⁴ See Multiple-Markets Letter, at 2.

²⁴⁵ The estimated annual information collection burden for the first year under the final amendments is 64,625 hours.

²⁴⁶ For the first year, there is a reduction of 59,225 burden hours relative to the immediately preceding collection of information.

participants will be able to go solely to one location to retrieve continuing disclosure documents rather than having to approach multiple locations, thereby allowing for a more convenient means to obtain such information. In addition, we believe that having one repository that electronically collects and makes available all continuing disclosure documents will increase the likelihood that investors and other market participants will obtain more complete information about municipal securities, thereby decreasing the potential for fraud.

We expect that a single repository that receives submissions in an electronic format could simplify compliance with regulatory requirements by broker-dealers and others, such as mutual funds, by providing them with consistent availability of continuing disclosure documents from a single source. Information vendors (including those NRMSIRs and SIDs that had been information repositories for Rule 15c2-12 purposes) and others also will have ready access to all continuing disclosure documents that they in turn can use in any value-added products that they create. The Commission also expects that having a single repository that receives submissions in an electronic format will make municipal disclosure information more accessible for all municipal market participants.

Moreover, providing for a single repository may reduce the paperwork and other costs that NRMSIRs currently incur because they no longer will have to maintain personnel and other resources solely in connection with their status as a NRMSIR. Also, the Commission believes that the proposed amendments may encourage the dissemination of information in the information services markets by providing easier access to continuing disclosure documents. As a result, there potentially may be an increase in the number of information vendors disseminating continuing disclosure documents and offering value-added products because the cost of entry into the municipal securities information services market may be reduced.

B. Costs

The Commission does not expect broker-dealers to incur any additional recurring costs as a result of the Rule 15c2-12 amendments, because the amendments will not alter substantively the existing Rule's requirements for these entities, except with respect to the place to which issuers would agree to make filings. The final amendments will change the location where the continuing disclosure documents of issuers or obligated persons will be submitted pursuant to continuing disclosure agreements. As noted above, we estimate that the annual information collection burden for each broker-dealer under the Rule will be one hour. This annual burden is identical to the burden that a broker-dealer previously had under the Rule. Accordingly, we estimate that it will cost each broker-dealer \$270 annually to comply with the Rule, as amended.²⁴⁷

We further estimate that a broker-dealer may have a one-time internal cost associated with having an in-house compliance attorney prepare and issue a memorandum advising the broker-dealer's employees who work on primary offerings of municipal securities about the amendments to Rule 15c2-12. Our estimate is that it will take internal counsel approximately 30 minutes to prepare this memorandum, for a cost of approximately \$135.²⁴⁸

We believe that the ongoing obligations of broker-dealers under the Rule will be handled internally because compliance with these obligations is consistent with the type of work that a broker-dealer typically handles internally. We do not believe that a broker-dealer will have any recurring external costs associated with the amendments to the Rule.

²⁴⁷ 1 hour (estimated annual information collection burden for each broker-dealer) x \$270 (hourly cost for a broker-dealer's internal compliance attorney) = \$270. The hourly rate for the compliance attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2007, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

²⁴⁸ See Section IV.D.1., supra.

The Commission received one comment letter regarding the obligations of a broker-dealer under the revised Rule, particularly with respect to its reasonably determining that the issuer or obligated person has contractually agreed to provide identifying information as prescribed by the MSRB.²⁴⁹ This commenter stated that this requirement would not be unreasonably burdensome on broker-dealers that are Participating Underwriters. The Commission included in the Proposing Release the foregoing cost estimate regarding a broker-dealer's obligations under the Rule, as amended, and received no comments regarding this cost estimates.

Although Rule 15c2-12 relates to the obligations of broker-dealers, issuers or obligated persons indirectly could incur costs as a result of the adopted amendments. In connection with today's amendments, issuers of municipal securities will undertake in their continuing disclosure agreements to provide continuing disclosure documents to the MSRB, either directly or indirectly through an indenture trustee or a designated agent. In either case, some issuers may be subject to the costs associated with the electronic filing of annual filings, material event notices and failure to file notices, particularly if they (or their agent) were submitting paper copies of these documents to the NRMSIRs. For those issuers that delivered their continuing disclosure documents electronically to the NRMSIRs, there is expected to be minimal change in costs as a result of the Rule's new requirement that documents be submitted electronically.

Issuers that had not been providing their annual filings, material event notices and/or failure to file notices in an electronic format and were sending paper copies of their documents to the NRMSIRs pursuant to their continuing disclosure agreements may incur some costs to obtain electronic copies of such documents from the party who prepared them or, alternatively, to have

²⁴⁹ See SIFMA Letter, at 3.

a paper copy converted into an electronic format. These costs will vary depending on how the issuer elects to convert their continuing disclosure documents into an electronic format. An issuer can elect to have a third-party vendor transfer their paper continuing disclosure documents into the appropriate electronic format. An issuer also can decide to undertake the work internally, and its costs will vary depending on the issuer's technology resources. An issuer also will need to have Internet access to submit documents electronically and will incur the costs of maintaining such service, if the issuer currently does not have Internet access, unless it relies on other sources of Internet access.

It is likely, however, that most issuers of municipal securities currently possess the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB. For issuers that currently have such capability, the start-up costs to provide continuing disclosure documents to the MSRB will be minimal because they already will have the necessary resources internally.

As described more fully in Section IV. above, we estimate that the costs to some issuers to submit continuing disclosure documents to the MSRB in an electronic format may include:

- (1) an approximate cost of \$8 per notice to use a third party vendor to scan a material event notice or failure to file notice, and an approximate cost of \$64 to use a third party vendor to scan an average-sized annual financial statement;
- (2) an approximate cost ranging from \$750 and \$4300 to acquire technology resources to convert continuing disclosure documents into an electronic format;
- (3) approximately \$50 to \$300 to upgrade or acquire the software to submit documents in an electronic format;
- (4) approximately \$50 per month to acquire Internet access;
- and (5) an approximate cost of \$16 per continuing disclosure document to have a designated

agent submit electronically continuing disclosure documents and identifying information to the MSRB. As noted in the Proposing Release, for an issuer that does not have Internet access and elects to have a third party convert continuing disclosure documents into an electronic format, the maximum external estimated cost such issuer will incur is \$752 per year.²⁵⁰ As noted in the Proposing Release, for an issuer that does not have Internet access and elects to acquire the technological resources to convert continuing disclosure documents into an electronic format internally, the maximum external estimated cost such issuer will incur is \$4,900 for the first year and \$600 per year thereafter.²⁵¹ As noted in the Proposing Release, the estimated total cost for issuers, if they all were classified as Category 1 issuers, is \$7,520,000 per year, and the estimated total cost for issuers, if they all were classified as Category 2 issuers, is \$49,000,000 for the first year and \$6,000,000 per year thereafter.²⁵² We included these cost estimates in the Proposing

²⁵⁰ [$\$64$ (cost to have third party convert annual filing into an electronic format) $\times$ 2 (maximum estimated number of annual filings filed per year per issuer)] + [$\$8$ (cost to have third party convert material event notice or failure to file notice into an electronic format) $\times$ 3 (maximum estimated number of material event or failure to file notices filed per year per issuer)] + [$\$50$ (estimated monthly Internet charge) $\times$ 12 months] = \$752. We estimate that an issuer would file one to five continuing disclosure documents per year. These documents generally consist of no more than two annual filings and three material event or failure to file notices.

²⁵¹ [$\$4,300$ (maximum estimated one-time cost to acquire technology to convert continuing disclosure documents into an electronic format)] + [$\$50$ (estimated monthly Internet charge) $\times$ 12 months] = \$4,900. After the initial year, issuers who acquire the technology to convert continuing disclosure documents into an electronic format internally only will have the cost of securing Internet access. $\$50$ (estimated monthly Internet charge) $\times$ 12 months = \$600.

²⁵² Total cost for Category 1 issuers: 10,000 issuers $\times$ \$752 (annual cost per issuer to have a third party convert continuing disclosure documents into an electronic format and for Internet access) = \$7,520,000. Total cost for Category 2 issuers: 10,000 issuers $\times$ \$4,900 (one-time cost to acquire technology to convert continuing disclosure documents into an electronic format and annual cost for Internet access) = \$49,000,000. 10,000 issuers $\times$ \$600 (annual cost per issuer for Internet access) = \$6,000,000. To provide an estimate of the total costs to issuers that would not be under-inclusive, we assumed that all 10,000 issuers are Category 1 issuers and Category 2 issuers.

Release and received no comments on them. In the Proposing Release, the Commission indicated that we believe that most issuers either currently submit continuing disclosure documents in an electronic format, or currently have the necessary technology resources to submit continuing disclosure documents in an electronic format. Accordingly, we believe that the actual total costs that will be incurred by issuers to convert continuing disclosure documents into an electronic format will be less than the estimated maximum external costs described above and discussed more fully in Section IV. above.

The Commission estimates that the annual costs for those issuers that need to acquire technology resources to submit documents to the MSRB will be approximately \$9,800,000²⁵³ for the first year after the adoption of the final amendments and approximately \$1,200,000²⁵⁴ for each year thereafter.

Also, as more fully described in Section IV. above, the total estimated cost of five designated agents to develop computer-to-computer interfaces for the submission of documents to the MSRB is \$693,600. The Commission included this cost estimate in the Proposing Release and received no comments regarding it. The Commission continues to believe that this estimate is appropriate.

Issuers or obligated persons also will have to provide certain identifying information to the repository pursuant to their undertakings in continuing disclosure agreements. As described more fully in Section IV. above, we estimate that each issuer will submit one to five continuing disclosure documents annually to the MSRB, for a maximum estimated annual labor cost of

²⁵³ 2,000 (Category 2 issuers) x \$4,900 = \$9,800,000. This estimate assumes 20% of issuers incur Category 2 costs at \$4,900 per issuer. To be conservative, we are using a number approximately double the percentage of issuers estimated in the Journal of Extension article. We acknowledge that this estimate yields a sum greater than the total Category 1 cost.

²⁵⁴ 2,000 (Category 2 issuers) x \$600 = \$1,200,000.

approximately \$232.50 per issuer,²⁵⁵ which equates to a total maximum annual cost of \$2,325,000 for all issuers (\$232.50 x 10,000 issuers). The Commission included these cost estimates for issuers in the Proposing Release and received no comments regarding these estimates. The Commission continues to believe that these estimates are appropriate.

The Commission expects that the costs to issuers may vary somewhat, depending on the issuer's size. In the Proposing Release, we noted our belief that any such difference would be attributable to the fact that larger issuers may tend to have more issuances of municipal securities; thus, larger issuers may tend to submit more documents than smaller issuers. We indicated that the costs of submitting documents under the proposal could be greater for larger issuers. Although no commenters took issue with any of the specific cost estimates set forth in the Proposing Release, two commenters discussed generally the potential costs of aspects of the proposed amendments, particularly with respect to smaller issuers.²⁵⁶ One of these commenters noted that small issuers relying on the exemption contained in paragraph (d)(2) of the Rule would incur increased costs associated with the electronic filing of the information set forth in the exemption.²⁵⁷ Prior to today's amendments, the exemption in paragraph (d)(2) of the Rule would not apply to a primary offering if, among other conditions, the issuer or obligated person has undertaken in a written agreement or contract to provide financial information or operating

²⁵⁵ 5 (maximum estimated number of continuing disclosure filed per year per issuer) x \$62 (hourly wage for a compliance clerk) x 45 minutes (.75 hours) (average estimated time for compliance clerk to submit a continuing disclosure document electronically) = \$232.50. The \$62 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2007, modified to account for an 1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead. In order to provide an estimate of total costs for issuers that would not be under-inclusive, the Commission elected to use the higher end of the estimate of annual submissions of continuing disclosure documents.

²⁵⁶ See NABL Letter, at 2, and GFOA Letter, at 2.

²⁵⁷ See NABL Letter, at 2.

data regarding each obligated person for which financial information or operating data is presented in the final official statement, including financial information and operating data which is customarily prepared by such obligated person and is publicly available, upon request to any person or at least annually to the appropriate SID.²⁵⁸ After today's amendments, Participating Underwriters seeking to utilize the exemption will need to reasonably determine that such issuer or obligated person has undertaken to provide such information to the MSRB annually. The amendment to paragraph (d)(2) of the Rule does not affect the nature of a Participating Underwriter's obligation to reasonably determine that a small issuer has undertaken to deliver continuing disclosure documents to fulfill the conditions of the exemption; rather, it affects what the Participating Underwriter needs to determine regarding the undertaking with respect to the location where such documents are to be sent. Specifically, the final amendments do not revise the provision limiting the commitment to provide annual financial or operating data only if such information is customarily prepared by such obligated person and is publicly available. We recognize that one effect of the amendments will be that some small issuers will submit annual financial information and operating data to the MSRB when currently they do not regularly submit such disclosures to any repository. We do not believe that electronically formatting information a small issuer already has and makes publicly available will be a significant burden. In addition, we do not believe that the final amendments would result in small issuers providing voluminous filings. Further, the costs that these issuers could incur to send documents electronically to the MSRB are included in the cost estimates for issuers discussed above. The only difference between the prior provision and the amended Rule is that, while issuers previously provided such information and data upon request, they now must provide it to the

²⁵⁸ 17 CFR 240.15c2-12(d)(2)(ii)(A).

MSRB annually. The other commenter noted that some smaller issuers may have to purchase new software to submit electronic documents, but it further stated that the overall savings that an electronic-based repository will provide will benefit state and local governments and authorities.²⁵⁹

Further, the Commission does not anticipate that issuers will incur any costs associated with the need to revise the template for continuing disclosure agreements. The Proposing Release noted that, based on conversations between Commission staff and NABL staff, NABL members advised that the cost of revising the template for continuing disclosure agreements to reflect the rule amendments will be insignificant and thus unlikely to be passed on to issuers. We received no comments regarding this estimate and continue to believe that it is appropriate.

As discussed in Section IV. above, the MSRB will incur costs to develop the computer system to allow it to collect, store, process, retrieve, and make available continuing disclosure documents furnished to it by issuers of municipal securities. We stated in the Proposing Release that the MSRB's start-up costs associated with developing the portal for continuing disclosure documents, including hardware, an additional hosting site, and software licensing and acquisition costs, will be approximately \$1,000,000; that the MSRB's ongoing costs of operating the system, including allocated costs associated with such items as office space and licensing fees, will be approximately \$1,350,000 for the first year and \$350,000 per year thereafter; and that the MSRB's personnel costs associated with operating the portal for continuing disclosure documents will be approximately \$400,000 per year.²⁶⁰ We received no comments regarding these estimates and continue to believe that they are appropriate.

²⁵⁹ See GFOA Letter, at 2.

²⁶⁰ This figure represents the estimated personnel costs associated with the MSRB's devoting three and one-half persons to the operation of the continuing disclosure portal.

Some NRMSIRs and other vendors of municipal disclosure information may incur costs in transitioning their business models as a result of the final amendments that call for the MSRB to serve as the single repository for continuing disclosure documents. In the Proposing Release, we noted that any NRMSIR that provided municipal disclosure documents as its primary business model could face a significant decline in its business, and thus in income, as a result of the proposed amendments, as well as the possible withdrawal of the "no action" letters issued to the NRMSIRs and the designation of the MSRB as the sole NRMSIR for existing continuing disclosure agreements. As a result, the NRMSIRs could experience an immediate decline in income with respect to those parts of their business that provide municipal disclosure documents to persons who request them. We also noted that NRMSIRs could have some costs if they continued to maintain historical continuing disclosure information that they have already received under existing continuing disclosure agreements. Two commenters that are NRMSIRs submitted comment letters opposing the proposed amendments.²⁶¹ One of these commenters acknowledged generally that the proposed amendments could affect its business model.²⁶² However, neither of these commenters provided any specific cost estimates of the impact of the proposed amendments on their operations. In addition, one potential consequence of the final amendments is that there could be fewer value-added products available to investors, market participants and others, and the potential reduction in such products is not quantifiable.²⁶³ The Commission included a discussion of the potential costs for NRMSIRs under the amended Rule in the Proposing Release and received no specific comments addressing these costs. The

²⁶¹ See DPC Data Letter and SPSE Letter.

²⁶² See DPC Data Letter at 1.

²⁶³ See Section VI. *infra* for a discussion of the competitive impact of the amendments on the NRMSIRs.

Commission believes that the potential costs discussed in the Proposing Release are still appropriate.

Finally, under the final amendments, Rule 15c2-12 no longer will refer to SIDs. The rule amendments will not affect the legal obligations of issuers or obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that may be required under the appropriate state law. In addition, the final amendments will have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to the effective date of today's amendments to the Rule, to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that may be required under the appropriate state law. SIDs are membership organizations and use information submitted to them in products for their members. While SIDs can charge fees for requested documents, we do not believe that this is a primary source of revenue for them. As discussed above, the Commission received a number of comments regarding the proposed removal of references to SIDs from the Rule.²⁶⁴ However, none of these comments included any discussions of the cost implications of removing references to SIDs from the Rule. In the Proposing Release, the Commission indicated that it does not expect that SIDs will experience a decline in operations or incur any costs as a result of the proposed amendments. The Commission received no comments regarding this statement and we continue to believe that this statement is appropriate.

²⁶⁴ See GFOA Letter, SIFMA Letter, Texas MAC Letter, OMAC Letter, and Multiple-Markets Letter.

In summary, the Commission estimates that the total annual cost for all respondents in the first year, under the amended Rule, is approximately \$14,602,350.²⁶⁵ The Commission also estimates that the total annual cost for all respondents after the first year, under the amended Rule, is approximately \$4,275,000.²⁶⁶

VI. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act²⁶⁷ requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act²⁶⁸ requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

In the Proposing Release, we considered the proposed amendments to Rule 15c2-12 in light of the standards set forth in the above-noted Exchange Act provisions. We solicited comment on whether, if adopted, the proposed amendments would result in any anti-competitive

²⁶⁵ (\$33,750 (estimated annual cost for broker-dealers in year one) + ((\$9,800,000 (estimated annual cost for issuers to acquire technology resources) + \$2,325,000 (estimated annual cost for all issuers' labor hours) + \$693,600 (estimated one-time cost for development of designated agents computer interface)) total estimated annual costs for issuers in year one) + \$1,750,000 (maximum estimated annual cost for the MSRB in year one)) = \$14,602,350.

²⁶⁶ (\$1,200,000 (estimated annual cost for issuers to convert documents into an electronic format) + \$2,325,000 (estimated annual cost for all issuers' labor hours)) estimated annual costs for issuers + \$750,000 (maximum estimated annual cost for the MSRB)) = \$4,275,000.

²⁶⁷ 15 U.S.C. 78c(f).

²⁶⁸ 15 U.S.C. 78w(a)(2).

effects or would promote efficiency, competition, and capital formation. We asked commenters to provide empirical data or other facts to support their views on any anti-competitive effects or any burdens on efficiency, competition, or capital formation that might result from adoption of the proposed amendments.

We believe that the amendments to the Rule will help make the municipal securities disclosure process more efficient and help conserve resources for municipal security issuers, as well as for investors and market participants. Under the regulatory framework that existed prior to today's amendments, issuers of municipal securities in their continuing disclosure agreements undertook to submit continuing disclosure documents to four separate NRMSIRs, and they submitted such documents in paper or electronic form. The Commission anticipates that the final rule amendments likely will promote the efficiency of the municipal disclosure process by reducing the resources municipal security issuers will need to devote to the process of submitting continuing disclosure documents.

As noted above, the Commission has long been interested in reducing the potential for fraud in the municipal securities market. At the time the Commission adopted Rule 15c2-12 in 1989 and adopted the 1994 Amendments, disclosure documents were submitted in paper form. The Commission believed that, in such an environment where document retrieval would be handled manually, the establishment of one or more repositories could be beneficial in widening the retrieval and availability of information in the secondary market, since the public could obtain the disclosure documents from multiple locations. The Commission's objective of deterring the potential for fraud by facilitating greater availability of municipal securities information remains unchanged.

However, there have been significant inefficiencies in the current use of multiple repositories that likely have affected the public's ability to retrieve continuing disclosure documents.²⁶⁹ In this regard, the Commission noted in the 1989 Adopting Release that "the creation of multiple repositories should be accompanied by the development of an information linkage among these repositories" so as to afford "the widest retrieval and dissemination of information in the secondary market."²⁷⁰ Although the Commission in the 1989 Adopting Release supported the development of an information linkage among the repositories, none was established to help broaden the availability of the disclosure information. Also, since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems, including the use of the Internet, to provide information quickly and inexpensively to market participants and investors. In this regard, the Commission believes that the use of a single repository to receive, in an electronic format, and make available continuing disclosure documents in an electronic format will substantially and effectively increase the availability of municipal securities information about municipal issues and enhance the efficiency of the secondary trading market for these securities.

In addition, we believe that having a single repository for electronically submitted information will provide investors, market participants, and others with a more efficient and convenient means to obtain continuing disclosure documents and will help increase the likelihood that investors, market participants, and others will make more informed investment decisions regarding whether to buy, sell or hold municipal securities. The Commission believes that the final amendments will foster a more efficient means of municipal disclosure and, as a result, the Commission is approving the adoption of the proposed amendments to Rule 15c2-12.

²⁶⁹ See supra note 35.

²⁷⁰ See 1989 Adopting Release, supra note 18.

With respect to the Exchange Act goal of promoting competition, the Commission notes that, when we adopted Rule 15c2-12 in 1989, we strongly supported the development of one or more central repositories for municipal disclosure documents.²⁷¹ The Commission "recognize[d] the benefits that may accrue from the creation of competing private repositories," and indicated that "the creation of central sources for municipal offering documents is an important first step that may eventually encourage widespread use of repositories to disseminate annual reports and other current information about issuers to the secondary markets."²⁷² Further, when we adopted the 1994 Amendments, the Commission stated that the "requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allay[ed] the anti-competitive concerns raised by the creation of a single repository."²⁷³

There have been significant advances in technology and information collection and delivery since that time, as discussed throughout this release and the Proposing Release, that indicate that having multiple repositories may not be necessary because the widespread availability and dissemination of information can be achieved through different, more efficient, means. Because the current environment differs markedly from the time when Rule 15c2-12 was adopted in 1989 and subsequently amended in 1994, the Commission believes that it is appropriate to adopt an approach that utilizes the significant technological advances, such as the development and use of various electronic formats, which have occurred in the intervening years.

The Commission's adoption of amendments to the Rule to provide for the use of a single repository for continuing disclosure documents will help further the Exchange Act objective of

²⁷¹ See 1989 Adopting Release at 54 FR 28807, supra note 18. See also 1994 Proposing Release, supra note 113.

²⁷² See 1989 Adopting Release, supra note 18. See also 1994 Proposing Release, supra note 113.

²⁷³ See 1994 Amendments, supra note 21.

promoting competition because information about municipal securities, provided in an electronic format, will be more widely available to market professionals, investors, information vendors, and others as a result of the final amendments. For example, the Commission believes that competition among vendors may increase because vendors can utilize this information to provide value-added services to municipal market participants. Our adoption of amendments to the Rule also may promote competition in the purchase and sale of municipal securities because the greater availability of information, delivered electronically through a single repository, may instill greater investor confidence in the municipal securities market. Moreover, this greater availability of information also may encourage improvement in the completeness and timeliness of issuer disclosures and may foster interest in municipal securities by individual and institutional customers. As a result, more investors may be attracted to this market sector and broker-dealers may compete for their business.

The Commission received two comment letters from NRMSIRs that raised concerns about the competitive effects of the proposed amendments.²⁷⁴ The primary concerns, raised by both commenters, relate to the MSRB's role as the sole repository of continuing disclosure documents and the competitive effects this would have on existing vendors of municipal disclosure information. One of these commenters stated that the Commission's proposal "would allow the MSRB to impose restrictions on municipal issuers and obligated persons by limiting the filings to a single, electronic format."²⁷⁵ In addition, this commenter noted that the Commission's proposal would place the MSRB "in direct competition with commercial vendors who have served the market as practical implementers of Rule 15c2-12 without any subsidy for

²⁷⁴ See DPC DATA Letter and SPSE Letter.

²⁷⁵ See DPC DATA Letter, at 1.

more than a decade.”²⁷⁶ The other commenter expressed similar sentiments and cited to the Commission’s statements in adopting Rule 15c2-12 in 1989 and amendments to the Rule in 1994, which discussed possible anti-competitive concerns over the creation of a single repository.²⁷⁷ This commenter noted its view that eliminating the NRMSIR function would upset the balance between its current business model and have an impact on its ability to provide value-added products and services.²⁷⁸ It disputed the Commission’s view that the potential burdens on competition would be justified by the proposed amendments’ adoption because, in its view, the current issues with municipal disclosure lie in the quality and timeliness of the information that is filed.²⁷⁹ The commenter also urged the Commission to adopt an alternative approach.²⁸⁰ Under its proposal, the MSRB would not be the sole repository for municipal disclosure information.²⁸¹ Instead, the commenter proposed having an unspecified entity serve as a central electronic post office for municipal disclosure information where “issuers and obligors would file documents through a single electronic format” and such entity “would then forward the centrally-filed documents in real time to the NRMSIRs.”²⁸² The commenter expressed no opinion regarding the identity of the entity that should serve as the central electronic post office or how such entity would be chosen.²⁸³

²⁷⁶ See DPC DATA Letter, at 2.

²⁷⁷ See SPSE Letter, at 5-7.

²⁷⁸ See SPSE Letter, at 7.

²⁷⁹ See SPSE Letter, at 7-8.

²⁸⁰ See SPSE Letter, at 3-5.

²⁸¹ See SPSE Letter, at 4.

²⁸² Id.

²⁸³ Id.

Although these commenters raised concerns about the competitive impact of the proposed amendments, circumstances have changed since we last considered Rule 15c2-12 amendments in 1994, as discussed throughout this release and in the Proposing Release. The NRMSIRs did not develop a linkage, technology developments have occurred to make it easier to access information; and access to municipal information remains costly and not easy to obtain for many individuals. For these reasons, we believe that there should be one repository. We continue to believe that one of the benefits in having the MSRB as the sole repository will be the MSRB's ability to provide a ready source of continuing disclosure documents to other information vendors who wish to use that information for their products. Private vendors can utilize the MSRB in its capacity as a repository as a means to collect information from the continuing disclosure documents to create value-added products for their customers.²⁸⁴

Commercial vendors will be able to readily access the information made available by the MSRB to re-disseminate it or use it in whatever value-added products they may wish to provide. In fact, a single repository in which documents are submitted in an electronic format may encourage the private information vendors to disseminate municipal securities information by reducing the cost of entry into the information services market. Existing vendors may need to make some adjustments to their infrastructure, facilities, or services offered. However, some vendors may determine that they no longer need to invest in the infrastructure and facilities necessary to collect and store continuing disclosure documents, and new entrants into the market will not need to obtain the information from multiple locations, but rather can readily access such

²⁸⁴ The Commission notes that both the DPC DATA Letter and the SPSE Letter raised concerns with the potential subscription fees associated with having the MSRB as the single repository. The Commission notes that the MSRB will be required to file a proposed rule change with the Commission pursuant to Section 19(b) of the Exchange Act regarding any subscription fees for a data stream that it proposes as well as any changes to those fees.

information from one centralized source. Thus, all vendors are expected to be able to obtain easily continuing disclosure documents and to be able to compete in providing value-added services. With respect to the comment regarding the "quality and timeliness" of the information issuers file, the Commission believes that the greater availability of information which will result from the final amendments to the Rule also may encourage improvement in the completeness and timeliness of disclosures by issuers and obligated persons and may foster interest in municipal securities by retail and institutional customers.

We previously stated that we would specifically consider the competitive implications of the MSRB becoming a repository.²⁸⁵ In addition, we stated that if we were to conclude that the MSRB's status as a repository might have adverse competitive implications, we would consider whether we should take any action to address these effects.²⁸⁶ As noted earlier, we recognize that competition with respect to certain information services regarding municipal securities that are provided by the existing NRMSIRs may decline should the MSRB become the central repository. The two commenters that raised competitive concerns suggested that a decrease in competition could occur as a result of the Commission's rulemaking.²⁸⁷ We continue to believe that one of the benefits in having the MSRB as the sole repository will be the MSRB's ability to provide a ready source of continuing disclosure documents to other information vendors who wish to use that information for their products. Private vendors can utilize the MSRB in its capacity as a repository as a means to collect information from the continuing disclosure documents to create value-added products for their customers.

²⁸⁵ See Securities Exchange Act Release No. 28081, supra note 131.

²⁸⁶ Id.

²⁸⁷ See DPC DATA Letter and SPSE Letter.

Regarding the comment that our proposal would permit the MSRB to impose restrictions on municipal issuers and obligated persons by limiting the filings to a single format, we note that the MSRB must file with the Commission under Section 19(b) of the Exchange Act the format it proposes to prescribe and any changes to that format. Thus, the format that the MSRB proposes to prescribe, and any subsequent changes to that format, would have to be consistent with the Exchange Act. With regard to the comments favoring a central electronic post office, as we noted above, we believe that this approach is less likely to achieve the benefits of the proposed amendments. For example, with a central post office there would continue to be no single location to which investors, particularly individuals, could turn for free access to information regarding municipal securities. Instead, individuals or entities that wish to obtain such information would find it necessary first to access the central post office to find out what documents might be available from NRMSIRs and SIDs and then to contact one or more NRMSIRs or SIDs and pay their fees to obtain the document or documents they seek. This would be a less efficient process than that contemplated by the final amendments, in which interested persons could directly access, view and print for free continuing disclosure documents from one place – the MSRB's Internet site.

We do not believe that there are competitive implications that will uniquely apply to the MSRB in its capacity as the sole repository as opposed to any another entity that could be the sole repository. In fact, we believe that, because the MSRB will be the sole repository, its status as an SRO will provide an additional level of Commission oversight, as changes to its rules relating to continuing disclosure documents will have to be filed for Commission consideration as a proposed rule change under Section 19(b) of the Exchange Act. Accordingly, we believe

that any competitive impact that could result from the MSRB's status as the sole repository would be justified by the benefits that such status could provide.

We, therefore, believe that any potential effect on competition that may arise from the adoption of the Rule 15c2-12 amendments is justified by the more efficient and effective process for the collection and availability of continuing disclosure documents that will result. A single repository for the electronic collection and availability of these documents will foster the Exchange Act objective of promoting competition by simplifying the method of submission of continuing disclosure documents to one location and making the documents more readily accessible to investors and others by virtue of the documents being in an electronic format.

We believe that the proposed amendments may have a positive effect on capital formation by municipal securities issuers. The Rule is addressed to the obligations of broker-dealers participating in a primary offering of municipal securities (i.e., Participating Underwriters). Because continuing disclosure documents will be submitted electronically to a single repository, investors and other market participants will be able to obtain information about these issuers more readily than they could in the past. They no longer will have to contact several NRMSIRs to make sure that they have obtained complete information about the municipal issuer. Easier access to continuing disclosure documents regarding municipal securities may provide investors and other market participants with more complete information about municipal issuers. Moreover, this ready availability of continuing disclosure documents may encourage investors to consider purchasing new issuances of municipal securities because they will be able to readily access information from a single repository and review that information in light of other available information when making an investment decision,

decreasing the potential for fraud. As a result, we believe that our amendments to Rule 15c2-12 will help foster the Exchange Act goal of capital formation.

We proposed to delete references to the SIDs in Rule 15c2-12. Since we are adopting amendments to the Rule that provide for a single repository for the electronic collection and availability of continuing disclosure documents that are aimed at improving disclosure in the municipal securities market, we believe that it is no longer necessary to require in the Rule that Participating Underwriters reasonably determine that issuers and obligated persons have contractually agreed to provide continuing disclosure documents to the appropriate SID.

Five commenters specifically addressed the deletion of SIDs from the Rule.²⁸⁸ Most of them commented that the MSRB should provide a data feed to SIDs of documents related to issuers in their states in order that issuers who may be required by their states to send continuing disclosure documents to a SID need not provide them to both the MSRB and a SID.²⁸⁹ They believed this would be more efficient for both issuers and SIDs and result in more complete and consistent data availability of information from SIDs and the MSRB. Furthermore, some of these commenters suggested that there should be no charge to SIDs to receive such a data feed.²⁹⁰ We agree that it is important for the document collections of the MSRB and SIDs to be consistent to avoid uneven access to information that could result, depending on the source from which continuing disclosure documents were obtained. However, the specific operations of the MSRB's repository, such as data feeds, are related to the MSRB's operation of the collection

²⁸⁸ See GFOA Letter, SIFMA Letter, Texas MAC Letter, OMAC Letter, and Multiple-Markets Letter.

²⁸⁹ See GFOA Letter, Texas MAC Letter, OMAC Letter, and Multiple-Markets Letter.

²⁹⁰ See GFOA Letter and Multiple-Markets Letter.

system and are subject to the rule filing process under Section 19(b) of the Exchange Act and are not an issue before us with respect to the amendments to the Rule.²⁹¹

We note that the amendments will not affect the legal obligations of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that are required under the relevant state law. In addition, the amendments will have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to any effective date of the amendments to the Rule to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that are required under the relevant state law. Accordingly, the Commission does not believe that its deletion of references to SIDs in Rule 15c2-12 will have any potential effect on efficiency, competition or capital formation.

VII. Regulatory Flexibility Act Certification

The Commission certified, under Section 605(b) of the Regulatory Flexibility Act,²⁹² that, when adopted, the proposed amendments to the Rule would not have a significant economic impact on a substantial number of small entities. This certification was set forth in Section VIII. of the Proposing Release.²⁹³ The Commission solicited comments regarding this certification and received no comments. The Commission continues to believe this certification is appropriate.

²⁹¹ See MSRB Approval Order, supra note 12.

²⁹² 5 U.S.C. 605(b).

²⁹³ See Proposing Release, supra note 3.

VIII. Statutory Authority

Pursuant to the Exchange Act, and particularly Sections 2, 3(b), 10, 15(c), 15B and 23(a)(1) thereof, 15 U.S.C. 78b, 78c(b), 78j, 78o(c), 78o-4, and 78w(a)(1), the Commission is adopting amendments to § 240.15c2-12 of Title 17 of the Code of Federal Regulations in the manner set forth below.

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows.

Text of Rule Amendments

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The **authority** citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.15c2-12 is amended by:

- a. Revising paragraph (b)(4)(ii), the introductory text of paragraph (b)(5)(i), and paragraphs (b)(5)(i)(A) and (B);

- b. In the introductory text of paragraph (b)(5)(i)(C) and in paragraph (b)(5)(i)(D) remove the phrase “to each nationally recognized municipal securities information repository or

to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any,”;

- c. In paragraph (b)(5)(ii)(C) remove the phrase “, and to whom it will be provided”;
- d. Adding paragraph (b)(5)(iv);
- e. Revising paragraph (d)(2)(ii); and
- f. Revising paragraphs (f)(3) and (f)(9).

The additions and revisions read as follows.

§ 240.15c2-12 Municipal securities disclosure.

* * * * *

(b) * * *

(4) * * *

(ii) The time when the official statement is available to any person from the Municipal Securities Rulemaking Board, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities

Rulemaking Board, either directly or indirectly through an indenture trustee or a designated agent:

(A) Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

* * * * *

(iv) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board.

* * * * *

(d) * * *

(2) * * *

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide

the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board:

(A) At least annually, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(C) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board; and

* * * * *

(f) * * *

(3) The term final official statement means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which

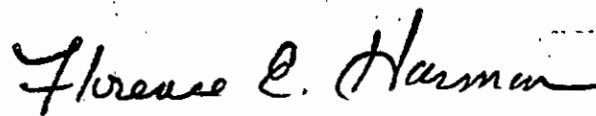
each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

* * * * *

(9) The term annual financial information means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

* * * * *

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: December 5, 2008

Note: Exhibit A to the Preamble will not appear in the Code of Federal Regulations

Exhibit A

Key to Comment Letters Cited in Adopting Release
Amendment to Municipal Securities Disclosure
(File No. S7-21-08)

1. Letter from Fran Busby to 21st Century Disclosure Initiative, Commission, dated October 7, 2008 ("Busby Letter").
2. Letter from Susan Gaffney, Director, Federal Liaison Center, Government Finance Officers Association ("GFOA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 24, 2008 ("GFOA Letter").
3. Letter from Christopher Alwine, Head of Municipal Money Market and Bond Groups, The Vanguard Group, Inc. ("Vanguard"), to Florence E. Harmon, Acting Secretary, Commission, dated September 24, 2008 ("Vanguard Letter").
4. Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("SIFMA Letter").
5. Letter from Paula Stuart, Chief Executive Officer, Digital Assurance Certification, LLC ("DAC"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("DAC Letter").
6. Letter from Louis V. Eccleston, President, Standard & Poor's Securities Evaluations, Inc. ("SPSE"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("SPSE Letter").
7. Letter from Frank Chin, Chair, Municipal Securities Rulemaking Board ("MSRB"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("MSRB Letter").
8. Letter from William A. Holby, President, National Association of Bond Lawyers ("NABL"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("NABL Letter").
9. Letter from Jennifer S. Choi, Assistant General Counsel, Investment Adviser Association ("IAA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("IAA Letter").
10. Letter from Denise L. Nappier, Treasurer, State of Connecticut, to Christopher Cox, Chairman, Commission, dated September 22, 2008 ("Treasurer of the State of Connecticut Letter").

11. Letter from Richard T. McNamar, Chief Executive Officer, e-certus, Inc. ("e-certus"), to Christopher Cox, Chairman, Commission, and to Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("e-certus Letter").
12. Letter from Laura Slaughter, Executive Director, Municipal Advisory Council of Texas ("Texas MAC"), to Christopher Cox, Chairman, Commission, and to Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("Texas MAC Letter").
13. Letter from Thomas H. McTavish, President, National Association of State Auditors, Comptrollers and Treasurers ("NASACT"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("NASACT Letter").
14. Letter from K.W. Gurney, Director, Ohio Municipal Advisory Council ("OMAC"), to Christopher Cox, Chairman, Commission, and to Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("OMAC Letter").
15. Letter from Karrie McMillan, General Counsel, Investment Company Institute ("ICI"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("ICI Letter").
16. Letter from Robert Donovan, Executive Director, Rhode Island Health and Educational Building Corporation, and Steven Fillebrown, Director of Research, Investor Relations and Compliance, New Jersey Healthcare Financing Authority, on behalf of the National Association of Health and Education Facilities Finance Authorities ("NAHEFFA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("NAHEFFA Letter").
17. Letter from Cate Long, Multiple-Markets ("Multiple-Markets"), to Florence E. Harmon, Acting Secretary, Commission, dated September 19, 2008 ("Multiple-Markets Letter").
18. Letter from Robert Yolland, Chairman, National Federation of Municipal Analysts ("NFMA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 19, 2008 ("NFMA Letter").
19. Letter from Peter J. Schmitt, Chief Executive Officer, DPC DATA, Inc. ("DPC DATA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 18, 2008 ("DPC DATA Letter").
20. Letter from Philip D. Moyer, Chief Executive Officer and President, EDGAR Online, Inc. ("EDGAR Online"), to Christopher Cox, Chairman, Commission, and to Ernesto Lanza, Senior Associate General Counsel, MSRB, dated September 9, 2008 ("EDGAR Online Letter").

21. Letter from Al B. Dickman, Professional Investor, to Florence E. Harmon, Acting Secretary, Commission, dated September 5, 2008 ("Dickman Letter").
22. Letter from Elizabeth V. Mooney, to Florence E. Harmon, Acting Secretary, Commission, dated August 21, 2008 ("Mooney Letter").
23. Letter from Aramintha Grant, to Florence E. Harmon, Acting Secretary, Commission, dated August 17, 2008 ("Grant Letter").

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-59061; File No. SR-MSRB-2008-05)

December 5, 2008

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to the Establishment of a Continuing Disclosure Service of the Electronic Municipal Market Access System (EMMA)

I. Introduction

On July 29, 2008, the Municipal Securities Rulemaking Board ("MSRB" or "Board"), filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to establish a continuing disclosure service (the "continuing disclosure service") of the MSRB's Electronic Municipal Market Access system ("EMMA"). The proposed rule change was published for comment in the Federal Register on August 7, 2008.³ The Commission received eighteen comment letters regarding the MSRB's proposed rule change.⁴ On November 5, 2008, the MSRB filed Amendment No. 1 to the proposed rule change.⁵ The text of Amendment No. 1 is available on the MSRB's Web site

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 58256 (July 30, 2008), 73 FR 46161 (August 7, 2008) ("Release No. 34-58256").

⁴ Exhibit A contains the citation key to the comments noted herein. Copies of the comment letters received by the Commission are available on the Commission's Internet Web site, located at <http://www.sec.gov/comments/sr-msrb-2008-05/msrb200805.shtml> and in the Commission's Public Reference Room at its Washington, DC headquarters.

⁵ In Amendment No. 1, the MSRB proposed to establish as the operative date of the continuing disclosure service the later of July 1, 2009 or the effective date of any amendments to Rule 15c2-12 under the Act ("Rule 15c2-12" or "Rule"), 17 CFR 240.15c2-12, that provide for the MSRB to serve as the sole repository for continuing disclosure documents, and to establish January 1, 2010 as the date on which submitters to

(<http://www.msrb.org>), at the MSRB's principal office, and at the Commission's Public Reference Room. On November 24, 2008, the MSRB submitted a letter responding to the comment letters.⁶ This order provides notice of the proposed rule change as modified by Amendment No. 1 and approves the proposed rule change, as amended, on an accelerated basis.⁷

II. Description of the Proposed Rule Change

Under Rule 15c2-12(b)(5), an underwriter for a primary offering of municipal securities subject to the Rule currently is prohibited from underwriting the offering unless the underwriter has determined that the issuer or an obligated person⁸ for whom financial information or operating data is presented in the final official statement has undertaken in writing to provide certain items of information to the marketplace.⁹ Rule 15c2-12(b)(5) provides that such items include: (A) annual financial information concerning obligated persons;¹⁰ (B) audited financial

the continuing disclosure service would be required to submit documents as word-searchable portable document format (PDF) files.

⁶ See Letter from Ernesto A. Lanza, General Counsel, MSRB, to Florence E. Harmon, Acting Secretary, Commission, dated November 24, 2008 ("MSRB Response Letter").

⁷ On August 7, 2008, the Commission published for comment in the Federal Register proposed amendments to Rule 15c2-12 that relate to the MSRB's implementation of the continuing disclosure service. See Securities Exchange Act Release No. 58255 (July 30, 2008), 73 FR 46138 (August 7, 2008) ("Release No. 34-58255"). In a separate release issued today, the Commission is approving its proposed amendments to Rule 15c2-12 ("Rule 15c2-12 Amendments"). See Securities Exchange Act Release No. 59062 (December 5, 2008) ("Rule 15c2-12 Amendments Adopting Release").

⁸ Rule 15c2-12(f)(10) defines "obligated person" as any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities sold in a primary offering (other than providers of bond insurance, letters of credit, or other liquidity facilities).

⁹ See also Rule 15c2-12(d)(2), which provides for an exemption from the requirements of paragraph (b)(5) of Rule 15c2-12.

¹⁰ Rule 15c2-12(f)(9) defines "annual financial information" as financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial

statements for obligated persons if available and if not included in the annual financial information; (C) notices of certain events, if material;¹¹ and (D) notices of failures to provide annual financial information on or before the date specified in the written undertaking.¹² Annual filings, material event notices, and failure to file notices generally are referred to as “continuing

information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis.

¹¹ Under Rule 15c2-12(b)(5)(C), such events currently consist of principal and interest payment delinquencies; non-payment related defaults; unscheduled draws on debt service reserves reflecting financial difficulties; unscheduled draws on credit enhancements reflecting financial difficulties; substitution of credit or liquidity providers, or their failure to perform; adverse tax opinions or events affecting the tax-exempt status of the security; modifications to rights of security holders; bond calls; defeasances; release, substitution, or sale of property securing repayment of the securities; and rating changes.

¹² Under current Rule 15c2-12(b)(5)(i), participating underwriters must reasonably determine whether the issuer has undertaken to send annual filings to all existing nationally recognized municipal securities information repositories (“NRMSIRs”) and any applicable state information depositories (“SIDs”), while the undertaking with respect to material event notices and failure to file notices must provide that they be sent to all existing NRMSIRs or to the MSRB, as well as to any applicable SID. Under the Rule 15c2-12 Amendments adopted today, participating underwriters must reasonably determine whether the issuer has undertaken to send continuing disclosure documents to the MSRB. See Rule 15c2-12 Amendments Adopting Release, supra note 7. The MSRB, which currently operates CDINet to process and disseminate notices of material events submitted to the MSRB, previously petitioned the Commission to amend Rule 15c2-12 to remove the MSRB as a recipient of material event notices due to the very limited level of submissions received by the MSRB, constituting a negligible percentage of material event notices currently provided to the marketplace. See Letter from Diane G. Klinke, General Counsel, MSRB, to Jonathan G. Katz, Secretary, Commission, dated September 8, 2005. In 2006, the Commission published proposed amendments to Rule 15c2-12 to eliminate the MSRB as a repository for material event notices. See Exchange Act Release No. 54863 (December 4, 2006), 71 FR 71109 (December 8, 2006) (“2006 Proposed Rule 15c2-12 Amendments”). In light of the Rule 15c2-12 Amendments and this proposal, the MSRB has determined to withdraw its petition and has requested that the Commission withdraw the 2006 Proposed Rule 15c2-12 Amendments. See Letter from Ernesto A. Lanza, General Counsel, MSRB to Florence E. Harmon, Acting Secretary, Commission, dated October 22, 2008. In this letter, the MSRB also noted its intention to file a proposed rule change with the Commission to discontinue CDINet since its functions would be replaced by the continuing disclosure component of EMMA.

disclosure documents.”

The proposed rule change would establish, as a component of EMMA, the continuing disclosure service for the receipt of, and for making available to the public, continuing disclosure documents and related information to be submitted by issuers, obligated persons and their agents pursuant to continuing disclosure undertakings entered into consistent with Rule 15c2-12.¹³ As proposed, all continuing disclosure documents and related information would be submitted to the MSRB, free of charge, through an Internet-based electronic submitter interface or electronic computer-to-computer data connection, at the election of the submitter, and public access to the documents and information would be provided through the continuing disclosure service on the Internet (“EMMA portal”) at no charge, as well as through a fee-based real-time data stream subscription service.¹⁴

As proposed, the continuing disclosure service would accept submissions of (i) continuing disclosure documents as described in Rule 15c2-12, and (ii) other disclosure documents specified in continuing disclosure undertakings entered into consistent with Rule 15c2-12 but not specifically described in Rule 15c2-12. In connection with documents submitted to the continuing disclosure service, the submitter would provide, at the time of submission,

¹³ EMMA was originally established, and began operation on March 31, 2008, as a complementary pilot facility of the MSRB’s existing Official Statement and Advance Refunding Document (OS/ARD) system of the Municipal Securities Information Library (MSIL) system. See Securities Exchange Act Release No. 57577 (March 28, 2008), 73 FR 18022 (April 2, 2008) (File No. SR-MSRB-2007-06) (approving operation of the EMMA pilot to provide free public access to the MSRB’s Municipal Securities Information Library (MSIL) system collection of official statements and advance refunding documents and to the MSRB’s Real-Time Transaction Reporting System (RTRS) historical and real-time transaction price data) (“pilot EMMA portal”). The pilot EMMA portal currently is accessible at <http://emma.msrb.org>.

¹⁴ We note that the MSRB is required to file with the Commission a proposed rule change under Section 19(b) of the Act with respect to any fees it intends to charge subscribers in connection with a real-time data stream subscription service.

information necessary to accurately identify: (i) the category of information being provided; (ii) the period covered by any annual financial information, financial statements or other financial information or operating data; (iii) the issues or specific securities to which such document is related or otherwise material (including CUSIP number, issuer name, state, issue description/securities name, dated date, maturity date, and/or coupon rate); (iv) the name of any obligated person other than the issuer; (v) the name and date of the document; and (vi) contact information for the submitter. Submitters would be responsible for the accuracy and completeness of all documents and information submitted to EMMA.

The MSRB proposed that submissions to the continuing disclosure service be made as portable document format (PDF) files configured to permit documents to be saved, viewed, printed and retransmitted by electronic means. If the submitted file is a reproduction of the original document, the submitted file must maintain the graphical and textual integrity of the original document. In addition, as of January 1, 2010, the MSRB would require that such PDF files must be word-searchable (that is, allowing the user to search for specific terms used within the document through a search or find function available in most standard software packages), provided that diagrams, images and other non-textual elements would not be required to be word-searchable due to current technical hurdles to uniformly producing such elements in word-searchable form without incurring undue costs.¹⁵ Although the MSRB would strongly encourage submitters to immediately begin making submissions as word-searchable PDF files (preferably as native PDF or PDF normal files, which generally produce smaller and more easily downloadable files as compared to scanned PDF files), implementation of this requirement would be deferred as noted above to provide issuers, obligated persons and their agents with

¹⁵ See Amendment No. 1, supra note 5.

sufficient time to adapt their processes and systems to provide for the routine creation or conversion of continuing disclosure documents as word-searchable PDF files.

All submissions to the continuing disclosure service pursuant to this proposal would be made through password protected accounts on EMMA by: (i) issuers, which may submit any documents with respect to their municipal securities; (ii) obligated persons, which may submit any documents with respect to any municipal securities for which they are obligated; and (iii) designated agents, which may be designated by issuers or obligated persons to make submissions on their behalf. Issuers and obligated persons would be permitted under the proposal to designate agents to submit documents and information on their behalf, and would be able to revoke the designation of any such agents, through the EMMA on-line account management utility. Such designated agents would be required to register to obtain password-protected accounts on EMMA in order to make submissions on behalf of the designating issuers or obligated persons. Any party identified in a continuing disclosure undertaking as a dissemination agent or other party responsible for disseminating continuing disclosure documents on behalf of an issuer or obligated person would be permitted to act as a designated agent for such issuer or obligated person, without a designation being made by the issuer or obligated person as described above, if such party certifies through the EMMA on-line account management utility that it is authorized to disseminate continuing disclosure documents on behalf of the issuer or obligated person under the continuing disclosure undertaking. The issuer or obligated person, through the EMMA on-line account management utility, would be able to revoke the authority of such party to act as a designated agent.

The MSRB proposed that electronic submissions of continuing disclosure documents through the continuing disclosure service would be made by issuers, obligated persons and their

agents, at no charge, through secured, password-protected interfaces. Continuing disclosure submitters would have a choice of making submissions to the proposed continuing disclosure service either through a Web-based electronic submission interface or through electronic computer-to-computer data connections with EMMA that would be designed to receive submissions on a bulk or continuous basis.

All documents and information submitted through the continuing disclosure service would be available to the public at no charge through the EMMA portal on the Internet, with documents made available for the life of the securities as PDF files for viewing, printing and downloading. As proposed, the EMMA portal would provide on-line search functions to enable users to readily identify and access documents that relate to specific municipal securities based on a broad range of search parameters. In addition, as noted above, the MSRB proposes that real-time data stream subscriptions to continuing disclosure documents submitted to EMMA would be made available for a fee.¹⁶ The MSRB would not be responsible for the content of the information or documents submitted by submitters displayed on the EMMA portal or distributed to subscribers through the continuing disclosure subscription service.

According to the MSRB, it has designed EMMA, including the EMMA portal, as a scalable system with sufficient current capacity and the ability to add further capacity to meet foreseeable usage levels based on reasonable estimates of expected usage, and the MSRB would monitor usage levels in order to assure continued capacity in the future.

The MSRB may restrict or terminate malicious, illegal or abusive usage for such periods as may be necessary and appropriate to ensure continuous and efficient access to the EMMA

¹⁶ We note that the MSRB is required to file with the Commission a proposed rule change under Section 19(b) of the Act with respect to any fees it intends to charge subscribers in connection with a real-time data stream subscription service.

portal and to maintain the integrity of EMMA and its operational components. Such usage may include, without limitation, usage intended to cause the EMMA portal to become inaccessible by other users; to cause the EMMA database or operational components to become corrupted or otherwise unusable; to alter the appearance or functionality of the EMMA portal; or to hyperlink to or otherwise use the EMMA portal or the information provided through the EMMA portal in furtherance of fraudulent or other illegal activities (such as, for example, creating any inference of MSRB complicity with or approval of such fraudulent or illegal activities or creating a false impression that information used to further such fraudulent or illegal activities has been obtained from the MSRB or EMMA). Measures taken by the MSRB in response to such unacceptable usage would be designed to minimize any potentially negative impact on the ability to access the EMMA portal.

The Commission received eighteen comment letters regarding the proposed rule change.¹⁷ Fifteen commenters generally supported the proposed rule change¹⁸ and many of these commenters also provided various observations and suggestions. Two commenters, both of which are NRMSIRs, opposed the proposed rule change and suggested alternative approaches to achieving the Commission's objectives.¹⁹ One commenter neither supported nor opposed the proposal and addressed CUSIP licensing issues.²⁰ The Commission also received the MSRB's

¹⁷ See supra note 4.

¹⁸ See Busby Letter, DAC Letter, Vanguard Letter, GFOA Letter, e-certus Letter, SIFMA Letter, NABL Letter, Treasurer of the State of Connecticut Letter, Texas MAC Letter, OMAC Letter, ICI Letter, NAHEFFA Letter, EDGAR Online Letter, MSRB Letter, and NFMA Letter.

¹⁹ See SPSE Letter and DPC DATA Letter.

²⁰ See ABA Letter.

response to the comment letters.²¹ These comment letters, as well as the MSRB's response to the comment letters, are more fully discussed below.

III. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change, the comment letters received, and the MSRB's response to the comment letters and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the MSRB²² and, in particular, the requirements of Section 15B(b)(2)(C) of the Act²³ and the rules and regulations thereunder. In particular, the Commission finds that the proposal to establish the continuing disclosure service will remove impediments to and help perfect the mechanisms of a free and open market in municipal securities, assist in preventing fraudulent and manipulative acts and practices, and, in general, will protect investors and the public interest by improving access to continuing disclosure documents by investors and market participants, enabling them to make informed investment decisions regarding municipal securities.

²¹ See MSRB Response Letter. A copy of the MSRB Response Letter is available on the Commission's Internet website at <http://www.sec.gov/comments/sr-msrb-2008-05/msrb200805.shtml> and in the Commission's Public Reference Room at its Washington, DC headquarters.

²² In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

²³ 15 U.S.C. 78o-4(b)(2)(C). Section 15B(b)(2)(C) of the Act requires, among other things, that the MSRB's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest; and not be designed to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

The Commission believes that the MSRB's proposed continuing disclosure service will serve as an additional mechanism to remove impediments to and help perfect the mechanisms of a free and open market in municipal securities. The continuing disclosure service will help make information more easily available to all participants in the municipal securities market on an equal basis and without charge through a centralized, searchable Internet-based repository, thereby removing potential barriers to obtaining such information. Broad availability of continuing disclosure documents through the continuing disclosure service should assist in preventing fraudulent and manipulative acts and practices by improving the opportunity for investors to obtain information about issuers and their securities, and help investors make informed investment decisions.

The continuing disclosure service also should reduce the effort necessary for issuers and obligated persons to comply with their continuing disclosure undertakings because submissions will be made to a single venue²⁴ through use of an electronic submission process. Similarly, a single centralized and searchable venue that provides for free public access to disclosure information should promote a more fair and efficient municipal securities market in which transactions are effected on the basis of information available to all parties to such transactions, which should assist investors in having a more complete understanding of the terms of the securities and the potential investment risks. Access to this information without charge, which was previously available in most cases only through paid subscription services or on a per-document fee basis, also should help reduce informational costs for broker-dealers and municipal

²⁴ Some states may require issuers and/or obligated persons to submit disclosure information to state information depositories ("SIDs") or other venues pursuant to state law. However, under the Rule 15c2-12 Amendments, participating underwriters no longer need to reasonably determine that issuers and/or obligated persons have undertaken to provide continuing disclosure documents to SIDs. See Rule 15c2-12 Amendments Adopting Release, supra note 7.

securities dealers, as well as other market participants, analysts, retail and institutional investors and the public generally. These changes are expected to further the objectives of Rule 15c2-12 of reducing the potential for fraud in the municipal securities market.

Indeed, we anticipate that the accessibility of documents through the repository will greatly benefit dealers in satisfying their obligation to have a reasonable basis for investment recommendations and other regulatory responsibilities, in addition to investors and other market participants who seek information about municipal securities. This conclusion is supported by various commenters.

As noted above, commenters generally supported the proposed rule change. In particular, one commenter expressed the opinion that allowing issuers, obligated parties and dissemination agents to submit information to one location,²⁵ electronically and free of charge in order to meet the obligations of Rule 15c2-12, is very useful to the state and local government community²⁶ and several commenters remarked that allowing investors to retrieve information from this location would be advantageous to the marketplace and investors.²⁷ Commenters believed that the single filing location would make the filing process easier for filers submitting filings and more efficient for investors accessing documents.²⁸ One commenter also remarked that the availability of continuing disclosure documents in one venue as a component of EMMA, where there will also be posted the final official statement (or similar primary market disclosure document), and pricing information, will provide readers the benefit of the proper context for

²⁵ See id.

²⁶ See GFOA Letter.

²⁷ See, e.g., GFOA Letter, SIFMA Letter, Vanguard Letter, Treasurer of the State of Connecticut Letter, ICI Letter.

²⁸ Id.

reviewing the continuing disclosure.²⁹ Others expressed support for the MSRB's proposal to make the continuing disclosure service a free service for both issuers and other obligated persons³⁰ submitting documents as well as for investors and other market participants³¹ accessing continuing disclosure information. One commenter expressed a belief that the proposed rule change would be a means of removing impediments to and helping to perfect the mechanisms of a free and open market in municipal securities within the meaning of the Act.³²

One commenter recommended that the Commission maintain close oversight of EMMA, ensure proper testing of the system, and revisit this matter in two to three years.³³ A second commenter also expressed a belief that the Commission should establish rigorous ongoing inspection and oversight of EMMA.³⁴ We note that, because the MSRB is a self-regulatory organization ("SRO"), the Commission has, and exercises, oversight authority over the MSRB. The MSRB must file proposed rule changes with the Commission under Section 19(b) of the Act, including any changes to the EMMA system and any fees relating to the EMMA system. In addition, the MSRB is subject to the recordkeeping requirements of 17(a) of the Act³⁵ and is subject to the Commission's examination authority under Section 17(b) of the Act.³⁶ Through the Commission's recordkeeping requirements and examination and rule filing processes, the Commission oversees the MSRB and will ascertain whether the MSRB is implementing EMMA

²⁹ See SIFMA Letter.

³⁰ See GFOA Letter.

³¹ See, e.g., GFOA Letter, Busby Letter, NFMA Letter, DAC Letter, Vanguard Letter, and EDGAR Online Letter.

³² See SIFMA Letter.

³³ See Treasurer of the State of Connecticut Letter.

³⁴ See DAC Letter.

³⁵ 15 U.S.C. 78q(a).

³⁶ 15 U.S.C. 78q(b).

appropriately and meeting EMMA's stated objectives, as well as complying with all of its legal obligations under the Act.

Eleven commenters that supported the proposed rule change also believed that EMMA submissions should be accompanied by identifying information.³⁷ Several of these commenters suggested various specific types of identifiers that were sometimes different from, or in addition to, those set forth in the proposed rule change. In this regard, specific identifiers that were suggested by commenters included: the identification of obligated persons other than issuers and successor parties;³⁸ the issuer's investor contact information;³⁹ a link to issuer's Web site;⁴⁰ the CUSIP numbers for all primary and secondary market debt covered by relevant information;⁴¹ the use of electronic "cover sheets;"⁴² the pre-registration of identifying information;⁴³ a mechanism to readily locate CUSIP numbers by the issuer's six digit prefix and at the same time list by nine digit CUSIPs in certain circumstances;⁴⁴ and a CUSIP catalog.⁴⁵ In its response letter, the MSRB noted that the use of accurate identifiers for continuing disclosure submissions in EMMA is vitally important to ensure correct indexing and access to continuing disclosure

³⁷ See NFMA Letter, DAC Letter, GFOA Letter, Vanguard Letter, SIFMA Letter, NABL Letter, Treasurer of the State of Connecticut Letter, Texas MAC Letter, OMAC Letter, ICI Letter, and EDGAR Online Letter.

³⁸ See GFOA Letter, Treasurer of the State of Connecticut Letter, Vanguard Letter, and ICI Letter.

³⁹ See NFMA Letter.

⁴⁰ Id.

⁴¹ Id.

⁴² See GFOA Letter.

⁴³ See Treasurer of the State of Connecticut Letter.

⁴⁴ Id.

⁴⁵ See NFMA Letter.

documents.⁴⁶ The MSRB indicated that, except as noted below,⁴⁷ documents provided to it are required to be accompanied by identifying information relating to the nature of the document, the securities and entities to which it applies, and the entity making the submission, as prescribed by the MSRB. In connection with EMMA submissions, the MSRB noted that the submitter will be required to provide, at the time of submission, information necessary to correctly identify the following: the category of information being provided; the period covered by any financial information; the issues or specific securities to which such document is related or otherwise material (including CUSIP number, issuer name, state issue description, securities name, dated date, maturity date and/or coupon rate); the name of any obligated person other than the issuer; the name and date of the document; and the contact information for the submitter.⁴⁸ According to the MSRB, since all continuing disclosure documents submitted to EMMA will be made through a unique, password protected accounts by issuers, obligated persons and their designated agents, once the indexing information is provided, the EMMA system will match each document with the appropriate identifying information for the submitter. The MSRB believes that these processes will adequately address issues relating to the use of identifiers for the submission process. The MSRB also believes that the use of these identifiers ensures both that the

⁴⁶ See MSRB Response Letter.

⁴⁷ See *infra* note 48.

⁴⁸ As the Commission noted in its adopting release for amendments to Rule 15c2-12 [Release No. 34-59062; File No. S7-21-08, December 5, 2008], the commitment by an issuer to provide identifying information exists only if it were included in a continuing disclosure agreement. As a result, issuers submitting continuing disclosure documents pursuant to the terms of undertakings that were entered into prior to the effective date of the final amendments and that did not require identifying information will be able to submit documents without supplying identifying information. In its response, the MSRB indicated that the submitter making a submission pursuant to a continuing disclosure undertaking entered into prior to the effective date of the proposed Rule 15c2-12 amendments who seeks to make such submission without providing identifying information could do so.

submission process is not unduly burdensome and that standardized market identifiers commonly used in the municipal marketplace serve as the basis on which EMMA users would be able to conduct document searches. Furthermore, while the MSRB believes that the identifiers it proposed are appropriate and cover most of the identifying elements recommended by the commenters, the MSRB also will consider whether any additional identifiers would be appropriate. The Commission believes that it is appropriate for the MSRB to incorporate without change in the continuing disclosure service the indexing information that the MSRB initially had proposed. The Commission believes that the MSRB has provided valid reasons for not incorporating at this time the additional indexing information that commenters suggested. As the MSRB noted, the proposed identifiers are standardized market identifiers used in the municipal marketplace, which should help ensure that the transition to the continuing disclosure service will not be unduly burdensome for submitters. We note, however, that the MSRB indicated that it will consider additional identifiers in the future.⁴⁹

One commenter, who neither supported nor opposed the proposal, questioned whether the MSRB would seek appropriate licensing for its use of the commenter's intellectual property rights with respect to the CUSIP database.⁵⁰ The MSRB stated in its response letter that it is continuing its discussions with the appropriate parties relating to the use of CUSIP data and expects that all necessary arrangements will be in place to operate the continuing disclosure service as anticipated by the July 1, 2009 implementation date.⁵¹ If there are any unanticipated and unresolved issues in connection with the use of the CUSIP data, the MSRB stated that it will

⁴⁹ We note that the MSRB is required to file with the Commission a proposed rule change under Section 19(b) of the Act with respect to any additional indexing information that it may propose to prescribe.

⁵⁰ See ABA Letter.

⁵¹ See MSRB Response Letter.

consult with the Commission and, if necessary, make any filings to modify data usage by EMMA or to adjust the implementation date. In light of the MSRB's assurances that this issue is expected to be resolved in advance of the continuing disclosure service's proposed implementation date of July 1, 2009, the Commission does not believe that it is necessary to delay its approval of the proposed rule change. Nonetheless, we will continue to monitor the progress of EMMA, including the issue relating to licensing rights to the CUSIP database, prior to EMMA's implementation.

Some commenters expressed their belief that EMMA should have a simple user interface and intuitive search functionality.⁵² One commenter noted that "[a]s demonstrated, we believe that there are ample ways for the public to locate particular documents, either through a CUSIP number or an entity's name. It is imperative for these fields to be applied to all securities and for the MSRB to determine the most efficient way to do so."⁵³ The MSRB stated its belief that its pilot of the primary market service of the EMMA portal is user-friendly and that the continuing disclosure service of EMMA will also be user-friendly, in part, because the continuing disclosure service will provide the same accessibility to information to municipal market participants and easy-to-use identifiers for submissions as currently provided by the pilot of the primary market service of the EMMA portal. For example, if users have a CUSIP number, they will be able to go directly to the related documents on the EMMA system and, similarly, a user can go to the market activity page and see all the disclosures that were posted on a certain date.⁵⁴ The MSRB also noted its intention to continue to make improvements to the system.⁵⁵ The Commission

⁵² See EDGAR Online Letter, NFMA Letter and GFOA Letter.

⁵³ See GFOA Letter.

⁵⁴ See MSRB Response Letter.

⁵⁵ Id.

believes the MSRB has proposed a reasonably efficient way to apply identifying fields to the continuing disclosure documents submitted to the EMMA system and expects that the MSRB will continue to monitor the EMMA portal to ensure that document submission is easy and document access is efficient on an ongoing basis and that the MSRB will propose rule changes to the continuing disclosure service pursuant to Section 19(b) of the Act as changes are needed.⁵⁶

Some commenters expressed concerns that access to previous filings made with NRMSIRs may no longer be available.⁵⁷ Nothing in the MSRB's proposal will prevent the NRMSIRs from continuing to make historical information available. We recognize, however, that the NRMSIRs may decide not to do so. The MSRB stated in its response letter that while it does not have the authority to mandate the submission of historical data by issuers, issuers, obligated persons and their agents will be free to submit to EMMA continuing disclosure documents and related information previously submitted to the NRMSIRs.⁵⁸ The MSRB also stated that it is willing to communicate with the NRMSIRs on the continued availability of historical documents and related information and believes that such communication will be fruitful.⁵⁹ As a practical matter, we believe that this is largely a transitional issue until EMMA has collected documents for a number of years and anticipate that requests for such documents from the NRMSIRs by those persons who are not already subscribers to their services may be expected to decline over time.

⁵⁶ We note that the MSRB is required to file with the Commission a proposed rule change under Section 19(b) of the Act with respect to the operation of the continuing disclosure service and with respect to any changes to the continuing disclosure service.

⁵⁷ See, e.g., Vanguard Letter and ICI Letter.

⁵⁸ See MSRB Response Letter.

⁵⁹ As discussed more fully in the Rule 15c2-12 Amendments Adopting Release, the Commission believes that the current NRMSIRs could decide it is in their commercial interest to make historical information available.

Several commenters also made observations and suggestions regarding the access and security features of the continuing disclosure service.⁶⁰ One commenter suggested that the MSRB should distinguish between the responsibilities of obligated persons and submitters.⁶¹ Two commenters recommended a special methodology for conduit borrowers to access EMMA.⁶² Three commenters stated that issuers and obligated persons should have the ability to verify information submitted to EMMA by third parties and to correct errors either by accessing the system directly or by reporting any errors to a "hotline."⁶³

The MSRB noted in its response letter that its proposal does not change the obligations of issuers or obligated persons and their designated agents, which are established pursuant to the terms of continuing disclosure agreements, and that all persons, including issuers, obligated persons and designated agents will be able to access filings on EMMA to verify their availability and the accuracy of their indexing. The MSRB also noted that all submission methods will provide appropriate feedback to submitters for error correction and submission confirmation purposes. The MSRB also provides a website that allows submitters to provide questions and comments associated with submissions, as well as a help desk with dedicated personnel during MSRB business hours. Furthermore, the proposal will allow issuers and obligated persons to maintain control over those persons who may submit filings on their behalf. The MSRB will permit only those persons identified as designated agents in continuing disclosure agreements to submit documents without advance approval through EMMA and will notify issuers of the identity of those persons who submit documents on their behalf. Issuers and obligated persons

⁶⁰ See NABL Letter, NAHEFFA Letter, GFOA Letter, and NFMA Letter.

⁶¹ See NABL Letter.

⁶² See NAHEFFA Letter and GFOA Letter.

⁶³ See NAHEFFA Letter, GFOA Letter, NFMA Letter.

also will be able to revoke self-certification of dissemination agents through the EMMA on-line account management utility at any time.

With respect to conduit financings,⁶⁴ two commenters⁶⁵ expressed concern that EMMA does not appropriately accommodate issues relating to the real parties in interest in such financings. In conduit financings, the bond issuing authority (e.g., a state or local government) may issue tax exempt bonds on behalf of certain entities (e.g., not-for profit organizations). Under these arrangements, the entity for which the tax exempt bonds were issued may be regarded as the real obligated party with the responsibility of submitting continuing disclosure documents and ensuring that such submissions are accurate. Accordingly, these commenters expressed concern that EMMA will not appropriately discriminate whether the bond issuing authority, or the certain entity on behalf of which the tax-exempt bonds are issued, is responsible for the continuing disclosure submissions. The MSRB responded that the proposal establishes, through the account opening process, a mechanism that would permit, on an optional basis, issuers of conduit financings to identify obligated persons and the securities for which such persons are obligated.⁶⁶ Furthermore, the MSRB plans to establish methods for submitters to contact it with questions and to report any problems submitters may discover with filings they electronically send to the EMMA system.⁶⁷ The Commission believes that the MSRB has established appropriate measures with respect to security and controls for the submission of documents to the continuing disclosure service.

⁶⁴ Conduit financings are financings in which authorities with bond issuing authority issue tax-exempt bonds on behalf of certain entities, including not-for profit organizations.

⁶⁵ See NAHEFFA Letter and NFMA Letter.

⁶⁶ See MSRB Response Letter.

⁶⁷ Id.

Some commenters that supported the proposed rule change suggested incorporation of an interactive data standard (i.e., XBRL).⁶⁸ The MSRB responded that it will take all such suggestions under consideration for future revisions to the continuing disclosure service. The MSRB noted, however, that documents need not be created in any particular manner in order to be saved or scanned into a PDF format. The MSRB indicated that it does not view establishing XBRL as a data standard for EMMA submissions as appropriate at this time, although it noted that it continues to be interested in working with the municipal market in the future on interactive data initiatives. The Commission believes that, in the future, access to continuing disclosure documents through the EMMA system could be enhanced by improved methods for the electronic presentation of information, but believes that the MSRB's technology choices for EMMA are appropriate at this time.

Seven of the commenters that supported the proposed rule change indicated that EMMA should have the capability to accept voluntary and non-periodic disclosures in addition to Rule 15c2-12 disclosures⁶⁹ or recommended the addition of features such as information regarding late or missing filings.⁷⁰ In its response letter, the MSRB stated that although the continuing disclosure service will not allow for the submission of continuing disclosure documents beyond those currently set forth in Rule 15c2-12 or those documents identified in an undertaking by the issuer or obligated person, the MSRB expects to propose in a future filing to accept submissions of a broader scope.⁷¹ The Commission believes that limiting the scope of the documents to be submitted through the continuing disclosure service to those referenced in continuing disclosure

⁶⁸ See, e.g., GFOA Letter, e-certus Letter, and EDGAR Online Letter.

⁶⁹ See ICI Letter, NFMA Letter, NABL Letter, GFOA Letter, Vanguard Letter and SIFMA Letter, Treasurer of the State of Connecticut Letter.

⁷⁰ See, e.g., ICI Letter.

⁷¹ See MSRB Response Letter.

agreements will fulfill the intended purpose of Rule 15c2-12 and thus is reasonable at this time.

One commenter expressed support for the dissemination of information in a bulk format.⁷² Some commenters expressed concerns regarding fees to be charged by the MSRB for subscriptions to the real-time data feed and whether the transfer of documents through the data feed would be delayed.⁷³ In addition, three commenters suggested that the MSRB should provide SIDs with a data feed of filing information and one of these commenters stated that this data feed should be provided free of charge.⁷⁴ Further, one commenter expressed concern that broker-dealers would pass on fees to their customers to support the EMMA system.⁷⁵

In its response letter, the MSRB stated that in addition to providing access to continuing disclosure documents through the EMMA portal without charge to all persons on an equal basis on its Internet website, the MSRB also will offer real-time subscriptions to EMMA's continuing disclosure documents and information as they are submitted and processed.⁷⁶ According to the MSRB, its goal is to ensure an efficient process for making available real-time data subscription products at a reasonable cost.⁷⁷ The MSRB also stated that it will work with the SIDs to ensure that they will have reasonable access to the documents submitted for issues in their respective states and will not incur costs related to the entire EMMA subscription product.⁷⁸

The Commission notes that fees relating to the EMMA system, such as subscription fees for a data feed for access to documents submitted to the continuing disclosure service, also must

⁷² See, e.g., EDGAR Online Letter.

⁷³ See DPC DATA Letter, NFMA Letter and GFOA Letter.

⁷⁴ See Texas Mac Letter, OMAC Letter, and GFOA Letter.

⁷⁵ See SPSE Letter.

⁷⁶ See MSRB Response Letter.

⁷⁷ Id.

⁷⁸ Id.

be filed with the Commission as a proposed rule change under Section 19(b) of the Act.

Accordingly, any fees relating to the continuing disclosure service would be published for public comment by the Commission and interested persons would have the opportunity to offer their views on them.

With respect to the comment that broker-dealers would pass on fees to their customers to support the EMMA system, the Commission again notes that the MSRB, as an SRO, would have to file any fees relating to the support or use of the continuing disclosure service with the Commission under Section 19(b) of the Exchange Act, to the extent such fees are not already covered by the MSRB's current fee schedule. The Commission further notes that broker-dealers currently are charged fees for access to disclosure documents obtained from the NRMSIRs that they currently may or may not pass on to their customers. According to the MSRB, it presently anticipates no increase in fees on brokers, dealers, and municipal securities dealers that effect transactions in municipal securities to establish and operate the EMMA system.⁷⁹ The MSRB has stated that it has funds on hand that, together with amounts it will collect in the future under its current fee schedule, it believes will be sufficient to establish and operate the continuing disclosure service of the EMMA system.⁸⁰

Two commenters opposed the proposal and suggested alternative approaches to greater access to continuing disclosure documents by investors and others.⁸¹ They believed that the MSRB's proposal would not improve the overall continuing disclosure regime and that it does not address the core problems with the current system, such as the significant level of delinquent filings. One of these commenters stated that the proposal imposes restrictions on filing formats

⁷⁹ See MSRB Response Letter.

⁸⁰ Id.

⁸¹ See DPC DATA Letter and SPSE Letter.

(i.e., single-electronic) and technology and misstates important attributes of the current municipal disclosure regime. This commenter urged enforcement of existing provisions of Rule 15c2-12 and otherwise working within the existing disclosure system. The other commenter believed that a "central post office" approach is preferable.⁸²

In its response letter, the MSRB expressed its belief that the establishment of single submission and dissemination venue through EMMA's continuing disclosure service would significantly improve upon the current municipal disclosure system.⁸³ The MSRB believed that a simple, secure and centralized system will simplify issuers' submissions. According to the MSRB, for example, the fact that continuing disclosure documents will be publicly available for free through a searchable website in which all filings for a particular issue are displayed as a single collection will serve, for the first time, to make it easy for issuers, investors and others to determine whether or not filings are missing, whether due to an issuer failing to make a filing or otherwise.

While the Commission acknowledges that the MSRB's proposal does not address all of the information challenges of the municipal market, the Commission continues to believe that the MSRB's proposal is a significant step forward in facilitating the submission of, and access to, secondary market municipal disclosures. As noted previously, a large majority of the commenters supported the MSRB's proposal and believed that it will improve the overall continuing disclosure regime. The Commission also believes that this will be the case. We anticipate that public access to all continuing disclosure documents on the Internet, as provided

⁸² Under a central post office approach, issuers and obligors would file documents through a single electronic venue in a standardized format. The central post office would then forward the centrally-filed documents in real time to the NRMSIRs. See also SPSE Letter, at 3-5.

⁸³ See MSRB Response Letter.

by the proposal, will promote market efficiency and help deter fraud and manipulation in the municipal securities market by improving the availability of information to all investors. With respect to one commenter's concern that the proposal would impose restrictions on filing formats, impose technology requirements that do not exist under the current system and provide no appreciable benefit, the Commission notes that the availability of continuing disclosure documents at a single repository that can be readily accessed and easily searched through electronic means will provide significant benefits that are not available under the current NRMSIR system. The Commission notes that the submission of continuing disclosure documents in an electronic format will allow the information to be posted and disseminated promptly. The Commission also notes that the MSRB's proposed filing format and choice of technology will eliminate the need for manual handling of paper documents, which is less efficient and more costly, and will increase the potential for a more complete record of continuing disclosure documents that otherwise might be misfiled or lost under a manual system. Furthermore, the Commission believes that submissions in an electronic format will not be burdensome on issuers or obligated persons since many documents are now routinely created in an electronic format and can be readily transmitted by electronic means. With respect to the comment that the existing disclosure system should be retained and the existing provisions of the Rule 15c2-12 enforced, the Commission believes that enforcement of the provisions of Rule 15c2-12 is an important mechanism for the protection of municipal securities investors and the efficient operation of the marketplace. However, the Commission also believes that the quality, timing, and availability of disclosure in the municipal securities markets will be substantially improved by the MSRB's proposal.

With respect to the comment favoring a "central post office," the Commission believes

that this approach is less likely to make access to continuing disclosure documents as efficient as the MSRB's continuing disclosure service and therefore would not achieve the goal. For example, with a central post office there would continue to be no single location to which investors, particularly individuals, could turn for free access to information regarding municipal securities. Instead, individuals or entities that wish to obtain such information would find it necessary first to access the central post office to find out what documents might be available from NRMSIRs and SIDs and then to contact one or more NRMSIRs or SIDs and pay their fees to obtain the document or documents they seek. This would be a less efficient process than the MSRB's proposal, in which interested persons could directly access, view and print for free continuing disclosure documents from one place – the MSRB's Internet site.

Moreover, a "central post office" would not, to the same extent as the MSRB's EMMA system, simplify compliance with regulatory requirements by, and reduce compliance costs of, broker-dealers, municipal securities dealers, and others. This is because they would have to first access the "central post office" to determine what documents are available and then contact one or more NRMSIRs or SIDs to obtain these documents for a fee or subscribe to commercial services to do so on their behalf. We believe that greater benefits will be achieved by providing public access to all continuing disclosure documents on the Internet, as provided by the proposal. We anticipate that access to all continuing disclosure documents without charge through the MSRB's Internet site will better promote market efficiency and help deter fraud and manipulation in the municipal securities market by improving the availability of information to all investors.

Two commenters, both of which are NRMSIRs, also raised concerns about the potential adverse effects on competition and raised issues about the proposal's consistency with

Congressional intent regarding the regulation of municipal securities.⁸⁴ Both of these commenters believed that the proposal is contrary to Section 15B(d) of the Act,⁸⁵ commonly referred to as the Tower Amendment. One of these commenters also expressed its belief that the proposal would reduce current value-added products and services provided by existing NRMSIRs and other vendors; narrow competing information services regarding municipal securities; and result in a loss of innovation in offering competing information services regarding municipal securities.⁸⁶ This commenter also expressed its belief that the proposal is anti-competitive and would unfairly displace private vendors that have made significant investment under the current system with a "quasi-governmental organization" that is subsidized and could provide value-added services for free.⁸⁷ The other commenter expressed a belief that the proposal places the MSRB in direct competition with commercial vendors.⁸⁸

With respect to their comments regarding competition, the MSRB responded that it did not believe that the proposed rule change would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.⁸⁹ The MSRB expressed its belief that existing vendors would continue to have rapid access to all of the same documents they previously received, now accompanied by consistent indexing information, and would fully be able to provide value added products based on such documents. Additionally, the MSRB responded that it believed that the availability of continuing disclosure documents through the EMMA portal and the continuing disclosure subscription service would promote competition

⁸⁴ See DPC DATA Letter and SPSE Letter.

⁸⁵ 15 U.S.C. 78o-4(d).

⁸⁶ See SPSE Letter.

⁸⁷ Id.

⁸⁸ See DPC DATA Letter.

⁸⁹ See MSRB Response Letter.

among private data vendors and other enterprises engaged in, or interested in becoming engaged in, the market for information services by eliminating existing barriers to new entrants into the market for municipal securities information. The MSRB added that none of the functionalities of the continuing disclosure service constitute value-added services that compete inappropriately with the private sector. Rather, the MSRB noted that these functionalities are critical for the continuing disclosure services operation as a free, centralized source of information for retail investors that provides investors with the necessary tools to find the information for which they are searching and to understand such information once it is found. Furthermore, the MSRB expressed its belief that its operation of the continuing disclosure service would serve as a basis on which private enterprises could themselves concentrate more of their resources on developing and marketing value-added services. In the MSRB's opinion, the shift in the flow of continuing disclosure documents from the current NRMSIRs to EMMA (from which such entities and others could still obtain documents on a real-time basis accompanied by indexing information) would represent only a temporary dislocation in the processes by which current vendors that produce value-added services obtain the raw documents on which these services are based.

Moreover, the MSRB expressed its belief that the proposal will prove to be of long-term benefit to such vendors. The MSRB noted that much of the impact of the proposed rule change on commercial enterprises will result from increased competition in the marketplace resulting from the entry of additional commercial enterprises to compete with existing market vendors for value-added services, rather than from the operation of the continuing disclosure service.

Furthermore, the MSRB stated its belief that the benefits realized by the investing public from the broader and easier availability of disclosure information about municipal securities justifies any potential negative impact on existing enterprises resulting from the operation of EMMA.

The MSRB emphasized that its activities are subject to the supervision of the Commission and that any changes to EMMA and related systems must be filed with the Commission. The MSRB further commented that it has worked closely with all of the marketplace's key constituencies, including issuers, bond attorneys, financial advisers, and others in the development of EMMA and represented that it will continue to do so as EMMA becomes fully operational.

The Commission believes that the proposal will modernize the method of availability of continuing disclosure documents by issuers and, by making use of the Internet, will make these documents readily accessible to investors and others at no charge. The continuing disclosure service will not alter the availability of such documents to commercial vendors or their ability to disseminate such information, together with whatever value-added products they may wish to provide. The Commission notes that the MSRB has represented that documents provided through EMMA will be available to all persons on an equal basis and that the MSRB will continue to make the full collection of documents available by subscription on an equal basis, without imposing restrictions on subscribers from re-disseminating such documents or from otherwise offering value-added service and products, based on such documents on terms determined by each subscriber.⁹⁰ Further, the Commission notes that the MSRB has represented that EMMA will be designed to provide real-time access to documents and information as they are submitted and processed⁹¹ and that all continuing disclosures received by the MSRB will be available through a data-stream subscription simultaneously with posting on the EMMA portal.⁹²

The Commission believes that the proposed rule change will encourage, rather than restrict, competition in the municipal securities information marketplace. The Commission

⁹⁰ See MSRB Response Letter.

⁹¹ See MSRB Response Letter.

⁹² See Release No. 34-58256, *supra* note 3.

further believes that any burdens on competition that may result from the proposed rule change are more than justified by the benefits that will flow from ready and free availability of municipal disclosure documents to broker-dealers, municipal securities dealers, mutual funds, analysts, retail and institutional investors, and the public generally. Both existing private vendors and new market entrants seeking to provide value-added products and services will be able to access all available continuing disclosure documents from EMMA for free, or for a subscription fee if they elect to receive a real-time data feed. Consequently, existing vendors and potential new market entrants no longer will have to pay multiple subscription fees or document charges to multiple NRMSIRs to access the continuing disclosure information that is necessary for value-added products and services. The MSRB's proposal is designed to help spur innovation and competition for value-added products and services and is expected to reduce barriers to entry for new market participants. The Commission also notes that because continuing disclosure information will be available at the MSRB, existing vendors and new market entrants can conserve resources that otherwise would be utilized to obtain a full complement of available continuing disclosure information that is spread out across multiple NRMSIRs. In addition, while the Commission acknowledges that some existing vendors may need to make some adjustments to their line of business or services offered, these vendors and others may determine that they no longer need to invest in the infrastructure and facilities necessary to collect and store continuing disclosure information. The Commission believes that the proposed rule change likely will have a net benefit on the competitive landscape for municipal securities disclosure information services and further the purposes of the Act by deterring the potential for fraud in the municipal securities market.

With respect to concerns that the MSRB could control private vendors' access to

information through unfair fee structures and biased dissemination of information for the purpose of conditioning the market to use EMMA and the MSRB's own services,⁹³ the Commission notes that the MSRB is required to file its fee changes and rule proposals relating to the EMMA system with the Commission under Section 19(b) of the Act. Thus, interested parties will have the opportunity to comment on any such proposal and bring to the Commission's attention any potential issues. The Commission has carefully considered the comments of the two NRMSIRs regarding competition, and the MSRB's response letter, and does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. To the contrary, as discussed above, the Commission believes that any competitive impact that may result from the proposed rule change is justified by the benefits that will be provided to investors, broker-dealers, mutual funds, vendors of municipal information, municipal security analysts, other market professionals and the market generally.

With respect to the comments of the two NRMSIRs regarding the Tower Amendment, the MSRB responded that it believes its proposal to create a continuing disclosure service is consistent with the MSRB's statutory authority under Section 15B(d) of the Act, i.e., the Tower Amendment.⁹⁴ The MSRB believes that the continuing disclosure service of EMMA will serve

⁹³ See DPC DATA Letter.

⁹⁴ Section 15B(d) of the Exchange Act states as follows: (1) Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities. (2) The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: Provided, however, That

as a necessary step to better facilitate the free and timely public access to continuing disclosure documents and related information. The service will remove impediments to and help perfect the mechanisms of a free and open market in municipal securities thereby, effectively, promoting investor protections and the public interest by ensuring equal access for all market participants to the critical disclosure information needed by investors in the municipal securities market. The MSRB believes that all of the continuing disclosure service's functionalities relate to the core mission of the MSRB and such functionalities are not inconsistent with any statutory limitations placed on MSRB activities. The MSRB believes that municipal securities disclosure documents should be made more readily and promptly available to the public and that all investors should have better access to important market information.

The Commission also does not believe that the proposed rule change is inconsistent with the Tower Amendment. The Tower Amendment prohibits the MSRB from directly or indirectly requiring an issuer of municipal securities to file with it any documents relating to the issuance, sale or distribution of such securities before such securities are sold.⁹⁵ The Tower Amendment also prohibits the MSRB from directly or indirectly requiring an issuer of municipal securities, directly or indirectly through a municipal securities broker or dealer or otherwise, to furnish to it documents relating to the issuer, unless such information is available from a source other than the issuer.⁹⁶ The MSRB's proposed rule change does not implicate Section 15B(d)(1) or (2) of

the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title. 15 U.S.C. 78o-4(d)(1) and (2).

⁹⁵ 15 U.S.C. 78o-4(d)(1).

⁹⁶ 15 U.S.C. 78o-4(d)(2).

the Act because it imposes no requirements on issuers. Instead, through the establishment of the continuing disclosure service of EMMA as an information venue, the proposed rule change enhances access to continuing disclosure information provided to the MSRB subsequent to the sale of municipal securities as a consequence of continuing disclosure agreements entered into consistent with a rule of the Commission's Rule 15c2-12, which is designed to deter fraud in the municipal securities market. The proposed rule change does not alter market participants' existing obligations, but rather it enhances the system for the receipt of, and for making available to the public of, the continuing disclosure documents. For these reasons, the Commission does not believe that the proposed rule change is contrary to Section 15B(d) of the Act.

Several commenters that supported the proposed rule change also made suggestions regarding the transition to the proposed system.⁹⁷ For example, one commenter believed that there should be a three- to six-month transition period for submissions to EMMA and a twelve-month transition period for the submissions of searchable PDFs.⁹⁸ Another commenter believed that there should be a nine-month transition period to a word searchable format.⁹⁹ Another commenter believed that parties who have made paper filings in the past should be allowed additional time to transition to electronic filings.¹⁰⁰ A fourth commenter noted that issuers and obligated persons may be confused as to where they should file continuing disclosure documents during the period of transition and suggested that these concerns could be addressed during a short transition period.¹⁰¹ The MSRB responded that, in view of the comments it received and

⁹⁷ See, e.g., GFOA Letter, e-certus Letter, Treasurer of the State of Connecticut Letter, and NABL Letter.

⁹⁸ See GFOA Letter.

⁹⁹ See Treasurer of the State of Connecticut Letter.

¹⁰⁰ See NABL Letter.

¹⁰¹ See Vanguard Letter.

discussions it has had with industry participants, and to further ensure a smooth transition for submitters and end users of continuing disclosures, it has filed Amendment No. 1 to delay the effectiveness of the continuing disclosure service until the later of July 1, 2009 or the effective date of the Rule 15c2-12 Amendments and to extend the transition to a word-searchable format until January 1, 2010. Furthermore, the MSRB stated that it expects to file with the Commission to establish a pilot program for the continuing disclosure service that would allow for system testing through voluntary submissions of continuing disclosures prior to the effectiveness of the amendments to Rule 15c2-12 and the launch of the permanent continuing disclosure service.

IV. Order Granting Accelerated Approval of Proposed Rule Change

As noted above, the MSRB now seeks pursuant to Amendment No. 1 to commence operation of the EMMA portal for continuing disclosure documents on July 1, 2009,¹⁰² which is commensurate with the effective date of the Rule 15c2-12 Amendments that we also are adopting today.¹⁰³ In addition, Amendment No. 1 requests that the Commission delay the effectiveness of the provision of the proposed rule change relating to word searchable PDF files until January 1, 2010. The MSRB requests that the Commission find good cause, pursuant to Section 19(b)(2) of the Act, for approving Amendment No. 1 prior to the thirtieth day after publication of notice of filing of Amendment No. 1 in the Federal Register. The MSRB believes that the Commission has good cause for granting accelerated approval of the proposed rule change because the amendment does not substantively alter the original proposed rule change other than changing two effective dates to allow more time for implementation.

The Commission finds good cause to approve the proposed rule change on an accelerated

¹⁰² See Amendment No. 1, supra note 5.

¹⁰³ See Rule 15c2-12 Amendments Adopting Release, supra note 7.

basis. The proposed rule change was published in the Federal Register on August 7, 2008.¹⁰⁴

The Commission believes that the proposal includes an appropriate transition period and believes that parties that have made paper filings in the past or that do not presently use word searchable formats will have sufficient time to transition to electronic filings as of July 1, 2009 and to a word searchable PDF format as of January 1, 2010, respectively.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2008-05 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-MSRB-2008-05. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications

¹⁰⁴ See Release No. 34-58256, supra note 3.

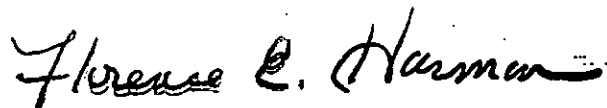
relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2008-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 15B(b)(2)(C) of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰⁵ that the proposed rule change (SR-MSRB-2008-05), as modified by Amendment No. 1, be, and it hereby is, approved on an accelerated basis.

By the Commission.



Florence E. Harmon
Acting Secretary

¹⁰⁵ 15 U.S.C. 78s(b)(2).

Exhibit A

**Key to Comment Letters Cited in Order Relating to the Establishment of a Continuing Disclosure Service of the Electronic Municipal Market Access System (EMMA)
(File No. SR-MSRB-2008-05)**

1. Letter from Fran Busby, to 21st Century Disclosure Initiative, Commission, dated October 7, 2008 ("Busby Letter").
2. Letter from Paula Stuart, Chief Executive Officer, Digital Assurance Certification, L.L.C. ("DAC"), to Florence E. Harmon, Acting Secretary, Commission, dated September 25, 2008 ("DAC Letter").
3. Letter from Christopher Alwine, Head of Municipal Money Market and Bond Groups, The Vanguard Group, Inc. ("Vanguard"), to Florence E. Harmon, Acting Secretary, Commission, dated September 24, 2008 ("Vanguard Letter").
4. Letter from Susan A. Gaffney, Director, Federal Liaison Center, Government Finance Officers Association ("GFOA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 24, 2008 ("GFOA Letter").
5. Letter from Louis V. Eccleston, President, Standard & Poor's Securities Evaluations, Inc. ("SPSE"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("SPSE Letter").
6. Letter from R.T. McNamar, CEO, e-certus, Inc. ("e-certus"), to Christopher Cox, Chairman, Commission, and Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("e-certus Letter").
7. Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("SIFMA Letter").
8. Letter from William A. Holby, President, National Association of Bond Lawyers ("NABL"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("NABL Letter").
9. Letter from Denise L. Nappier, Treasurer, State of Connecticut, to Christopher Cox, Chairman, Commission, dated September 22, 2008 ("Treasurer of the State of Connecticut Letter").
10. Letter from J. Douglas Adamson, Executive Vice President, Technical Services Division, American Bankers Association ("ABA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("ABA Letter").

11. Letter from Laura Slaughter, Executive Director, Municipal Advisory Council of Texas ("Texas MAC"), to Christopher Cox, Chairman, Commission, and Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("Texas MAC Letter").
12. Letter from K.W. Gurney, Director, Ohio Municipal Advisory Council ("OMAC"), to Christopher Cox, Chairman, Commission, and Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 22, 2008 ("OMAC Letter").
13. Letter from Karrie McMillan, General Counsel, Investment Company Institute ("ICI"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("ICI Letter").
14. Letter from Robert Donovan, Executive Director, Rhode Island Health and Educational Building Corporation and Steven Fillebrown, Director of Research, Investor Relations and Compliance, New Jersey Healthcare Financing Authority, on behalf of the National Association of Health and Educational Facilities Finance Authorities ("NAHEFFA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 22, 2008 ("NAHEFFA Letter").
15. Letter from Peter J. Schmitt, CEO, DPC DATA Inc. ("DPC DATA"), to Florence E. Harmon, Acting Secretary, Commission, dated September 18, 2008 ("DPC DATA Letter").
16. Letter from Philip D. Moyer, CEO & President, EDGAR Online ("EDGAR Online"), to Christopher Cox, Chairman, Commission, and Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated September 9, 2008 ("EDGAR Online Letter").
17. Letter from Lynette Kelly Hotchkiss, Executive Director, MSRB, to Christopher Cox, Chairman, and James L. Eastman, Counsel, Commission, dated September 8, 2008 ("MSRB Letter").
18. Letter from Rob Yolland, Chairman, National Federation of Municipal Analysts (NFMA), to Ernesto A. Lanza, Senior Associate General Counsel, MSRB, Commission, dated March 10, 2008 ("NFMA Letter").

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 8, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13304

In the Matter of

**CentreInvest, Inc.,
OOO CentreInvest Securities,
Vladimir Chekholko,
William Herlyn,
Dan Rapoport, and
Svyatoslav Yenin,**

Respondents.

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against CentreInvest, Inc. ("CI-New York"), OOO CentreInvest Securities ("CI-Moscow"), Vladimir Chekholko ("Chekholko"), William Herlyn ("Herlyn"), Dan Rapoport ("Rapoport"), and Svyatoslav Yenin ("Yenin").

II.

After an investigation, the Division of Enforcement alleges that:

SUMMARY

1. These proceedings arise out of violations of the broker-dealer registration, reporting, and record-keeping requirements of the Exchange Act by CI-Moscow, a Moscow-based unregistered broker-dealer, its New York-based affiliate, CI-New York, a registered broker-dealer, and four associated individuals. From about 2003 through November 2007, CI-Moscow and its executive director Rapoport – directly and through CI-New York, Yenin, CI-New York's managing director, FINOP and CFO, Chekholko, its head of sales, and Herlyn, its chief compliance officer – solicited institutional investors in the United States to purchase and sell thinly-traded stocks of Russian companies, without registering as a broker-dealer as required by

Section 15(a) of the Exchange Act or meeting the requirements for the exemption from registration for foreign broker-dealers under Exchange Act Rule 15a-6(a). In addition, Yenin and Herlyn were responsible for CI-New York's filing of Forms BD that failed to disclose CI-Moscow and Rapoport's control of CI-New York, or that the license of the CI-New York's parent company had been revoked by the Cyprus SEC, and Yenin was responsible for its failure to maintain business-related emails.

RESPONDENTS

2. **OOO CentreInvest Securities** ("CI-Moscow") is a Moscow-based broker-dealer and limited liability company, specializing in the sale of second-tier Russian equities. During the relevant period, it was an affiliate of CI-New York. It was founded in 1992 under the laws of Russia and is regulated by the Russian Federal Financial Markets Service. CI-Moscow has never been registered with the Commission as a broker or dealer.

3. **CentreInvest, Inc.** ("CI-New York") is a registered broker-dealer organized under the laws of New York State with its principal place of business in New York, New York. During the relevant period, it was a subsidiary of Cyprus-based Intelsa Investments Limited. CI-New York first registered with the Commission on June 23, 1998, and during the relevant period, employed four to five full-time employees. On October 2, 2008, the Financial Industry Regulatory Authority, Inc. ("FINRA") expelled CI-New York for failure to file a Financial and Operational Combined Uniform Single ("FOCUS") report.

4. **Vladimir Chekholko**, age 48, is a resident of Forest Hills, New York, and holds Series 7, 24 and 55 licenses. From July 2004 to November 2007, he was the head of sales at CI-New York.

5. **William Herlyn**, age 40, is a resident of Westport, Connecticut, and holds Series 7, 24 and 63 licenses. He was employed by CI-New York from 2003 until October 2008. From June 2006 until October 2008, Herlyn held the title of chief compliance officer. For most of his tenure, Herlyn was also responsible for marketing CI-New York's fee-based research and soliciting U.S. institutional investors.

6. **Dan Rapoport**, age 40, is a resident of Russia. He joined CI-Moscow in 1995. Rapoport relocated to New York and became a registered representative at CI-New York in January 1999. He served as CI-New York's managing director from January 2001 until November 2001. Rapoport apparently returned to CI-Moscow, as a managing director, in 2003, and was later promoted to executive director. While at CI-Moscow, Rapoport was responsible for the brokerage operations at both CI-Moscow and CI-New York. CI-Moscow terminated his employment in February 2008. During the relevant period, Rapoport held series 7, 24 and 63 licenses.

7. **Svyatoslav ("Slava") Yenin**, age 36, is a resident of Russia. In about July 2003, he became the managing director, CFO and financial and operations principal ("FINOP") of CI-New York. He continued to hold these positions, even after moving to Russia in early 2006, until he left

CI-New York in about November 2007. During the relevant period, Yenin held series 7, 24, 27, 62, 68, 82 and 87 licenses.

OTHER RELEVANT ENTITIES

8. **Intelsa Investments Limited** ("Intelsa"), located in Cyprus, was, during the relevant period, the majority, if not sole, owner of CI-New York. On January 11, 2006 and May 29, 2006, respectively, the Cyprus Securities and Exchange Commission suspended and revoked Intelsa's license.

CI-MOSCOW AND RAPOPORT ACTED AS BROKER-DEALERS BUT FAILED TO REGISTER OR COMPLY WITH AN EXEMPTION FROM REGISTRATION

9. From about 2003 until at least November 2007, CI-Moscow and the head of its brokerage operations, Rapoport, directly and indirectly solicited investors in the United States to purchase and sell thinly-traded stocks of Russian companies – so-called "second-tier," or micro-cap, Russian companies – without registering as broker-dealers, as required by Section 15(a) of the Exchange Act, or meeting the requirements for an exemption.

10. Under Rapoport's direction, employees of CI-New York, including Yenin, CI-New York's managing director, FINOP and CFO, Chekholko, the firm's head of sales, and Herlyn, its chief compliance officer, regularly solicited U.S. institutional investors for the purchase and sale of Russian securities. Investors who expressed interest in a transaction were referred to CI-Moscow to complete the transaction.

11. In some cases, Rapoport and other employees of CI-Moscow, who were not licensed to sell securities under U.S. law or registered as brokers or dealers under U.S. law and were not exempt from such licensing and registration requirements, solicited U.S. investors directly.

12. CI-New York failed to maintain virtually any records concerning CI-Moscow's transactions with the U.S. investors.

13. In late 2003, Yenin learned from consultants to CI-New York that, in order for CI-Moscow to qualify for an exemption from registration pursuant to Rule 15a-6(a) of the Exchange Act, CI-New York would need to maintain, among other things, required books and records relating to the transactions with U.S. investors, including those required by Rules 17a-3 and 17a-4 under the Exchange Act.

14. At all relevant times, Rapoport knew that any representative of CI-Moscow who solicited a U.S. investor would have to be licensed and registered with the Commission or an appropriate U.S. self-regulatory organization.

15. At some or all relevant times, Chekholko knew that he was referring investors to representatives of CI-Moscow who were neither licensed and registered with the Commission or

an appropriate U.S. self-regulatory organization, nor exempt from such licensing and registration requirements.

16. Respondents benefited financially from CI-Moscow's transactions in securities with or on behalf of U.S. investors. For example, in 2006 alone, CI-Moscow received at least \$928,000 in revenue as a result of its unlawful solicitation of U.S. institutional investors.

**CI-NEW YORK FAILED TO DISCLOSE
CI-MOSCOW'S AND RAPOPORT'S CONTROL**

17. Throughout the relevant period, CI-New York was under the control of CI-Moscow and, in at least 2006 and 2007, Rapoport. CI-Moscow and Rapoport controlled CI-New York by, among other things, supervising and directing the staff of CI-New York and controlling its budget and finances. Indeed, CI-New York employees sometimes referred to Rapoport as their "boss" and to CI-Moscow as CI-New York's "parent broker-dealer."

18. CI-New York filed its initial Form BD on July 5, 1999 and subsequently filed numerous amendments. Form BD amendments, signed and filed by Herlyn or Yenin on behalf of CI-New York from October 1, 2003 through December 6, 2007, failed to disclose CI-Moscow's and Rapoport's control of CI-New York.

19. At the time Herlyn and Yenin signed these Form BD amendments, they knew that CI-Moscow and Rapoport controlled CI-New York by, among other things, supervising and directing the staff of CI-New York and controlling its budget and finances.

**CI-NEW YORK FAILED TO DISCLOSE THE
DISCIPLINARY ACTIONS AGAINST INTELSA**

20. In Form BD amendments, signed and filed by Herlyn or Yenin on behalf of CI-New York, the firm inaccurately responded "No" to the question: "Has any other regulatory agency, any state regulatory agency or foreign financial regulatory authority: . . . ever denied, suspended, or revoked the applicant's or a control affiliate's registration or license or otherwise, by order, prevented it from associating with an investment-related business or restricted its activities?"

21. CI-New York should have answered that question "Yes" because the Cyprus Securities and Exchange Commission suspended the license of CI-New York's parent, Intelsa, on January 11, 2006 and revoked its license on May 26, 2006.

22. At the time that Herlyn and Yenin signed at least some of the Form BD amendments that failed to disclose the regulatory action against Intelsa by the Cyprus Securities and Exchange Commission, they knew, or at a minimum should have known, of that regulatory action and that Intelsa was a control affiliate.

CI-NEW YORK FAILED TO MAINTAIN BUSINESS-RELATED E-MAILS

23. In response to requests by the Commission staff, CI-New York failed to produce many records, including many business-related emails sent or received by Yenin and the individual who was CI-New York's president from 2004 until October 2006 and its chief compliance officer from August 2005 until October 2006.

24. CI-New York either failed to maintain these emails as required by Exchange Act Rule 17a-4(b)(4), or failed to produce them at the request of the staff as required by Exchange Act Rule 17a-4(j).

25. Yenin was responsible for CI-New York's record keeping, by virtue of his status as CI-New York's FINOP and under the terms of the firm's written supervisory procedures. Yenin knew, or at a minimum should have known, of the firm's failure to maintain business-related emails.

VIOLATIONS

26. Rule 15a-6(a) of the Exchange Act permits unregistered foreign broker-dealers to effect transactions for U.S. institutional investors in certain limited circumstances, subject to reporting, record keeping and other requirements designed to ensure the protection of U.S. investors. Rule 15a-6(b)(3) defines a "foreign broker or dealer" as "any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by this rule) that is not an office or branch of, or a natural person associated with, a registered broker-dealer, whose securities activities, if conducted in the U.S., would be described by the definition of "broker" or "dealer" in Sections 3(a)(4) or 3(a)(5) of the [Exchange Act]." Section 3(a)(4) of the Exchange Act defines a "broker" as any person, other than a bank, in certain circumstances, "engaged in the business of effecting transactions in securities for the account of others." A person "effects transactions in securities" if he or she participates in such transactions "at key points in the chain of distribution." Massachusetts Fin. Servs., Inc. v. Security Investor Protection Corp., 411 F. Sup. 411, 415 (D. Mass.), aff'd, 545 F. 2d 754 (1st Cir. 1976).

27. As a result of the conduct described above, CI-Moscow and Rapoport willfully violated Section 15(a) of the Exchange Act, which makes it illegal for a broker to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security unless the broker is registered with the Commission or, in the case of a natural person, is associated with a registered broker or dealer.

28. CI-Moscow and Rapoport failed to qualify for any exemption from registration.

29. As a result of the conduct described above, CI-New York, Yenin and Chekholko willfully aided and abetted and caused CI-Moscow's violations of Section 15(a) of the Exchange Act.

30. As a result of the conduct described above, Herlyn caused CI-Moscow's violations of Section 15(a) of the Exchange Act.

31. Section 15(b)(1) of the Exchange Act and Rule 15b3-1 require all brokers or dealers applying for registration with the Commission to file a Form BD with the Commission and to correct any information in the Form BD if it is or becomes inaccurate for any reason. Section 17(a) of the Exchange Act requires registered brokers or dealers, among other things, "to make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act]." Among other things, Form BD requires registered brokers and dealers to disclose whether any person not identified as an owner or officer of the broker-dealer "directly or indirectly [has] control [over] the management or policies of the [broker-dealer] through agreement or otherwise." See, e.g., Alderman v. SEC, 104 F.3d 285, 287 n.1 (9th Cir. 1997). "[T]he correct disclosure of the . . . controlling persons of an applicant is more than a 'minor' point, indeed it is most important to the proper administration of the [Exchange] Act." Capital Funds, Inc. v. SEC, 348 F.2d 582, 588 (8th Cir. 1968). Form BD also requires registered broker-dealers to disclose whether any foreign financial regulatory authority has "ever denied, suspended, or revoked the applicant's or a control affiliate's registration or license or otherwise, by order, prevented it from associating with an investment-related business or restricted its activities."

32. As a result of the conduct described above, CI-New York willfully violated Section 17(a) of the Exchange Act and Rule 15b3-1 thereunder.

33. As a result of the conduct described above, Yenin and Herlyn willfully aided and abetted and caused CI-New York's violation of Section 17(a) of the Exchange Act and Rule 15b3-1 thereunder.

34. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require that every registered broker-dealer maintain copies of all business-related communications, including email correspondence. Specifically, Rule 17a-4(b)(4) requires that a registered broker-dealer "preserve for a period of not less than three years, the first two years in an easily accessible place . . . [o]riginals of all communications received and copies of all communications sent . . . (including inter-office memoranda and communications) relating to its business as such . . ." Rule 17a-4 is not, by its terms, limited to physical documents. The Commission has stated that internal e-mails relating to a broker-dealer's "business as such" fall within the purview of Rule 17a-4 and that, for the purposes of Rule 17a-4, "the content of the electronic communication is determinative" as to whether that communication is required to be retained and accessible. Reporting Requirements for Brokers or Dealers under the Securities Exchange Act of 1934, Rel. No. 34-38245 (Feb. 5, 1997); See also, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc., Exchange Act Release No. 53473 (March 13, 2006). In addition, under Rule 17a-4(j), broker-dealers are required to "furnish promptly" to a representative of the Commission such legible, true and complete copies of records required to be preserved under Section 17(a) of the Exchange Act, as are requested by representatives of the Commission. See Merrill Lynch, *supra*.

35. As a result of the conduct described above, CI-New York willfully violated Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) or, in the alternative, Rule 17a-4(j) thereunder.

36. As a result of the conduct described above, Yenin willfully aided and abetted and caused CI-New York's violation of Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder.

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondents CI-New York, CI-Moscow, Rapoport, Herlyn, Yenin and Chekholko, pursuant to Section 15(b) of the Exchange Act, including, but not limited to, an accounting, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. Whether, pursuant to Section 21C of the Exchange Act, Respondents CI-Moscow, Rapoport and Chekholko should be ordered to cease and desist from committing or causing violations of and any future violations of Section 15(a) of the Exchange Act and whether Respondents CI-Moscow, Rapoport and Chekholko should be ordered to provide an accounting and pay disgorgement pursuant to Section 21C(e) of the Exchange Act.

D. Whether, pursuant to Section 21C of the Exchange Act, Respondent CI-New York should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 15(a) and 17(a) of the Exchange Act and Rules 15b3-1 and 17a-4(b)(4) or, in the alternative, Rule 17a-4(j), thereunder, and whether Respondent CI-New York should be ordered to provide an accounting and pay disgorgement pursuant to Section 21C(e) of the Exchange Act.

E. Whether, pursuant to Section 21C of the Exchange Act, Respondent Yenin should be ordered to cease and desist from committing or causing violations of and any future violations of Section 15(a) of the Exchange Act, and from causing violations of and any future violations of Section 17(a) of the Exchange Act and Rules 15b3-1 and 17a-4(b)(4), thereunder, and whether Respondent Yenin should be ordered to provide an accounting and pay disgorgement pursuant to Section 21C(e) of the Exchange Act.

F. Whether, pursuant to Section 21C of the Exchange Act Respondent Herlyn should be ordered to cease and desist from causing violations of and any future violations of Section 17(a) of the Exchange Act and Rule 15b3-1 thereunder, and whether Respondent Herlyn should be ordered to provide an accounting and pay disgorgement pursuant to Section 21C(e) of the Exchange Act.

IV.

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

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

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

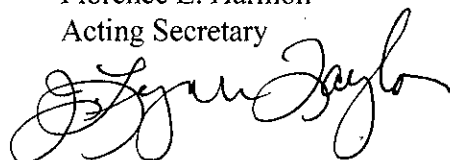
This Order shall be served forthwith upon each Respondent personally, by certified mail or by any other means permitted by Rule 141(a)(2)(iv) of the Commission's Rules of Practice, 17 C.F.R. §§ 201.141(a)(2)(iv).

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

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

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59071 / December 9, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2907 / December 9, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13305

In the Matter of

ROBERT P. VERHEECKE (CPA),

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO RULE
102(e) OF THE COMMISSION'S RULES OF
PRACTICE, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Robert P. Verheecke ("Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.¹

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Respondent, age 56, is and has been a certified public accountant licensed to practice in the State of California. He served as senior vice president, chief financial officer, and secretary of Blue Coat Systems, Inc. ("Blue Coat") from May 2001 until May 2005 and continued to work on special projects for Blue Coat until January 2006.

2. Blue Coat was, at all relevant times, a Delaware corporation with its principal place of business in Sunnyvale, California. Blue Coat was engaged in the business of making appliances to secure and monitor computer networks. At all relevant times, Blue Coat's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ National Market.

3. On November 12, 2008, the Commission filed a complaint against Respondent in SEC v. Blue Coat Systems, Inc. (Civil Action No. CV 08-5127 JF). On November 21, 2008, the court entered an order permanently enjoining Respondent, by consent, from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b) and 13(b)(5) of the Exchange Act, and Rules 10b-5, 13a-14, 13b2-1, and 13b2-2 thereunder, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-9 thereunder. Respondent was also ordered to pay \$30,000 in disgorgement, \$5,946 in prejudgment interest, and a \$150,000 civil money penalty.

4. The Commission's complaint alleged, among other things, that from at least 2001 through 2005, Blue Coat and Verheecke backdated stock options granted to company employees and executives and failed to disclose millions of dollars in expenses to Blue Coat shareholders. Verheecke used hindsight to pick dates corresponding to low stock prices for stock option grants, prepared or distributed misleading documents that made it appear as if the options had been granted on the earlier dates, and prepared or approved financial statements and Commission filings that omitted necessary expenses for backdated options and falsely described Blue Coat's option granting practices.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Respondent is suspended from appearing or practicing before the Commission as an accountant.

B. After five years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews, and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of

accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59074 / December 10, 2008

Admin. Proc. File No. 3-13140

In the Matter of

Birman Managed Care, Inc. (n/k/a Alcar Chemicals Group, Inc.)

Respondent

ORDER GRANTING MOTION TO AMEND ORDER INSTITUTING PROCEEDINGS

On August 20, 2008, the Commission issued an Order Instituting Proceedings ("OIP") against Birman Managed Care, Inc. (n/k/a Alcar Chemicals Group, Inc.) and five other respondents pursuant to Section 12(j) of the Securities Exchange Act of 1934 ^{1/} to determine whether to revoke or suspend the registration of these issuers. The OIP alleged that each of the named issuers was delinquent in its required Exchange Act periodic filings with the Commission. In the OIP, the Division of Enforcement referred to Birman Managed Care, Inc. ("Birman"), to which the Commission previously had assigned the Central Index Key number 1009822, ^{2/} as "Birman Managed Care, Inc. (n/k/a Alcar Chemicals Group, Inc.)." The Division based its identification of Alcar as Birman's successor upon information obtained from www.pinksheets.com. The pink sheets stated "Birman Managed Care, Inc." was a prior name of Alcar and listed Alcar with the same CIK number as Birman. On August 21, 2008, "a private process server for the Division" served the OIP on Alcar through the registered agent listed for Alcar in the records of the Delaware Secretary of State. On August 25, 2008, the Division served the OIP on Birman at the address shown in the company's last filing with the Commission.

On September 8, 2008, the administrative law judge assigned to the proceeding issued an order pursuant to Exchange Act Section 12(j) finding all six respondents in default and revoking the registration of each class of their securities registered pursuant to Exchange Act

^{1/} 15 U.S.C. § 78l(j).

^{2/} The Central Index Key (CIK) is "[a] unique number assigned by the SEC, distinguishing the company or individual to which it is assigned." <http://www.sec.gov/info/edgar/edgarfm-vol1-v2r1.pdf>.

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Section 12(g). ^{3/} On September 11, 2008, Birman filed an Answer and a Motion to Set Aside Order Revoking Registrations by Default of Birman Managed Care. On September 23, 2008, the law judge set aside the default as to Birman. To date, Alcar has not responded to the OIP.

On October 21, 2008, the Division and Birman jointly moved pursuant to Rule of Practice 200(d)(1) ^{4/} to amend the OIP to "strik[e] Alcar Chemicals Group, Inc. ("Alcar") from the caption and body of the pleadings and all allegations about Alcar in ¶ II.A.1 of the OIP" In their joint motion, the parties state that "after the OIP was instituted, Birman in its Motion to Set Aside the Default alleged, among other things, that Alcar was not a legitimate successor to Birman." The parties represent that the Division, after reviewing Delaware corporate records, agreed that Alcar Chemicals Group, Inc. ("Alcar") was not a successor of Birman and, therefore, not properly a party to these proceedings.

In a supporting declaration, counsel for the Division described the steps the Division took to reach the conclusion that Alcar was not a successor of Birman. The Division reviewed the Delaware corporate records and determined that there were two Delaware corporations that used the name "Birman Managed Care, Inc." Respondent Birman, identified by its Delaware Corporate File No. 2658719, was incorporated on August 30, 1996. On March 1, 2003, Birman's charter was declared void by the State of Delaware, an event that caused its corporate name to be free for reassignment to another corporation. Birman's corporate charter remained void until August 21, 2008, when it was restored to good standing.

On July 6, 2005, during the period that Birman's corporate charter was void, a second, unrelated, entity incorporated in Delaware under Delaware Corporate File No. 3995118, taking the then-available name "Birman Managed Care, Inc." ("Second Birman"). Second Birman subsequently changed its name to "Hackerproof Ltd." and then "Alcard Chemical Group, Inc." and most recently "Alcar Chemical Group, Inc." In its declaration, the Division represents that its investigation determined that the Respondent "Birman (Delaware Corporate File No. 2658719) and Second Birman (Delaware Corporate File No. 3995118) are two entirely separate and unrelated corporate entities." The Division bases its conclusion on the information in the Delaware corporate records and the representation of Respondent Birman director David Hunt that, as described in the Division's declaration, "at no time has Second Birman shared any stockholders, officers, directors, or offices with Birman, nor has it ever had any relationship with Birman." The Division also represents in its declaration that, based on a search of the Commission's records, at no time has Alcar (or its predecessors Alcard Chemicals Group, Inc. or Hackerproof Ltd) ever had "a class of securities registered with the Commission pursuant to Exchange Act Section 12."

^{3/} 15 U.S.C. § 78l(g).

^{4/} 17 C.F.R. § 201.200(d)(1).

Rule of Practice 200(d)(1) provides that the Commission "may, at any time, amend an order instituting proceedings to include any new matters of fact or law." 5/ The Commission has stated that such amendments should be "freely granted, subject only to the consideration that other parties should not be surprised, nor their rights prejudiced." 6/ The Commission has found that "where an amendment is intended to correct an error and is within the scope of the original order, the Commission has authority to amend the OIP." 7/

In this case, the amendment seeks to correct an error in the OIP. Although at one time Alcar had the same name as the Respondent Birman, it appears on the record before us that there never has been a corporate relationship between the companies. Thus, Alcar is not a successor entity to the respondent, whose periodic filings are the subject matter of the proceeding. 8/ Consequently, Alcar should not be named in the OIP. Moreover, because Alcar does not now have, and never has had, any securities registered with the Commission, the Commission does not have jurisdiction to take action against Alcar pursuant to Exchange Act Section 12(j). 9/ Finally, it does not appear that Alcar or any of the other parties to the proceeding will be surprised by this amendment or have their rights prejudiced. Therefore, it is appropriate to amend the OIP consistent with the proposed amended OIP attached to the joint motion.

Accordingly, IT IS ORDERED that the Joint Motion of the Division of Enforcement and Birman Managed Care, Inc. to amend the OIP to remove all references to Alcar Chemicals Group, Inc. be, and it hereby is, granted.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

5/ Id.

6/ 17 C.F.R. § 201.200(d)(1), Comment (d), (as quoted in Steven Wise, Securities Exchange Act Rel. No. 48850 (November 26, 2003), 81 SEC Docket 2774 (Order Amending OIP with respect to references to Vladlen Larry Vindman)).

7/ Wise, 81 SEC Docket at 2775.

8/ See 17 C.F.R. § 240.12b-2 (defining *succession* to include "the direct acquisition of the assets comprising a going business, whether by merger, consolidation, purchase, or other direct transfer . . .").

9/ 15 U.S.C. § 78j.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59074 / December 10, 2008

Admin. Proc. File No. 3-13140

In the Matter of

Birman Managed Care, Inc. (n/k/a Alcar Chemicals Group, Inc.)

Respondent

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On September 8, 2008, the administrative law judge assigned to the proceeding issued an order pursuant to Exchange Act Section 12(j) finding all six respondents in default and revoking the registration of each class of their securities registered pursuant to Exchange Act

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Section 12(g). ^{3/} On September 11, 2008, Birman filed an Answer and a Motion to Set Aside Order Revoking Registrations by Default of Birman Managed Care. On September 23, 2008, the law judge set aside the default as to Birman. To date, Alcar has not responded to the OIP.

On October 21, 2008, the Division and Birman jointly moved pursuant to Rule of Practice 200(d)(1) ^{4/} to amend the OIP to "strik[e] Alcar Chemicals Group, Inc. ("Alcar") from the caption and body of the pleadings and all allegations about Alcar in ¶ II.A.1 of the OIP" In their joint motion, the parties state that "after the OIP was instituted, Birman in its Motion to Set Aside the Default alleged, among other things, that Alcar was not a legitimate successor to Birman." The parties represent that the Division, after reviewing Delaware corporate records, agreed that Alcar Chemicals Group, Inc. ("Alcar") was not a successor of Birman and, therefore, not properly a party to these proceedings.

In a supporting declaration, counsel for the Division described the steps the Division took to reach the conclusion that Alcar was not a successor of Birman. The Division reviewed the Delaware corporate records and determined that there were two Delaware corporations that used the name "Birman Managed Care, Inc." Respondent Birman, identified by its Delaware Corporate File No. 2658719, was incorporated on August 30, 1996. On March 1, 2003, Birman's charter was declared void by the State of Delaware, an event that caused its corporate name to be free for reassignment to another corporation. Birman's corporate charter remained void until August 21, 2008, when it was restored to good standing.

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^{3/} 15 U.S.C. § 78l(g).

^{4/} 17 C.F.R. § 201.200(d)(1).

Rule of Practice 200(d)(1) provides that the Commission "may, at any time, amend an order instituting proceedings to include any new matters of fact or law." 5/ The Commission has stated that such amendments should be "freely granted, subject only to the consideration that other parties should not be surprised, nor their rights prejudiced." 6/ The Commission has found that "where an amendment is intended to correct an error and is within the scope of the original order, the Commission has authority to amend the OIP." 7/

In this case, the amendment seeks to correct an error in the OIP. Although at one time Alcar had the same name as the Respondent Birman, it appears on the record before us that there never has been a corporate relationship between the companies. Thus, Alcar is not a successor entity to the respondent, whose periodic filings are the subject matter of the proceeding. 8/ Consequently, Alcar should not be named in the OIP. Moreover, because Alcar does not now have, and never has had, any securities registered with the Commission, the Commission does not have jurisdiction to take action against Alcar pursuant to Exchange Act Section 12(j). 9/ Finally, it does not appear that Alcar or any of the other parties to the proceeding will be surprised by this amendment or have their rights prejudiced. Therefore, it is appropriate to amend the OIP consistent with the proposed amended OIP attached to the joint motion.

Accordingly, IT IS ORDERED that the Joint Motion of the Division of Enforcement and Birman Managed Care, Inc. to amend the OIP to remove all references to Alcar Chemicals Group, Inc. be, and it hereby is, granted.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

5/ Id.

6/ 17 C.F.R. § 201.200(d)(1), Comment (d), (as quoted in Steven Wise, Securities Exchange Act Rel. No. 48850 (November 26, 2003), 81 SEC Docket 2774 (Order Amending OIP with respect to references to Vladlen Larry Vindman)).

7/ Wise, 81 SEC Docket at 2775.

8/ See 17 C.F.R. § 240.12b-2 (defining *succession* to include "the direct acquisition of the assets comprising a going business, whether by merger, consolidation, purchase, or other direct transfer . . .").

9/ 15 U.S.C. § 78j.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933

Release No. 8988 / December 11, 2008

SECURITIES EXCHANGE ACT OF 1934

Release No. 59084 / December 11, 2008

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2909 / December 11, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13307

In the Matter of

**SCOR Holding (Switzerland) Ltd.,
formerly known as Converium Holding AG,**

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE
SECURITIES ACT OF 1933 AND
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against SCOR Holding (Switzerland) Ltd., formerly known as Converium Holding AG ("Converium" or "Respondent").¹

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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

¹ All of the conduct that gave rise to this proceeding took place prior to Converium being acquired by SCOR SE, the parent company of SCOR Holding (Switzerland) Ltd. The conduct described in this Order occurred prior to October 2005. The tender offer by SCOR SE for all publicly-held shares of Converium was consummated on August 8, 2007, at which time Converium became a subsidiary of SCOR SE. In September 2007, Converium was renamed SCOR Holding (Switzerland) Ltd.

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 it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and 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 Respondent's Offer, the Commission finds² that:

SUMMARY

1. Converium engaged in a fraudulent scheme to improperly inflate its financial performance through the use of finite reinsurance transactions. The scheme began in 1999, when Converium was a business unit of Zurich Financial Services ("Zurich"), operating under the name Zurich Re. Zurich developed three reinsurance transactions for the purpose of obtaining the financial benefits of reinsurance accounting. However, in order for a company to obtain the benefits of reinsurance accounting, the reinsurance transaction must transfer risk. Here, Zurich designed the transactions to make it appear that risk was transferred to third-party reinsurers, when, in fact, no risk had been transferred outside of Zurich-owned entities. For two of the transactions at issue, Zurich ceded risk to third-party reinsurers, but took it back through reinsurance agreements – known as retrocessions – with another Zurich entity. For the third transaction, Zurich ceded the risk to a third-party reinsurer but simultaneously entered into an undisclosed side agreement with the reinsurer pursuant to which Zurich agreed to hold the reinsurer harmless for any losses the reinsurer realized under the reinsurance contracts. Because the ultimate risk under the reinsurance contracts remained with Zurich, these transactions should not have been accounted for as reinsurance.

2. In March 2001, Zurich announced its intent to spin off its assumed reinsurance business in an initial public offering. Zurich then created Converium, which assumed the rights and obligations of Zurich's assumed reinsurance business. On December 11, 2001, Converium conducted its IPO. As a result of the fraudulent finite reinsurance transactions and the improper accounting treatment they received, Converium's IPO documents, including the Form F-1 it filed with the Commission, were materially misleading. Among other things, Converium understated its reported loss before taxes by approximately \$100 million (67%) in 2000 and by approximately \$3 million (1%) in 2001. In addition, for certain periods, the transactions had the effect of artificially decreasing Converium's reported loss ratios for certain reporting segments – the ratio between losses paid by an insurer and premiums earned that is frequently cited by analysts as a key performance metric for insurance companies.

3. Zurich's and Converium's fraud had a significant impact on investors who purchased shares in the IPO. Through the IPO, which was the largest reinsurance IPO in history,

² The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Zurich raised significantly more than it would have raised had Zurich and Converium not each engaged in fraud.

4. Following the IPO, Converium continued the fraudulent scheme. Converium entered into two additional reinsurance agreements for which risk transfer was negated by undisclosed side agreements. Converium also entered into transactions to reimburse the reinsurer that Zurich had agreed to indemnify in a pre-IPO side agreement. In 2003, Converium took affirmative steps to conceal the fraud from the Financial Services Authority of the United Kingdom.

5. On November 4, 2005, Converium announced its intention to restate prior period financial statements and, on December 19, 2005, disclosed that it had incorrectly accounted for a number of transactions as reinsurance. On March 1, 2006, Converium filed with the Commission an amended Form 20-F which contained restated financial statements for the years ended December 31, 1998 through December 31, 2004 (the "Restatement").

6. As a result of the foregoing conduct, Converium violated Section 17(a) of the Securities Act, and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-1 thereunder.

RESPONDENT

7. **Converium, now known as SCOR Holding (Switzerland) Ltd.**, is a corporation organized under the laws of Switzerland. Converium is a global reinsurance company that offers property, casualty, life and non-life reinsurance products. Zurich formed Converium in 2001 by transferring the rights and liabilities of the reinsurance businesses that made up Zurich's assumed reinsurance business, which operated under the name Zurich Re. Converium began operations under the Converium brand name on or around October 1, 2001. From that time, until December 11, 2001, Converium operated as a wholly owned subsidiary of Zurich. In December 2001 and January 2002, pursuant to the Registration Statement and Prospectus, Zurich sold 40 million shares of Converium in the form of shares and American Depositary Shares ("ADSs"), representing its entire stake in Converium, for proceeds of approximately \$1.9 billion. From December 11, 2001 until August 8, 2007, Converium was an independent publicly-traded company. In August 2007, SCOR SE, a French reinsurer acquired Converium. In August 2007 SCOR held 96.23% of Converium's shares following the completion of a tender offer, and Converium became a subsidiary of SCOR. Converium's name was changed to SCOR Holding (Switzerland) Ltd. in September 2007. Between December 11, 2001 and January 7, 2008, Converium's common stock and ADSs were registered with the Commission pursuant to Section 12(b) of the Exchange Act. On January 7, 2008, Converium shares and ADSs were delisted from the New York Stock Exchange. On May 23, 2008, SCOR (the parent company) announced that the remaining publicly held shares of SCOR Holding (Switzerland) Ltd.'s shares had been cancelled and that the shares would be delisted from the SWX Swiss Exchange on May 30, 2008, with May 29, 2008 as the last day of trading. In 2007, SCOR delisted its own ADSs from the New York Stock Exchange and terminated the registration of its securities under the Exchange Act. SCOR's ADSs currently trade on the pink sheets under the symbol SCRYYY and its common stock trades on the Euronext under the symbol SCR and on the SWX Swiss Exchange.

OTHER RELEVANT PERSONS AND ENTITIES

8. **Zurich** is a corporation organized under the laws of Switzerland with its principal place of business in Zurich, Switzerland. Prior to Converium's IPO, Zurich restructured its reinsurance operations and transferred substantially all of the reinsurance business operated under Zurich Re to Converium.

9. **Inter-Ocean Reinsurance Company, Ltd.** ("Inter-Ocean") is a Bermuda corporation with its principal corporate offices in Bermuda. Inter-Ocean is a wholly-owned subsidiary of Inter-Ocean Holdings, Inc., which was formed in 1990 as a joint venture between ten reinsurers. In 1998, Zurich acquired a 9.9% interest in Inter-Ocean effective at the end of that year. Prior to Converium's IPO, Zurich transferred its 9.9% interest in Inter-Ocean to Converium.

Reinsurance Accounting Principles

10. In basic terms, reinsurance is insurance for insurers. Reinsurance is the transfer of the insurance risk by the primary insurer to a second insurance carrier, called the reinsurer, in exchange for a payment or premium.

11. Whether a contract is accounted for as reinsurance depends on whether the contract indemnifies the ceding company – here Zurich and Converium – from loss or liability. Such indemnification is known as risk transfer. Risk is transferred when (1) the reinsurer assumes significant insurance risk and (2) it is reasonably possible that the reinsurer will realize a significant loss in the transaction. A risk transfer analysis for a contract emphasizes substance over form, and Generally Accepted Accounting Principles ("GAAP") require "an evaluation of all contractual features that . . . limit the amount of insurance risk to which the reinsurer is subject . . ."³ Accordingly, under GAAP, "if agreements with the reinsurer . . . in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured."⁴

12. Where there is insufficient risk transfer, a transaction may not be treated as reinsurance under GAAP, and must be accounted for using the deposit method, which lacks the potential accounting benefits of reinsurance accounting. Under reinsurance accounting, when losses on the ceded business are incurred, the ceding insurer records an offset to the increase in its gross loss reserves in an amount equal to the reinsurance it expects to recover from the reinsurer, thus increasing its net income by that amount. Deposit accounting has no comparable income statement benefit.

³ FASB, Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (December 1992), para. 8.

⁴ FASB, Emerging Issues Task Force Topic D-34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113* (July 22, 1993), Question 13.

13. From 1999 through 2004, Zurich, and later Converium, designed five reinsurance transactions that created the *appearance* of risk transfer in order to benefit from reinsurance accounting. Three of the five transactions were entered into prior to the December 2001 IPO and affected the financial statements Converium included in the IPO prospectus. In two of the three pre-IPO transactions, Zurich purchased reinsurance from Inter-Ocean, which, in turn, ceded these liabilities to a Zurich entity (the "Inter-Ocean transactions"). Zurich's use of Inter-Ocean as an intermediary in the transaction helped obscure the transactions' circular structure and the fact that Zurich had merely moved the risk from one Zurich entity to another. In the remaining transactions, including one pre-IPO transaction, Zurich and later Converium entered into reinsurance transactions for which the contract terms were all undone through undisclosed side agreements or purportedly unrelated contracts. Effectively, these side agreements or unrelated contracts protected the reinsurer against losses suffered under the reinsurance contract and placed all risk of loss on a Zurich or Converium entity. Zurich and later Converium improperly accounted for these transactions using reinsurance accounting.

The Circular Inter-Ocean Transactions

The Medical Defence Union Transactions

14. In 2000, Zurich sought reinsurance for medical malpractice coverage it provided to British doctors who were members of the Medical Defence Union ("MDU"). In an April 25, 2000 e-mail concerning expected losses related to the MDU contract, the Chief Executive Officer of certain Zurich Re entities and later Converium (the "CEO") informed Zurich Re's (and later Converium's) Chief Underwriting Officer (the "CUO") that "we need to begin working on the actual placement of the [MDU] stop loss to relieve the GAAP hit" for Zurich.⁵ Internally, Zurich personnel used the term "GAAP hit" to mean the expense and increased reserve requirements associated with the medical defense coverage. The expense would decrease or "hit" reported income. The CEO warned that, in obtaining the reinsurance, "we need to be conscious of the issue of circularity."⁶

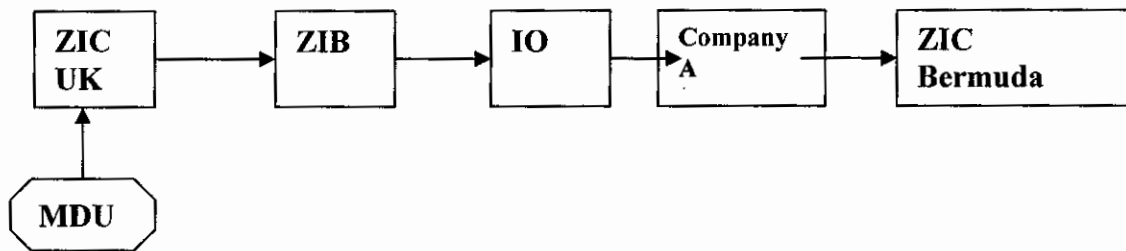
15. Between April and December 2000, Zurich attempted to negotiate reinsurance contracts for its MDU business that contained genuine risk transfer. However, by December 2, 2000, Zurich had not found any reinsurer willing to take on such a contract. In December 2000, the CUO emailed the CEO and suggested that Zurich utilize Inter-Ocean or a similar non-controlled foreign corporation. The CEO responded "we need to get something in the books now! We close our books this week."

16. Soon thereafter Zurich entered into the following agreements: ZIC UK entered into a reinsurance agreement with Zurich Insurance Bermuda ("ZIB") and ceded 80% of the MDU claims made on business written on or after July 1, 2000. At the same time, ZIB entered

⁵ A stop loss policy is a form of reinsurance that covers all losses above a specified amount.

⁶ Both the CEO and the CUO ceased to be associated with Converium before it announced it would restate its financial statements. Neither was ever associated with SCOR.

into a reinsurance agreement with Inter-Ocean to cover a portion of ZIB's MDU liabilities for the 2000 policy year. This agreement provided for Inter-Ocean to cover ultimate net losses in excess of 85% of gross premiums written for the 2000 policy year. Inter-Ocean then ceded all the liabilities it had assumed under the ZIB/Inter-Ocean agreement to an unaffiliated reinsurer (Company A). Company A, in turn, ceded all the liabilities to a Zurich affiliate, ZIC Bermuda.



17. Although Zurich accounted for the transactions with Inter-Ocean and Company A as reinsurance, in reality, Zurich had re-circulated the risk from one Zurich entity to another, while interposing intermediaries (Inter-Ocean and Company A) that obscured the transaction's circular structure. Because this transaction was circular, there was no risk transfer and Zurich and later Converium should not have accounted for the contract as reinsurance. As a result, and as reported in Converium's December 2001 Form F-1, Converium understated its pre-tax losses for the year ended December 31, 2000 by \$1.36 million.

18. Zurich and Company A renewed the ZIB/Inter-Ocean agreement in 2001 to include MDU business written from January 1, 2001 through March 31, 2002. At the time the parties negotiated the agreement, Zurich had already announced its intention to spin-off its reinsurance operations. Due to the increased scrutiny of Zurich's contracts occasioned by the due diligence for the IPO, the CUO requested that the 2001 MDU reinsurance contracts not include specific cross references that might have revealed that the reinsurance structure was circular. The contracts ultimately executed by the parties did not specifically reference the other related agreements.

19. As a result of the MDU transaction, in its Form 20-F filings for the years ended December 31, 2001, 2002 and 2003, Converium understated its pre-tax losses for 2001 by \$10.04 million (1.86%) and overstated its pre-tax income for 2002 by \$6.52 million (9.49%) and by \$14.47 million (7.39%) for 2003.

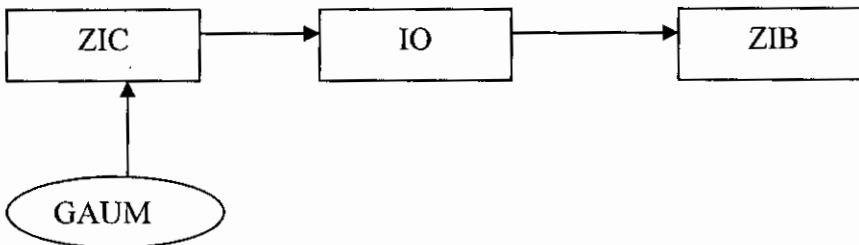
The GAUM Transaction

20. Just as it had done with MDU, in 2001, Zurich negotiated a circular reinsurance transaction aimed at managing losses related to reinsurance coverage it provided to Global Aerospace Underwriting Managers Ltd. ("GAUM"), an aerospace underwriting pool.

21. In July 2001, Zurich estimated that losses under its reinsurance agreement with GAUM would negatively impact Zurich Re's earnings for the year ended December 31, 2001.

In a July 12, 2001 memo to the CEO and other senior executives, the CUO suggested the "possibility to buy a GAAP cover" for the GAUM business. In an August 31, 2001 email to the CEO and others, the CUO provided the following description of the reinsurance structure, reflecting that Zurich intended it to be circular from early on: "Zurich Re retrocedes a 100% [quota share] of its Stop Loss Reinsurance covering GAUM's net retention for the underwriting year 2001 . . . to InterOcean . . . InterOcean enters into a Speed of Settlement (SOS) excess of loss reinsurance with Zurich Insurance Bermuda . . ."

22. In 2001, Zurich entered into the following transactions: On September 25, 2001, ZIC entered into an excess of loss reinsurance agreement with GAUM covering GAUM's losses for risks attaching during 2001 in excess of a certain attachment point. On December 5, 2001, ZIC ceded 100% of its risks under the GAUM excess of loss reinsurance agreement to Inter-Ocean, which in turn, ceded all of its liabilities to ZIB.



23. Similar to the MDU transaction, Zurich and later Converium improperly accounted for the GAUM contracts as reinsurance. Specifically, because Zurich reassumed 100% of the risk from Inter-Ocean, it should not have accounted for the contracts as reinsurance. By improperly accounting for the transaction as reinsurance in its Form 20-F filings for 2001 and 2002, Converium understated its pre-tax loss for 2001 by \$4.88 million (0.9%) and overstated its pre-tax income for 2002 by \$4.24 million (6.18%).

Transactions Involving Undisclosed Side Agreements

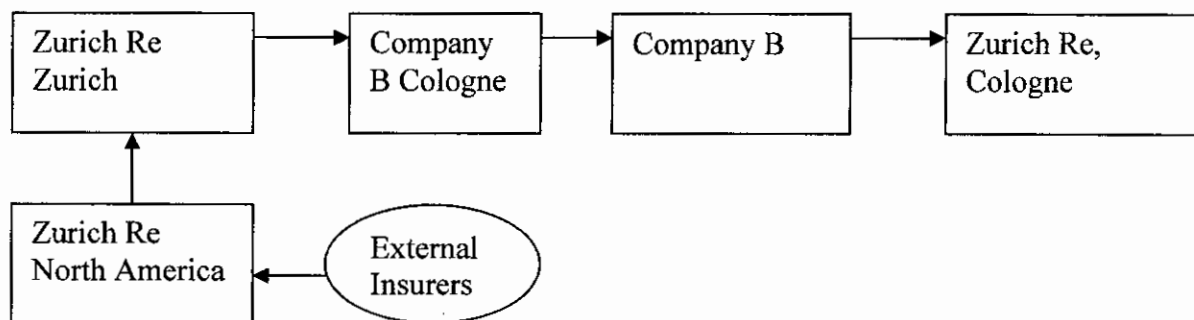
24. In addition to the Inter-Ocean transactions, Zurich and later Converium entered into three reinsurance transactions that appeared to transfer risk, but in fact did not due to side agreements that left the risk with Zurich and Converium. The first of these transactions began before the IPO and involved a reinsurance facility known as the Z-1 Facility. The other two transactions, which are addressed separately below, occurred after Converium's IPO.

The Z-1 Facility

25. In 1999, Zurich established the Z-1 Facility with a Barbados insurance company (Company B).

26. Under the Z-1 Facility, Company B and a Cologne-based affiliate of Company B ("Company B Cologne") acted as reinsurers for six finite reinsurance transactions between external cedents and ZIC, in which ZIC had reinsured losses of unaffiliated insurers. ZIC

retroceded 100% of its obligations and premiums to another Zurich division, which then retroceded 100% of its obligations and premiums to Company B Cologne, which then ceded the business to Company B. Company B, in turn, retroceded most but not all of the risk it had assumed from Company B Cologne to a separate Zurich subsidiary, Zurich Re Cologne pursuant to a "speed of settlement" stop loss agreement ("SOS"). A SOS is a type of aggregate stop loss agreement that limits the total losses incurred by the ceding company. Under the SOS, Company B retained the risk of up to \$60 million of losses (including \$10 million of losses under Endorsement 1); Zurich Re Cologne was responsible for aggregate losses above that \$60 million.



Cover B Negates Risk Transfer

27. Although Company B ceded much of the risk it assumed under the Z-1 Facility to Zurich Re Cologne, Company B did not want to have *any* exposure for losses under the Z-1 Facility. Accordingly, Company B sought a commitment from Zurich that Company B would not realize any losses under the Z-1 Facility. The CEO assured the Company B executive responsible for the transaction that Company B would not realize any losses under the Z-1 Facility.

28. The Company B executive insisted on security beyond the CEO's oral commitment. At the CEO's instruction, a Zurich employee prepared a separate reinsurance agreement between ZIC and Company B to serve as security for the CEO's promise. The agreement, which was unrelated to the Z-1 Facility on its face, was structured as a payback mechanism and was intended to reimburse Company B for any losses suffered under the Z-1 Facility. In internal correspondence, Zurich and later Converium referred to the agreement as "Cover B." Cover B provided ZIC catastrophic coverage for the years 2000 through 2002 in exchange for a total of \$39 million in non-refundable premiums to Company B. The attachment point for coverage under Cover B was set intentionally high -- at a level that neither party expected to be reached. So, although Company B theoretically could have suffered losses under Cover B, the agreement was structured to allow Company B to receive a premium with very little risk. The \$39 million premium figure represented the present value of the maximum possible loss that Company B could suffer under the Z-1 Facility (\$60 million). Moreover, Cover B was drafted to give Company B the option to trigger the parties'

obligations and, by doing so, offset losses, if any, sustained under the Z-1 Facility. In fact, Company B referred to Cover B as the "option contract."

29. In the fall of 1999, prior to finalizing the terms of Cover B, the Zurich employee who drafted the agreement told the CEO that he believed that Cover B negated risk transfer under the Z-1 Facility. Notwithstanding this warning, the CEO approved Cover B, and on November 18, 1999, the CEO executed it on behalf of ZIC.

30. In December 2000, Cover B was renewed, with the CEO again signing on behalf of ZIC. The terms of the 2000 Cover B agreement were substantially the same as the 1999 Cover B agreement, although the premium amount was increased to \$15 million per year, for a total of \$45 million.

Unicover Losses Are Ceded to the Z-1 Facility

31. In September 2000, Zurich became concerned about the financial statement impact of Zurich's exposure to losses arising out of Zurich's involvement in the failed Unicover Occupational Accident Reinsurance Pool ("Unicover Pool"). To address these concerns, Zurich approached Company B about including Zurich's Unicover Pool exposure under the Z-1 Facility. Specifically, Zurich proposed ceding a potential exposure of \$58.6 million under the Unicover Pool, as well as assorted other potential exposures, in exchange for a \$15 million premium.

32. During a December 20, 2000 dinner with the CEO in Zurich, the Company B executive who negotiated the Z-1 Facility and Cover B agreed to adjust the Z-1 Facility to permit Zurich to cede potential Unicover losses to the Z-1 Facility. The Company B executive agreed to accept the cessions because he believed that Cover B protected Company B from risk of loss under the Z-1 Facility. Cover B was renewed and signed on December 20, 2000.

33. By the time Zurich had completed the Converium IPO, significant losses on the Unicover business had been recorded. Converium ultimately ceded those losses to the Z-1 Facility. Converium was prepared to honor Zurich's prior commitment that Company B would not suffer any losses under the Z-1 Facility, and Converium did not want Company B to trigger Cover B. To induce Company B not to trigger Cover B, Converium offered to enter into reinsurance agreements that would be structured in such a way as to ensure that Company B would realize sufficient profit to offset the Z-1 Facility losses. The Company B executive described the arrangement and reasoning in an internal memo following a January 2003 meeting with the CEO: "Converium does not want us to trigger the option cover (contract 5), since it would make it obvious that this transaction was a circular transaction. Instead they have offered us [other profitable business] Converium and especially [the CEO] have proved to us that Converium will hold [Company B's parent] harmless under the [Z-1 Facility]. The option cover (contract 5) [Cover B] was always considered to be a sleep-easy cover in case Converium does not fulfill it's [sic] obligation they gave to [Company B]"

Converium Cedes Profitable Business to Company B as Payback for Z-1 Losses

34. Consistent with the CEO's representations, Converium entered into three purportedly unrelated agreements with Company B in lieu of the option contract to offset losses ceded to the Z-1 Facility. First, in 2003, Converium entered into a multiple year third event industry warranty catastrophe excess of loss reinsurance contract with Company B for the years 2003 through 2005. Converium purchased coverage for this contract from Company B. As a result, in exchange for providing coverage for a remote layer of risk, Converium paid Company B an \$8 million premium each year.

35. Second, in early 2000, pursuant to a novation agreement, Company B replaced another Bermuda-based reinsurer, as the retrocessionaire for risks related to a pre-existing reinsurance agreement between Zurich and a third-party reinsurer. According to internal Converium and Company B documents, Converium used \$2.6 million in excess fees that would have been payable to the original retrocessionaire but that Company B received in its place to offset a portion of the losses suffered by Company B under the Z-1 Facility.

36. Third, in 2004, in exchange for assuming the risk in connection with a policy for only the final month of a year-long agreement, Company B received the vast bulk of the premiums under the contract - - \$9.85 million of the \$10.2 million annual premium.

37. In connection with the above reinsurance agreements, Converium paid a total of \$35.73 million to Company B as a means of repaying the deficit that had arisen through losses ceded to Company B via the Z-1 Facility.

The Net Effect of the Z-1 Transactions

38. The Z-1 transactions did not transfer insurance risk outside of entities included in Zurich's, and later Converium's, consolidated financial statements and should not have been accounted for as reinsurance. As a result, in its December 2001 Form F-1, Converium understated its pre-tax loss for the year ended December 31, 2000 by \$98.20 million or 66.19%.

The Converium IPO

39. On March 22, 2001, in connection with its announcement of disappointing financial results for 2000, Zurich reported that it intended to exit the assumed reinsurance business. In a September 6, 2001 press release, Zurich announced that its reinsurance business would be spun off in an IPO, and that as of October 1, 2001, the business would operate under the name Converium.

40. As a result of the misrepresentations described above, the IPO offering documents were materially misleading. The Registration Statement and Prospectus filed by Converium in connection with the IPO, which became effective on December 11, 2001, failed to disclose the

impact of the circular Inter-Ocean and the Z-1 Facility transactions on Converium's business operations, financial results and shareholders' equity at the time of the IPO.

41. Converium's historical financial data reported in its prospectus was derived from data from the Zurich subsidiaries combined to form Converium.

42. The statements in the prospectus regarding Converium's financial results for 2000 and the first half of 2001 were materially false and misleading. As a consequence of the pre-IPO circular Inter-Ocean transactions and the Z-1 Facility transactions, rather than reporting a loss before taxes of \$48.8 million for 2000, Converium should have reported a loss of at least \$148.4 million. Also according to Converium's restatement filed on March 1, 2006, as the result of reinsurance transactions, Converium overstated its \$1.09 billion in reported shareholders' equity as of December 31, 2000 by at least \$72.3 million (approximately 6.6% of the total reported shareholders' equity), an amount including the effect of \$100 million attributable to the Inter-Ocean and Z-1 Facility transactions and partially offset by \$27.7 million attributable to other reinsurance transactions not addressed within this Order. Finally, because Converium's loss ratio for its non-life reinsurance business was directly affected by the improperly recorded reinsurance obtained through the circular Inter-Ocean and the Z-1 Facility transactions, Converium materially understated its reported loss ratios for its "Global Non-life" and "Converium Zurich" segments in 2000 and 2001. Had Converium accounted for these transactions as deposits, Converium would have reported for its "Global Non-life" segment a 92.6% loss ratio (a 6% increase from the 86.6% it reported) and for its "Converium Zurich" segment a 94% loss ratio (a 14.5% increase from the 79.5% it reported) in 2000. In 2001, Converium should have reported for its "Global Non-life" segment a loss ratio above 100% (up from the 99.7% reported to 100.2%), which indicates an underwriting loss.

43. On December 11, 2001, Converium conducted its IPO pursuant to the Registration Statement and Prospectus. The Converium IPO was the largest initial public offering of a reinsurance company in history. Moreover, it was the largest initial public offering of a Swiss company in three years. Zurich sold 35 million shares of Converium stock in the IPO at a price of 82 Swiss Francs per share, or \$24.59 per ADS (with each ADS representing one half of one share of stock). The IPO yielded gross proceeds of approximately \$1.7 billion. Zurich received net proceeds of approximately \$1.6 billion from its sale of Converium securities through the IPO.

44. In addition to the 35 million shares Zurich sold in the December 11, 2001 IPO, Zurich granted the underwriters an over-allotment of 5 million shares of Converium stock, representing the remainder of Zurich's interest in Converium. On January 9, 2002, Zurich issued a press release in which it announced that the over-allotment had been exercised, and that it had sold its remaining 5 million shares of Converium. In total, through the IPO, Zurich sold 40 million shares of Converium – every single share of Converium that it owned – and reaped proceeds of approximately \$1.97 billion.

45. As a result of the Inter-Ocean transactions (MDU and GAUM) and the Z-1 Facility, Converium's financial statements contained in Form F-1 filings for the IPO materially overstated shareholders equity as of October 1, 2001. Had Converium properly accounted for

the true nature of the Inter-Ocean and Z-1 Facility transactions, Zurich would have received materially less from its proceeds of the offering.

False Statements in Press Releases

46. Converium also made false and misleading statements in press releases. On March 18, 2002, Converium issued a press release reporting its financial results for the year ending December 31, 2001. Converium reported a net loss of \$367 million for fiscal 2001, which Converium downplayed as endemic of the industry-wide impact of the September 11 attacks and the Enron collapse – one-time catastrophic events. In the press release, Converium touted the material improvement in its adjusted non-life combined ratio, excluding the impact of September 11 and Enron:

Converium has a very solid balance sheet and is strongly capitalized at \$1.6 billion to benefit in the hardening markets. ... We substantially improved our underlying adjusted non-life combined ratio in 2001 by 7.8 points to 105.4%. ... Our objective for 2002 is to generate a non-life combined ratio of close to 100% and to target an ROE of more than 12.5%

47. On May 23, 2002, Converium filed its Form 20-F for the year ended December 31, 2001 (the “2001 20-F”) in which it repeated the results first announced in Converium’s March 18, 2002 press release, and represented that those results were prepared in accordance with GAAP. In addition, the 2001 20-F reported that, as of December 31, 2001, Converium had shareholders’ equity of \$1.6 billion.

48. The financial results reported in Converium’s March 18, 2002 press release and its 2001 20-F were materially false and misleading. Specifically, as a result of the fraudulent reinsurance transactions described above, Converium overstated its shareholders’ equity as of December 31, 2001 by \$103.1 million or 7.02%.

Converium Modifies the MDU Transaction to Deceive the FSA

49. After the IPO, Converium continued to use circular transactions to manipulate its financial statements. However, because of regulatory concerns in Europe, Converium engaged in further subterfuge to hide the circular nature of certain reinsurance transactions.

50. In January 2003, Converium submitted an application to license Converium Insurance Company UK (“Converium UK”) to write insurance within the United Kingdom. In April and May 2003, the Financial Services Authority (“FSA”) requested, among other things, that Converium provide additional information regarding: (a) the ownership structure of Inter-Ocean; and (b) whether any member of the Converium group provided retrocessional protection to Inter-Ocean related to the MDU business. Prior to the FSA seeking information about Converium’s transactions with Inter-Ocean, Converium had agreed with Company A that Company A would continue to participate in the MDU business for 2002 and 2003. Specifically, the parties had agreed that the transactions would utilize the same circular

structure that had been used prior to the IPO: Converium to Inter-Ocean to Company A and back to Converium.

51. On May 7, 2003, the CUO contacted a senior Company A executive by e-mail regarding the FSA's inquiry about whether Converium acts as a reinsurer for Inter-Ocean. The CUO wrote: "If we answer this question with yes this would have implications on the capital charges for [Converium] and some reputational issues we would like to avoid." Instead, the CUO asked whether, in order to avoid the issue of circularity, Company A would replace Converium on the back end of the transactions for years 2002 and 2003.

52. In order to provide written security that Company A would not incur losses under the restructured MDU transaction, Converium gave Company A a "put option," under which Company A could "put" the business back to Converium if the MDU business began to incur losses. Because the put option placed all risk of loss with Converium, the put option had the effect of recreating circularity. Although the put option was never exercised (because economic losses under the agreement never materialized), Converium, as had Zurich before it, continued to account improperly for the agreements as reinsurance.

53. On May 9, 2003, after Company A agreed to restructure the transaction, Converium responded to the FSA's request for information. The letter stated that Converium owns a minority interest (9.9%) of Inter-Ocean Holding, Ltd., which wholly owns Inter-Ocean Reinsurance Co. Ltd. Converium also stated that it did not provide any retrocession to Inter-Ocean concerning the MDU business.

Converium's Post-IPO Fraudulent Transactions

54. Following the IPO, Converium entered into two additional reinsurance transactions involving side agreements. The first transaction included an undisclosed "profit sharing agreement" that served as a vehicle to protect the reinsurer from any loss. The second transaction involved an undisclosed side agreement that also served to make the reinsurer whole. Converium improperly accounted for these transactions as reinsurance since these side agreements sought to reimburse the reinsurers for any losses and therefore negated any risk transfer.

The Transaction with Company C

55. Just prior to the IPO, Converium became concerned about the effect a catastrophic event loss might have on its balance sheet. As a result, in late 2001, Converium began soliciting quotes for excess of loss reinsurance from a number of reinsurers, including Company C, an unaffiliated reinsurer. However, before writing any reinsurance policy to Converium, Company C wanted comfort at the back end that it would not lose money on any reinsurance policy it might write, which ultimately led the parties to enter into an undisclosed side agreement that ensured Company C that it would not experience any losses. This side agreement negated Converium's transfer of any reinsurance risk to Company C in any of the contracts.

56. From early March 2002 through late fall 2003, Converium entered into three excess of loss reinsurance policies with Company C. In October 2001, prior to entering into any of the reinsurance agreements, Company C forwarded to the CUO a proposed agreement captioned "side-letter" that ensured that Company C would experience no losses on the reinsurance contracts. Specifically, the "side letter" obligated Converium "to specifically hold [Company C] harmless at the end in all respects under said reinsurance contracts. [Company C] acts purely as an enabler."

57. On October 20, 2001, the CUO sent a revised "side letter" to the CEO, along with an e-mail written entirely in German – except for the word "FRAUD." The English translation of the e-mail is as follows:

Enclosed is the draft side agreement as well as the [Company C] images. We must first work hard on these. Do you want to involve someone from legal? If yes, who? They have not liked these things and I fear that our actions would turn into a difficult situation (compliance etc). One alternative would be to handle it in the market ourselves and apply common sense. Actually, there should be no contractual document otherwise according to [Converium's Senior Legal Counsel] the reinsurance agreement is void and all "FRAUD." Let me know!

58. The next day, the CEO informed the CUO via e-mail that the side letter was "too restrictive" and that he "would prefer a letter of comfort and some additional protections built in for Company C in the contract which do not cause us problems from an accounting perspective."

59. On December 7, 2001, Company C sent the CUO a "corrected side letter" that included a "pay-back clause." The "pay-back clause" stated that, should Company C experience an economic loss on any of the three contracts, Converium would pay Company C additional premiums to make up for the loss. In addition, the "corrected side letter" did not alter that "Converium confirms specifically to hold [Company C] harmless at the end in all respects under said reinsurance contracts. Company C acts purely as an enabler."

60. Converium improperly accounted for the transactions with Company C as reinsurance. As a result of the "side-letter," Company C assumed no reinsurance risk, and Converium should have accounted for the transaction using deposit accounting. As a result, Converium, in its December 31, 2003 Form 20-F, overstated its pre-tax income for 2003 by \$21.67 million or 11.06%.

The Transactions with Company D

61. Zurich, and later Converium, maintained a book of business related to reinsurance for Guaranteed Minimum Death Benefit ("GMDB") liabilities it maintained through treaties with third-party cedents. In early 2003, analysts criticized Converium for being under-reserved with respect to its risks related to its GMDB business and, in response, Converium sought reinsurance from an unaffiliated reinsurer (Company D) through two reinsurance agreements.

However, in order to protect Company D from suffering any combined losses under both reinsurance agreements, Converium and Company D entered a "Master Profit Sharing Agreement" that linked the two reinsurance agreements and negated Converium's transfer of reinsurance risk to Company D.

62. In 2003, Converium and Company D entered into a GMDB Stop Loss Reinsurance Agreement (the "GMDB agreement") effective October 1, 2003. The GMDB agreement covered Converium's risks related to its GMDB business up to \$75 million in excess of ultimate net loss of \$93.2 million. In exchange, Company D received \$10 million in premium, and Converium was required to pay an additional premium of 85% of the risk between \$55 million and \$75 million. The net exposure to Company D in the transaction was \$50 million.

63. At the same time they entered into the GMDB agreement, Converium and Company D entered into a Property Catastrophe Excess of Loss Agreement that covered losses from European windstorms over a five year period (January 1, 2004 through December 31, 2008) (the "windstorm agreement"). In exchange, Company D received an \$11.2 million annual premium. Company D then retroceded the windstorm agreement to Inter-Ocean, which then retroceded the risks to Converium. After taking into account each leg of the transaction, Company D would receive an annual net premium of \$10.2 million or a total of \$51 million over the five years, which fully covered its net exposure under the GMDB agreement.

64. While there was real risk that Company D would incur losses under the GMDB agreement, there was a low probability that Company D would incur losses under the windstorm agreement. In order to protect Company D from suffering any combined losses under both the GMDB and windstorm transactions, Converium and Company D entered into a Master Profit Sharing Agreement ("the profit sharing agreement") that linked the two reinsurance agreements. Taking the GMDB and windstorm agreements together, Company D would receive approximately \$75 million in premiums under both agreements, thereby pre-funding or reimbursing Company D for any losses it could have experienced under the GMDB Stop Loss agreement.

65. Converium improperly accounted for the Company D transaction as reinsurance. As a result of the profit sharing agreement linking the GMDB and windstorm agreements, Company D assumed no (or very little) reinsurance risk under both reinsurance agreements and should have accounted for the transactions using deposit accounting.

Converium's Restatement

66. On November 4, 2005, following an internal review of certain finite insurance and reinsurance transactions, including the transactions described above, Converium announced that it planned to restate prior period financial statements. Converium's closing stock price declined 4.7%, from \$4.91 per ADS on November 3, 2005 to \$4.68 per ADS on November 4, 2005.

67. On March 1, 2006, Converium restated its financial statements as of and for the years ended December 31, 1998 through December 31, 2004 and disclosed that it had improperly accounted for the Inter-Ocean, the Z-1 Facility, Company C and Company D transactions.

68. By accounting for these transactions as reinsurance, Converium overstated its pre-tax income and shareholder's equity. The financial statements for 2000 were included in Converium's F-1 filings made in connection with its IPO in December 2001. The financial statements for 2000 and 2001 were included in Converium's F-1 filings made in connection with a debt offering in December 2002. The financial statements for 2001 through 2004 were included in Converium's annual reports on Form 20-F filed with the Commission on May 23, 2002, April 18, 2003, April 9, 2004, and June 30, 2005, respectively.

VIOLATIONS

69. As a result of the conduct described above, Converium violated Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer and sale of securities. Converium made material misrepresentations and omitted material facts in its (a) Registration Statement on Form F-1 and Prospectus for its December 2001 IPO; and (b) Registration Statement on Form F-1 and Prospectus for its December 2002 offering of guaranteed subordinated notes.

70. As a result of the conduct described above, Converium violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities. Converium improperly accounted for five finite reinsurance transactions and made material misrepresentations regarding its true financial condition in its (a) Registration Statement on Form F-1 and Prospectus for its December 2001 IPO; (b) March 18, 2002 press release; (c) 2001 Annual Report on Form 20-F; (d) 2002 Annual Report on Form 20-F; (e) Registration Statement on Form F-1 and Prospectus for its December 2002 offering of guaranteed subordinated notes; (f) 2003 Annual Report on Form 20-F; and (g) 2004 Annual Report on Form 20-F.

71. As a result of the conduct described above, Converium violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder, which require issuers to file true, accurate and complete periodic reports with the Commission. Converium filed false periodic reports with the Commission by misstating material facts concerning its financial performance due to Converium's improper accounting treatment of the finite transactions at issue.

72. As a result of the conduct described above, Converium violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. Because Converium improperly accounted for and recorded the five finite reinsurance transactions at issue, its books, records and accounts did not, in reasonable detail, accurately reflect its transactions and dispositions of assets.

73. As a result of the conduct described above, Converium violated Section 13(b)(2)(B) of the Exchange Act, which require all reporting companies to maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles and prohibit them from, directly or indirectly, falsifying or causing to be falsified, any book, record, or account. Converium's internal controls were not sufficient to prevent numerous false accounting entries related to the finite reinsurance transactions at issue to be recorded and to account for the transactions in conformity with generally accepted accounting principles.

Converium's Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

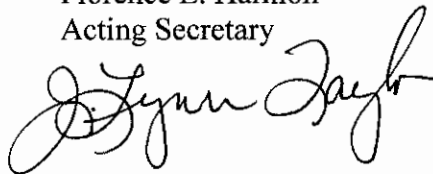
In view of the foregoing, the Commission deems it appropriate to impose the relief agreed to in Respondent Converium's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent Converium shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-1 thereunder.

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59083 / December 11, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2908 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13306

In the Matter of

Zurich Financial Services

Respondent.

**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**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Zurich Financial Services ("Zurich" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer"), 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 it and the subject matter of these proceedings, which are admitted, Respondent consents 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, as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:¹

SUMMARY

1. Zurich caused a fraud by Converium Holding AG ("Converium") involving the use of finite reinsurance transactions to inflate improperly Converium's financial performance. Beginning in 1999, the management of Zurich's reinsurance group, which operated under the name Zurich Re, developed three reinsurance transactions for the purpose of obtaining the financial benefits of reinsurance accounting. However, in order for a company to obtain the benefits of reinsurance accounting, the reinsurance transaction must transfer risk. Here, Zurich Re management designed the transactions to make them appear to transfer risk to third-party reinsurers, when, in fact, no risk was transferred outside of Zurich-owned entities. For two of the transactions at issue, Zurich Re ceded risk to third-party reinsurers, but took it back through reinsurance agreements - known as retrocessions - with another Zurich entity. For the third transaction, Zurich Re ceded the risk to a third-party reinsurer but simultaneously entered into an undisclosed side agreement with the reinsurer pursuant to which Zurich Re agreed to hold the reinsurer harmless for any losses the reinsurer realized under the reinsurance contracts. Because the ultimate risk under the reinsurance contracts remained with Zurich-owned entities, these transactions should not have been accounted for as reinsurance.

2. In March 2001, Zurich announced its intent to spin off its assumed reinsurance business in an initial public offering. Zurich then created and capitalized Converium, which assumed the rights and obligations of Zurich's assumed reinsurance business. On December 11, 2001, Zurich spun off Converium in an IPO. At the conclusion of the IPO, the members of Zurich Re management responsible for the three reinsurance transactions described herein ceased to be affiliated with Zurich and continued as officers of Converium. As a result of the improper accounting treatment these reinsurance transactions received, the historical financial statements included in Converium's IPO documents, including the Form F-1 it filed with the Commission, were materially misleading. Among other things, Converium understated its reported loss before taxes by approximately \$100 million (67%) in 2000 and by approximately \$3 million (1%) in 2001. In addition, for certain periods, the transactions had the effect of artificially decreasing Converium's reported loss ratios for certain reporting segments - the ratio between losses paid by an insurer and premiums earned that is frequently cited by analysts as a key performance metric for insurance companies.

3. Converium's misstatements relate to facts that were material to investors who purchased shares in the IPO. Through the IPO, which was the largest reinsurance

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

IPO in history, Zurich raised significantly more than it would have raised had Zurich and Converium not improperly inflated Converium's financial performance.

4. As a result of the foregoing conduct, Converium violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Zurich caused Converium's violation of Section 10(b) and Rule 10b-5.

RESPONDENT

5. **Zurich** is a corporation organized under the laws of Switzerland with its principal place of business in Zurich, Switzerland. Historically, Zurich operated its reinsurance business under the brand name Zurich Re, which operated as a separate division within Zurich Insurance Company ("ZIC"), a wholly-owned subsidiary of Zurich, and through its North American subsidiary, Zurich Reinsurance (North America) Inc. ("Zurich Re North America"). Prior to Converium's IPO, Zurich restructured its reinsurance operations and transferred substantially all of the reinsurance business operated under Zurich Re to Converium. In December 2001 and January 2002, pursuant to the Registration Statement and Prospectus, Zurich sold 40 million shares of Converium in the form of shares and American Depositary Shares ("ADSs"), representing its entire stake in Converium, for proceeds of approximately \$1.9 billion. Zurich's common stock trades on the SWX Swiss Exchange under the symbol ZURN and its ADSs trade on the Over-the-Counter Bulletin Board (OTCBB) and on the Pink Sheets under the symbol ZFSVY. Each Zurich ADS equals one-tenth of one share of Zurich common stock.

OTHER RELEVANT ENTITIES

6. **Converium, now known as SCOR Holding (Switzerland) Ltd.**, is a corporation organized under the laws of Switzerland. Zurich formed Converium in 2001 by transferring the rights and liabilities of the reinsurance businesses that made up Zurich's assumed reinsurance business, which operated under the name Zurich Re. Converium began operations under the Converium brand name on or around October 1, 2001. From that time, until December 11, 2001, Converium operated as a wholly owned subsidiary of Zurich. Between December 11, 2001 and January 7, 2008, Converium's common stock and ADSs were registered with the Commission pursuant to Section 12(b) of the Exchange Act. In August 2007, SCOR SE, a French reinsurer acquired Converium.

7. **Inter-Ocean Reinsurance Company, Ltd.** ("Inter-Ocean") was, at all times relevant to this Order, a Bermuda corporation with its principal corporate offices in Bermuda, and a wholly-owned subsidiary of Inter-Ocean Holdings, Inc., which was formed in 1990 as a joint venture between ten reinsurers. In 1998, Zurich acquired a 9.9% interest in Inter-Ocean effective at the end of that year. Prior to Converium's IPO, Zurich transferred its 9.9% interest in Inter-Ocean to Converium.

Reinsurance Accounting Principles

8. In basic terms, reinsurance is insurance for insurers. Reinsurance is the transfer of insurance risk by the primary insurer to a second insurance carrier, called the reinsurer, in exchange for a payment or premium.

9. Whether a contract is accounted for as reinsurance depends on whether the contract indemnifies the ceding company - here Zurich and Converium - from loss or liability. Such indemnification is known as risk transfer. Risk is transferred when (1) the reinsurer assumes significant insurance risk and (2) it is reasonably possible that the reinsurer will realize a significant loss in the transaction. A risk transfer analysis for a contract emphasizes substance over form, and Generally Accepted Accounting Principles ("GAAP") require "an evaluation of all contractual features that...limit the amount of insurance risk to which the reinsurer is subject..."² Accordingly, under GAAP, "if agreements with the reinsurer...in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured."³

10. Where there is insufficient risk transfer, a transaction may not be treated as reinsurance under GAAP, and must be accounted for using the deposit method, which lacks the potential accounting benefits of reinsurance accounting. Under reinsurance accounting, when losses on the ceded business are incurred, the ceding insurer records an offset to the increase in its gross loss reserves in an amount equal to the reinsurance it expects to recover from the reinsurer, thus increasing its net income by that amount. Deposit accounting has no comparable income statement benefit.

11. From 1999 through 2001, management of Zurich Re designed three reinsurance transactions that created the *appearance* of risk transfer in order to benefit from reinsurance accounting. These three transactions affected the financial statements included in Converium's IPO prospectus. In two of the three transactions, Zurich Re purchased reinsurance from Inter-Ocean, which, in turn, ceded these liabilities to a Zurich entity (the "Inter-Ocean transactions"), in one transaction directly and in the other transaction indirectly through a third reinsurer. Zurich's Re's use of Inter-Ocean as an intermediary in the transaction helped obscure the transactions' circular structure and the fact that Zurich Re had merely moved the risk from one Zurich Re entity to another. In the third transaction, Zurich Re entered into a reinsurance transaction for which the risk transfer was negated by an undisclosed and purportedly unrelated side agreement that protected the reinsurer against losses suffered under the reinsurance contract. Zurich Re improperly accounted for these transactions using reinsurance accounting.

² FASB, Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (December 1992), para. 8.

³ FASB, Emerging Issues Task Force Topic D-34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113* (July 22, 1993), Question 13.

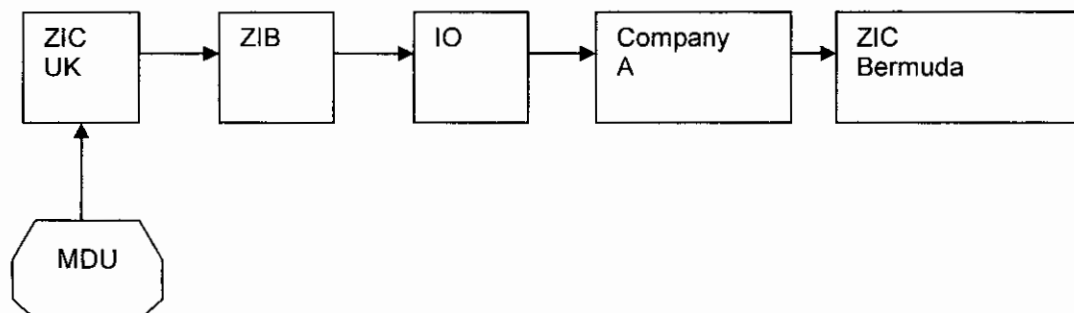
The Circular Inter-Ocean Transactions

The Medical Defence Union Transactions

12. In 2000, Zurich Re sought reinsurance for medical malpractice coverage it provided to British doctors who were members of the Medical Defence Union ("MDU"). In an April 25, 2000 e-mail concerning expected losses related to the MDU contract, the Chief Executive Officer of certain Zurich Re entities and later Converium (the "CEO") informed Zurich Re's (and later Converium's) Chief Underwriting Officer (the "CUO") that "we need to begin working on the actual placement of the [MDU] stop loss to relieve the GAAP hit" for Zurich. Internally, Zurich Re personnel used the term "GAAP hit" to mean the expense and increased reserve requirements associated with the medical defense coverage. The expense would decrease or "hit" reported income. The CEO, who was also a senior executive of Zurich, warned that, in obtaining the reinsurance, "we need to be conscious of the issue of circularity."

13. Between April and December 2000, Zurich Re management attempted to negotiate reinsurance contracts for its MDU business that contained genuine risk transfer. However, by December 2, 2000, they had not found any reinsurer willing to take on such a contract. In December 2000, the CUO emailed the CEO and suggested that Zurich Re utilize Inter-Ocean or a similar non-controlled foreign corporation. The CEO responded "we need to get something in the books now! We close our books this week."

14. Soon thereafter Zurich Re entered into the following agreements: ZIC UK entered into a reinsurance agreement with Zurich Insurance Bermuda ("ZIB") and ceded 80% of the MDU claims made on business written on or after July 1, 2000. At the same time, ZIB entered into a reinsurance agreement with Inter-Ocean to cover a portion of ZIB's MDU liabilities for the 2000 policy year. This agreement provided for Inter-Ocean to cover ultimate net losses in excess of 85% of gross premiums written for the 2000 policy year. Inter-Ocean then ceded all the liabilities it had assumed under the ZIB/Inter-Ocean agreement to an unaffiliated reinsurer (Company A). Company A, in turn, ceded all the liabilities to a Zurich affiliate, ZIC Bermuda.



15. Although Zurich Re accounted for the transactions with Inter-Ocean and Company A as reinsurance, in reality, Zurich Re had re-circulated the risk from one Zurich entity to another, while interposing intermediaries (Inter-Ocean and Company A)

that obscured the transaction's circular structure. Because this transaction was circular, there was no risk transfer and Zurich Re and later Converium should not have accounted for the contract as reinsurance. As a result, and as reported in Converium's December 2001 Form F1, Converium understated its pre-tax losses for the year ended December 31, 2000 by \$1.36 million.

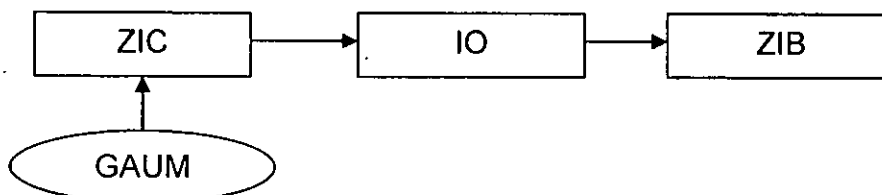
16. Zurich Re and Company A renewed the ZIB/Inter-Ocean agreement in 2001 to include MDU business written from January 1, 2001 through March 31, 2002. At the time the parties negotiated the agreement, Zurich had already announced its intention to spin-off its reinsurance operations. Due to the increased scrutiny of Zurich Re's contracts occasioned by the due diligence for the IPO, the CUO requested that the 2001 MDU reinsurance contracts not include specific cross references that might have revealed that the reinsurance structure was circular. The contracts ultimately executed by the parties did not specifically reference the other related agreements. As a result of the MDU transaction, in its December 2001 Form F-1, Converium understated its pre-tax losses for the six months ended June 30, 2001 by \$5.02 million.

The GAUM Transaction

17. Just as it had done with MDU, in 2001, management of Zurich Re negotiated a circular reinsurance transaction aimed at managing losses related to reinsurance coverage it provided to Global Aerospace Underwriting Managers Ltd. ("GAUM"), an aerospace underwriting pool.

18. In July 2001, Zurich Re management estimated that losses under Zurich Re's reinsurance agreement with GAUM would negatively affect Zurich Re's earnings for the year ended December 31, 2001. In a July 12, 2001 memo to the CEO and other senior executives, the CUO suggested the "possibility to buy a GAAP cover" for the GAUM business. In an August 31, 2001 email to the CEO and others, the CUO provided the following description of the reinsurance structure, reflecting that Zurich Re management intended it to be circular from early on: "Zurich Re retrocedes a 100% [quota share] of its Stop Loss Reinsurance covering GAUM's net retention for the underwriting year 2001...to Interocean...Interocean enters into a Speed of Settlement (SOS) excess of loss reinsurance with Zurich Insurance Bermuda..."

19. In 2001, Zurich Re entered into the following transactions: On September 25, 2001, ZIC entered into an excess of loss reinsurance agreement with GAUM covering GAUM's losses for risks attaching during 2001 in excess of a certain attachment point. On December 5, 2001, ZIC ceded 100% of its risks under the GAUM excess of loss reinsurance agreement to Inter-Ocean, which in turn, ceded all of its liabilities to ZIB.

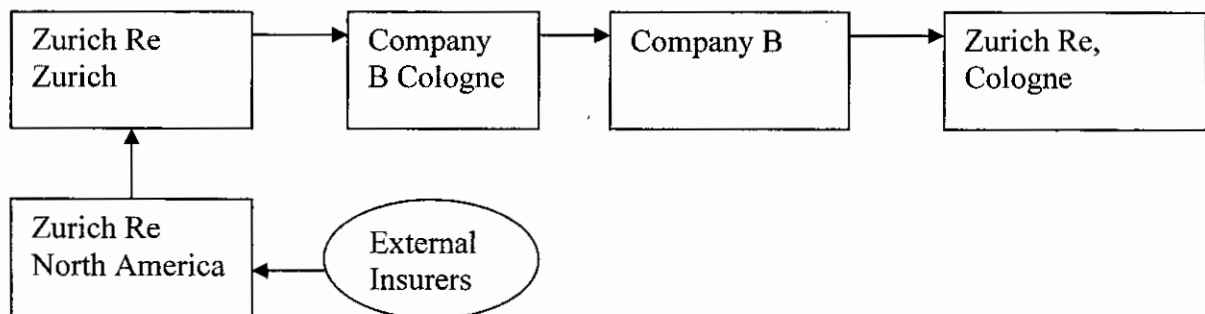


20. Similar to the MDU transaction, Zurich Re and later Converium improperly accounted for the GAUM contracts as reinsurance. Specifically, because Zurich reassumed 100% of the risk from Inter-Ocean, it should not have accounted for the contracts as reinsurance. Because Zurich Re, and later Converium, improperly accounted for the transaction as reinsurance, in Converium's December 2001 Form F-1, Converium understated its pre-tax loss for the six-month period ended June 30, 2001 by \$2.44 million.

The Z-1 Facility and Undisclosed Side Agreement

21. In addition to the circular Inter-Ocean transactions, Zurich Re management entered into a reinsurance agreement -- known as the Z-1 Facility -- that appeared to transfer risk, but in fact did not, due to a side agreement that left the risk with Zurich Re.

22. In 1999, Zurich Re established the Z-1 Facility with a Barbados insurance company (Company B). Under the Z-1 Facility, Company B and a Cologne-based affiliate of Company B ("Company B Cologne") acted as reinsurers for six finite reinsurance transactions between external cedents and Zurich Re North America, in which Zurich Re North America had reinsured losses of unaffiliated insurers. Zurich Re North America retroceded 100% of its obligations and premiums to Zurich Re Zurich, a division of ZIC. Zurich Re Zurich then retroceded 100% of its obligations and premiums to Company B Cologne, which then ceded the business to Company B. Company B, in turn, retroceded most but not all of the risk it had assumed from Company B Cologne to a separate Zurich subsidiary, Zurich Re Cologne, pursuant to a "speed of settlement" stop loss agreement ("SOS"). A SOS is a type of aggregate stop loss agreement that limits the total losses incurred by the ceding company. Under the SOS, Company B retained the risk of up to \$60 million of losses (including \$10 million of losses under Endorsement 1); Zurich Re Cologne was responsible for aggregate losses above that \$60 million.



Cover B Negates Risk Transfer

23. Although Company B ceded much of the risk it assumed under the Z-1 Facility to Zurich Re Cologne, Company B did not want to have *any* exposure for losses under the Z-1 Facility. Accordingly, Company B sought a commitment from Zurich Re management that Company B would not realize any losses under the Z-1 Facility. The

CEO assured the Company B executive responsible for the transaction that Company B would not realize any losses under the Z-1 Facility.

24. The Company B executive insisted on security beyond the CEO's oral commitment. At the CEO's instruction, a Zurich Re North America employee prepared a separate reinsurance agreement between ZIC and Company B to serve as security for the CEO's promise. The agreement, which was unrelated to the Z-1 Facility on its face, was structured as a payback mechanism and was intended to reimburse Company B for any losses suffered under the Z-1 Facility. In internal correspondence, Zurich Re management and later Converium referred to the agreement as "Cover B." Cover B provided ZIC catastrophic coverage for the years 2000 through 2002 in exchange for a total of \$39 million in non-refundable premiums to Company B. The attachment point for coverage under Cover B was set intentionally high -- at a level that neither party expected to be reached. So, although Company B theoretically could have suffered losses under Cover B, the agreement was structured to allow Company B to receive a premium with very little risk. The \$39 million premium figure represented the present value of the maximum possible loss that Company B could suffer under the Z-1 Facility (\$60 million). Moreover, Cover B was drafted to give Company B the option to trigger the parties' obligations and, by doing so, offset losses, if any, sustained under the Z-1 Facility. In fact, Company B referred to Cover B as the "option contract."

25. In the fall of 1999, prior to finalizing the terms of Cover B, the Zurich Re North America employee who drafted the agreement told the CEO that he believed that Cover B negated risk transfer under the Z-1 Facility. Notwithstanding this warning, the CEO approved Cover B, and on November 18, 1999, the CEO executed the agreement.

26. In December 2000, Cover B was renewed, with the CEO again signing the agreement. The terms of the 2000 Cover B agreement were substantially the same as the 1999 Cover B agreement, although the premium amount was increased to \$15 million per year, for a total of \$45 million.

Unicover Losses Are Ceded to the Z-1 Facility

27. In September 2000, Zurich Re management became concerned about the financial statement impact of Zurich Re's exposure to losses arising out of Zurich Re's involvement in the failed Unicover Occupational Accident Reinsurance Pool ("Unicover Pool"). To address these concerns, Zurich Re management approached Company B about including Zurich's Unicover Pool exposure under the Z-1 Facility. Specifically, Zurich Re proposed ceding a potential exposure of \$58.6 million under the Unicover Pool, as well as assorted other potential exposures, in exchange for a \$15 million premium.

28. During a December 20, 2000 dinner with the CEO in Zurich, the Company B executive who negotiated the Z-1 Facility and Cover B agreed to adjust the Z-1 Facility to permit Zurich Re to cede potential Unicover losses to the Z-1 Facility. The Company B executive agreed to accept the cessions because he believed that Cover B protected

Company B from risk of loss under the Z-1 Facility. Cover B was renewed and signed on December 20, 2000.

29. By the time Zurich had completed the Converium IPO, significant losses on the Unicover business had been recorded. Converium ultimately ceded those losses to the Z-1 Facility.

Post-IPO Conduct of Converium

30. Converium was prepared to honor Zurich Re's prior commitment that Company B would not suffer any losses under the Z-1 Facility, and Converium did not want Company B to trigger Cover B. To induce Company B not to trigger Cover B, Converium offered to enter into reinsurance agreements that would be structured in such a way as to ensure that Company B would realize sufficient profit to offset the Z-1 Facility losses. The Company B executive described the arrangement and reasoning in an internal memo following a January 2003 meeting with the CEO: "Converium does not want us to trigger the option cover (contract 5), since it would make it obvious that this transaction was a circular transaction. Instead they have offered us [other profitable business]...Converium and especially [the CEO] have proved to us that Converium will hold [Company B's parent] harmless under the [Z-1 Facility]. The option cover (contract 5) [Cover B] was always considered to be a sleep-easy cover in case Converium does not fulfill it's [sic] obligation they gave to [Company B]"

Converium Cedes Profitable Business to Company B as Payback for Z-1 Losses

31. Consistent with these representations, Converium used three purportedly unrelated agreements with Company B in lieu of the option contract to offset losses ceded to the Z-1 Facility. First, in 2003, Converium entered into a multiple year third event industry warranty catastrophe excess of loss reinsurance contract with Company B for the years 2003 through 2005. Converium purchased coverage for this contract from Company B. As a result, in exchange for providing coverage for a remote layer of risk, Converium paid Company B an \$8 million premium each year.

32. Second, in early 2000, before the IPO, Company B replaced another Bermuda-based reinsurer as the retrocessionaire for risks related to a pre-existing reinsurance agreement between Zurich and a third party reinsurer. According to internal Converium and Company B documents, after the IPO, when losses under the Z-1 Facility emerged, Converium used \$2.6 million in excess fees that would have been payable to the original retrocessionaire but that Company B received in its place to offset a portion of the losses suffered by Company B under the Z-1 Facility.

33. Third, in 2004, in exchange for assuming the risk in connection with a policy for only the final month of a year-long agreement, Company B received the vast bulk of the premiums under the contract -- \$9.85 million of the \$10.2 million annual premium.

34. In connection with the above reinsurance agreements, Converium paid a total of \$35.73 million to Company B as a means of repaying the deficit that had arisen through losses ceded to Company B via the Z-1 Facility.

The Net Effect of the Z-1 Transactions

35. The Z-1 transactions did not transfer insurance risk outside of entities included in Zurich's, and later Converium's, consolidated financial statements and should not have been accounted for as reinsurance. As a result, in its December 2001 Form F-1, Converium understated its pre-tax loss for the year ended December 31, 2000 by \$98.20 million or 66.19%.

The Converium IPO

36. On March 22, 2001, in connection with its announcement of disappointing financial results for 2000, Zurich reported that it intended to exit the assumed reinsurance business. In a September 6, 2001 press release, Zurich announced that its reinsurance business would be spun off in an IPO, and that as of October 1, 2001, the business would operate under the name Converium.

37. The Registration Statement and Prospectus filed by Converium in connection with the IPO, which became effective on December 11, 2001, was derived from data from the Zurich subsidiaries combined to form Converium and failed to disclose the impact of the circular Inter-Ocean and the Z-1 Facility transactions on Converium's business operations, financial results and shareholders' equity at the time of the IPO.

38. Accordingly, the statements in the prospectus regarding Converium's financial results for 2000 and the first half of 2001 were materially false and misleading. As a consequence of the circular Inter-Ocean transactions and the Z-1 Facility transactions, rather than reporting a loss before taxes of \$48.8 million for 2000, Converium should have reported a loss of at least \$148.4 million. Converium also overstated its \$1.09 billion in reported shareholders' equity as of December 31, 2000 by at least \$72.3 million (approximately 6.6% of the total reported shareholders' equity), an amount including the effect of \$100 million attributable to the Inter-Ocean and Z-1 Facility transactions and partially offset by \$27.7 million attributable to other reinsurance transactions not addressed within this Order.

39. Finally, because Converium's loss ratio for its non-life reinsurance business was directly affected by the improperly recorded reinsurance obtained through the circular Inter-Ocean and the Z-1 Facility transactions, Converium materially understated its reported loss ratios for its "Global Non-life" and "Converium Zurich" segments in 2000 and 2001. Had Converium accounted for these transactions as deposits, Converium would have reported for its "Global Non-life" segment a 92.6% loss ratio (a 6% increase from the 86.6% it reported) and for its "Converium Zurich" segment

a 94% loss ratio (a 14.5% increase from the 79.5% it reported) in 2000. In 2001, Converium should have reported for its "Global Non-life" segment a loss ratio above 100% (up from the 99.7% reported to 100.2%), which indicates an underwriting loss.

40. On December 11, 2001, Converium conducted its IPO pursuant to the Registration Statement and Prospectus. The Converium IPO was the largest initial public offering of a reinsurance company in history. Moreover, it was the largest initial public offering of a Swiss company in three years. Zurich sold 35 million shares of Converium stock in the IPO at a price of 82 Swiss Francs per share, or \$24.59 per ADS (with each ADS representing one half of one share of stock). The IPO yielded gross proceeds of approximately \$ 1.7 billion. Zurich received net proceeds of approximately \$1.6 billion from its sale of Converium securities through the IPO.

41. In addition to the 35 million shares Zurich sold in the December 11, 2001 IPO, Zurich granted the underwriters an over-allotment of 5 million shares of Converium stock, representing the remainder of Zurich's interest in Converium. On January 9, 2002, Zurich issued a press release in which it announced that the over-allotment had been exercised, and that it had sold its remaining 5 million shares of Converium. In total, through the IPO, Zurich sold 40 million shares of Converium - every single share of Converium that it owned - and reaped proceeds of approximately \$1.97 billion.

42. As a result of the Inter-Ocean transactions (MDU and GAUM) and the Z-1 Facility, Converium's financial statements contained in Form F-1 filings for the IPO materially overstated shareholders' equity as of October 1, 2001.

43. Had Zurich and Converium properly accounted for the true nature of the Inter-Ocean and Z-1 Facility transactions, Zurich would have received materially less from its proceeds of the offering.

Violation

44. As a result of the conduct described above, Converium violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

45. As a result of the conduct described above, Zurich caused Converium's violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities. Among other things, Zurich entered into finite reinsurance transactions described above for the purpose of improperly inflating its financial performance and improperly using reinsurance accounting rules to account for the transactions, with the knowledge that such accounting was improper.

Zurich's Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

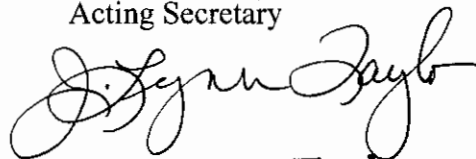
In view of the foregoing, the Commission deems it appropriate to impose the relief agreed to in Respondent Zurich's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Respondent Zurich cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

By the Commission.

Florence E. Harmon
Acting Secretary

A handwritten signature in cursive script, appearing to read "J. Lynn Taylor".

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

*Chairman Cox,
Commissioner Aguilar, and
Commissioner Harades
not participating*

INVESTMENT ADVISERS ACT OF 1940
Release No. 2813 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28532 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of

SCOTT E. DeSANO,
THOMAS H. BRUDERMAN,
TIMOTHY J. BURNIEIKA,
ROBERT L. BURNS,
DAVID K. DONOVAN,
EDWARD S. DRISCOLL,
JEFFREY D. HARRIS,
CHRISTOPHER J. HORAN,
STEVEN P. PASCUCCI and
KIRK C. SMITH,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
JEFFREY D. HARRIS

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris ("Harris" or "Respondent Harris"), Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Harris has submitted an Offer of Settlement ("Offer") 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 him and the subject matter of these proceedings, which are admitted, Respondent Harris consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Jeffrey D. Harris ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Harris' Offer, the Commission finds¹ that:

Settling Respondent

1. **Harris**, age 35, lives in Charlestown, Massachusetts. He was an equity trader at FMR Co., Inc. from 1998 until his resignation in July 2005. At all relevant times, he was a sector trader specializing in technology stocks.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

Summary

4. These proceedings concern Harris' acceptance of travel and tickets from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on

¹ The findings herein are made pursuant to Respondent Harris' Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Harris accepted tickets to several events and a significant amount of travel, including trips with brokers that included private jet travel and lodging. By accepting that travel and those tickets, Harris willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Harris worked as a sector trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Harris was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Harris Accepted Travel and Tickets from Brokerage Firms

6. Harris received tickets to several events as well as a significant amount of travel from representatives of brokerage firms during the Relevant Period, consisting of some or all of his lodging and travel expenses on a significant number of trips with brokers to destinations such as a golf club in South Carolina and to the Super Bowl. Many of the trips were by private jet and were attended by other Fidelity employees.

Harris Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Harris willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Harris was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Harris' receipt of travel and tickets from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Harris' Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Harris cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;

B. Respondent Harris is censured; and

C. Respondent Harris shall, within ten days of the entry of this Order, pay disgorgement of \$45,000, prejudgment interest of \$15,986.84 and a civil money penalty in the amount of \$30,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Harris as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*CHAIRMAN Cox
Commissioner Aguilar,
and Commissioner Paredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2812 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28531 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of

SCOTT E. DeSANO,
THOMAS H. BRUDERMAN,
TIMOTHY J. BURNIEIKA,
ROBERT L. BURNS,
DAVID K. DONOVAN,
EDWARD S. DRISCOLL,
JEFFREY D. HARRIS,
CHRISTOPHER J. HORAN,
STEVEN P. PASCUCCI and
KIRK C. SMITH,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
DAVID K. DONOVAN

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan ("Donovan" or "Respondent"), Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Donovan has submitted an Offer of Settlement ("Offer") 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

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to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent Donovan consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to David K. Donovan ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Donovan's Offer, the Commission finds¹ that:

Settling Respondent

1. **Donovan**, age 45, lives in Marblehead, Massachusetts. He was an equity trader at FMR Co., Inc. from 1992 until his resignation in March 2005. During the Relevant Period, he was a sector trader specializing in technology stocks, and he was also a team leader of several sector traders.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

¹ The findings herein are made pursuant to Respondent Donovan's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

Summary

4. These proceedings concern Donovan's acceptance of travel and gifts from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Donovan accepted a significant amount of travel and gifts, including many trips by private jet, as well as a case of expensive wine and tickets to several events that the broker did not attend. By accepting that travel and those gifts, Donovan willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Donovan worked as a sector trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Donovan was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Donovan Accepted Travel and Gifts from Brokerage Firms

6. Donovan received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period, primarily consisting of some or all of his lodging and other travel expenses on many trips with brokers, most of which were by private jet, to destinations such as the Super Bowl, Las Vegas and the Bahamas. On a few occasions, brokers provided Donovan with the personal use of a private jet as part of the trip. In addition, brokerage firms provided Donovan with a case of expensive wine, as well as tickets to several sporting events that Donovan did not attend with the representatives of brokerage firms.

Donovan Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Donovan willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Donovan was an

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Donovan's receipt of travel and gifts from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Donovan's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

- A. Respondent Donovan cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;
- B. Respondent Donovan is censured; and
- C. Respondent Donovan shall, within ten days of the entry of this Order, pay disgorgement of \$120,816, prejudgment interest of \$42,921.51 and a civil money penalty in the amount of \$45,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Donovan as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar and
Commissioner Faredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2814 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28533 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of)
)
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SCOTT E. DeSANO,)
THOMAS H. BRUDERMAN,)
TIMOTHY J. BURNIEIKA,)
ROBERT L. BURNS,)
DAVID K. DONOVAN,)
EDWARD S. DRISCOLL,)
JEFFREY D. HARRIS,)
CHRISTOPHER J. HORAN,)
STEVEN P. PASCUCCHI and)
KIRK C. SMITH,)

Respondents.)
)

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
TIMOTHY J. BURNIEIKA

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika ("Burnieika" or "Respondent Burnieika"), Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Burnieika has submitted an Offer of Settlement ("Offer") 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

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to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent Burnieika consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Timothy J. Burnieika ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Burnieika's Offer, the Commission finds¹ that:

Settling Respondent

1. **Burnieika**, age 39, is a resident of Cohasset, Massachusetts. At all relevant times, Burnieika was employed as a primary trader on the equity trading desk of FMR Co., Inc. located in Boston, Massachusetts. Burnieika has been associated with FMR Co., Inc. since 2000.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

Summary

4. These proceedings concern Burnieika's acceptance of travel and gifts from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted

¹ The findings herein are made pursuant to Respondent Burnieika's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Burnieika accepted a significant amount of travel and gifts, mostly consisting of premium tickets to professional sporting events that he did not attend with the representatives of the brokerage firms. In addition, representatives of brokerage firms paid for some of his travel, lodging and other costs on a number of trips, certain of which were by private jet. By accepting the travel, gifts and tickets, Burnieika willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Burnieika worked as a primary trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Burnieika was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Burnieika Accepted Travel and Gifts from Brokerage Firms

6. Burnieika received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period, consisting primarily of numerous tickets to events that the broker did not attend, including Celtics and Red Sox playoff and regular season games, and concerts, including by Bruce Springsteen. Brokers also provided some of Burnieika's airfare, lodging and other expenses on a number of trips – certain of which were by private jet – to such destinations as the Super Bowl, Las Vegas, and Aspen, Colorado.

Burnieika Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Burnieika willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Burnieika was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Burnieika's receipt of gifts and travel from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Olis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Burnieika's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

- A. Respondent Burnieika cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;
- B. Respondent Burnieika is censured; and
- C. Respondent Burnieika shall, within ten days of the entry of this Order, pay disgorgement of \$39,000, prejudgment interest of \$13,420 and a civil money penalty in the amount of \$30,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies Burnieika as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Aguilar and
Commissioner Paredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2815 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28534 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of

SCOTT E. DeSANO,
THOMAS H. BRUDERMAN,
TIMOTHY J. BURNIEIKA,
ROBERT L. BURNS,
DAVID K. DONOVAN,
EDWARD S. DRISCOLL,
JEFFREY D. HARRIS,
CHRISTOPHER J. HORAN,
STEVEN P. PASCUCCHI and
KIRK C. SMITH,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTIONS
203(f) and 203(k) OF THE INVESTMENT
ADVISERS ACT OF 1940 AND SECTIONS 9(b)
AND 9(f) OF THE INVESTMENT COMPANY
ACT OF 1940 AS TO SCOTT E. DESANO

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano ("DeSano" or "Respondent"), Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent DeSano has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of

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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 him and the subject matter of these proceedings, which are admitted, Respondent DeSano consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Scott E. DeSano ("Order"), as set forth below.

III.

On the basis of this Order and Respondent DeSano's Offer, the Commission finds¹ that:

Settling Respondent

1. **Scott E. DeSano** ("DeSano"), age 47, lives in Boston, Massachusetts. He was associated with the adviser to the Fidelity group of mutual funds, FMR Co., Inc. (FMR Co.), from 1991 to July 2005, and was its senior vice president in charge of global equity trading during the relevant period. DeSano resigned on July 25, 2007, and is currently not employed in the financial services industry. During the period from January 1, 2002 through October 31, 2004 (the "Relevant Period"), DeSano supervised FMR Co.'s Boston domestic equity trading desk, ("Equity Trading Desk") and other equity trading operations.² DeSano supervised more than thirty equity traders during the Relevant Period. He also appeared as a representative of FMR Co. in public testimony before Congress, the Commission, and other regulatory bodies.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned

¹ The findings herein are made pursuant to Respondent DeSano's Offer and are not binding on any other person or entity in this or any other proceeding.

² As discussed below, the Equity Trading Desk included "primary" traders, who worked closely with certain FMR Co., Inc. portfolio managers, and "sector" traders, who were responsible for trading equities in certain industries.

subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.³

4. **Thomas H. Bruderman** ("Bruderman"), age 39, lives in Boston, Massachusetts. He was an equity trader at FMR Co. from 1998 until his resignation in December 2004. During the Relevant Period, he was a sector trader specializing in healthcare and pharmaceuticals stocks.

5. **Timothy J. Burnieika** ("Burnieika"), age 38, lives in Cohasset, Massachusetts. He was an equity trader at FMR Co. from 2000 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader reporting to respondent Steven P. Pascucci.

6. **Robert L. Burns** ("Burns"), age 46, lives in Brookline, Massachusetts. He was an equity trader at FMR Co. from 1986 until his resignation in December 2004. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent David K. Donovan.

7. **David K. Donovan** ("Donovan"), age 45, lives in Marblehead, Massachusetts. He was an equity trader at FMR Co. from 1992 until his resignation in March 2005. During the Relevant Period, he was a sector trader specializing in technology stocks, and he was also a team leader of several sector traders, including respondents Burns, Jeffrey D. Harris and Kirk C. Smith.

8. **Edward S. Driscoll** ("Driscoll"), age 42, lives in Scituate, Massachusetts. Aside from a ten-month stint at another firm, he was an equity trader at FMR Co. from 1997 until his resignation in March 2005. During the Relevant Period, he was a sector trader specializing in food and beverage, household items, materials, and capital goods stocks.

9. **Jeffrey D. Harris** ("Harris"), age 35, lives in Charlestown, Massachusetts. He was an equity trader at FMR Co. from 1998 until his resignation in July 2005. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent Donovan.

10. **Christopher J. Horan** ("Horan"), age 37, lives in Milton, Massachusetts. He was an equity trader at FMR Co. from 1999 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in insurance, aerospace and defense, and restaurant stocks.

³ On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

11. **Steven P. Pascucci** ("Pascucci"), age 41, lives in Concord, Massachusetts. He was an equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader, and from 1998 until early 2005, he was a team leader of the other primary traders, including respondent Burnieika.

12. **Kirk C. Smith** ("Smith"), age 43, lives in Walpole, Massachusetts. He was an equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent Donovan.

13. **Marc C. Beran**, age 38, lives in Southborough, Massachusetts. He was an equity trader at FMR Co. from 1997 until his resignation in January 2005. During the Relevant Period, he was a sector trader specializing in energy and materials stocks. On March 5, 2008, the Commission accepted Beran's offer of settlement and entered an Order that found that Beran willfully violated Section 17(e) of the Investment Company Act through the receipt of compensation in the form of travel and gifts paid for by brokers doing business with Fidelity.

Summary

14. During the Relevant Period, DeSano and ten Fidelity equity traders whom he supervised accepted a significant amount of travel, entertainment and/or gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients, including the Fidelity Funds. Those brokerage firms each received millions of dollars in commission revenue for handling orders from Fidelity's advisory clients' accounts. Among the items accepted by DeSano from brokers were a three-day trip by private jet to Las Vegas and Cabo San Lucas, Mexico, travel by private jet to Fidelity trader Bruderman's bachelor party in Miami, golf excursions in locations such as Pebble Beach, California and Shinnecock, New York, lodging at fine hotels, and more than fifty tickets to over twenty events, including Celtics and Red Sox playoff games and a Rolling Stones concert. The ten equity traders whom DeSano supervised (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith, hereafter, the "ten equity traders"), in aggregate, accepted from brokers dozens of expensive trips, frequently by private jet, including excursions to the Super Bowl, family vacations to Bermuda, Nantucket and the Caribbean, golf outings at exclusive clubs in Florida and South Carolina, weekends in Las Vegas, lodging at fine hotels, and, for Bruderman, an extravagant, three-day bachelor party in Miami. Brokers also provided the traders premium tickets to events including the World Series, the U.S. Open, and Wimbledon, and dozens of other sporting events and concerts.

15. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as DeSano and the ten equity traders, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company. During the Relevant Period, DeSano and the ten equity traders received compensation within the meaning of Section 17(e)(1) of the Investment Company Act in the form of travel, entertainment

and gifts paid for by brokers who sought and obtained transactions for Fidelity's clients. As a result, DeSano and the ten equity traders willfully violated Section 17(e)(1) of the Investment Company Act.⁴

16. DeSano, who supervised Fidelity's equity trading operations, personally accompanied certain traders on several trips by private jet paid for by brokers, including attending part of Bruderman's bachelor party in Miami, and personally solicited tickets from brokers for himself (on at least two occasions) and to satisfy requests from his supervisor. Certain traders also told DeSano about some of the other private jet trips and tickets they received from brokers. Nevertheless, DeSano took inadequate steps to limit traders' receipt of travel, entertainment and gifts, and failed to monitor their receipt in any systematic way. As a result, DeSano failed reasonably to supervise the ten equity traders within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

17. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to seek best execution for its clients' securities transactions. During the Relevant Period, certain Fidelity traders allowed factors other than best execution -- their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers -- to influence their selection of brokers to handle Fidelity's securities transactions.⁵ DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act because, as head of the equity trading desk, he did not ensure that factors other than best execution, (i.e., certain traders' receipt of travel, entertainment and gifts from, and family or romantic relationships with, brokers) were excluded from the traders' selection of brokers.

18. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its advisory clients the material conflicts of interest arising from the receipt by certain Fidelity executives and traders, as described herein, of travel, entertainment and gifts paid for by brokers, and certain traders' family and romantic relationships with brokers doing business with Fidelity. Fidelity also failed to disclose that such travel, entertainment, gifts and relationships were additional factors in the traders' selection of brokers. DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act because he did not disclose that certain traders received travel, entertainment and gifts from, and had family and romantic relationships with, brokers doing business with Fidelity.

⁴ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

⁵ Two traders not identified in this Order sent Fidelity brokerage business to brokers with whom they were having romantic relationships.

19. In addition, during the Relevant Period, DeSano made periodic presentations on behalf of Fidelity concerning Fidelity's equity trading to a committee of the trustees of the Fidelity Funds. At those presentations, DeSano failed to disclose that certain equity traders received travel, entertainment and gifts from, and had family or romantic relationships with, brokers doing business with Fidelity. The receipt of such travel, entertainment and gifts from, and family or romantic relationships with, brokers doing business with Fidelity constituted material conflicts of interest. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and DeSano was a cause of Fidelity's violation.

Background on Fidelity's Equity Trading Desk

20. Fidelity manages one of the largest mutual fund complexes in the United States. Its equity trading desk buys and sells millions of shares of stock every day for the Fidelity Funds and other institutional clients. The Fidelity Funds and certain of Fidelity's other institutional clients' accounts are managed by portfolio managers who make investment decisions on their behalf. The portfolio managers send their orders to equity traders, who are responsible for selecting brokers to handle the transactions. During the Relevant Period, the Equity Trading Desk bought and sold more than 73 billion shares of equity securities (nearly 26 billion shares per year) with a total principal of more than \$1.4 trillion (nearly \$500 billion per year). Fidelity's equity trading generated more than \$2.3 billion in commissions (over \$800 million per year) paid to brokerage firms by Fidelity's clients, including the Fidelity Funds.

21. During the Relevant Period, Fidelity's equity trading operations employed nearly sixty people, including 33 traders (seven "primary" traders and 26 "sector" traders). Under DeSano's supervision, the traders had broad discretion to select brokerage firms to handle securities transactions. The primary limitation was that the traders could only select from a list of approximately 100 firms that had been formally approved by Fidelity.

DeSano and Traders Received Travel, Entertainment and Gifts Paid for by Brokers Doing Business with Fidelity

22. During the Relevant Period, one brokerage firm seeking and obtaining Fidelity's business, Jefferies & Co., Inc. ("Jefferies"), gave one of its brokers, Kevin W. Quinn, a travel and entertainment budget of \$1.5 million per year. From that budget, Quinn entertained DeSano and several traders, primarily by taking DeSano and/or traders on weekend excursions by private jet.⁶ For example, Quinn organized an annual trip he called the "Fall Classic," which included private jet travel, exclusive golf outings, lodging at expensive resorts, and other activities. During the November 2002 Fall Classic, for example, Quinn took DeSano, Bruderman and Harris by private jet to Las Vegas. Quinn provided accommodations at the Bellagio Hotel, a private band, meals, and golf. The group continued by private jet to Cabo San Lucas, Mexico,

⁶ Quinn signed an employment agreement with Jefferies in May 2002 and began working in the firm's Boston office on September 3, 2002. On December 1, 2006, the Commission instituted settled administrative proceedings against Jefferies, a Jefferies senior executive, and Quinn with respect to Quinn's provision of approximately \$2 million in travel, entertainment and gifts to DeSano and certain Fidelity traders. See Matter of Jefferies & Co., Inc. et al., Release No. 34-54861 (Dec. 1, 2006), and Matter of Kevin W. Quinn, Release No. 34-54862 (Dec. 1, 2006).

where Quinn provided accommodations in villas at the Esperanza Hotel, meals, more golf, and entertainment.

23. Brokers other than Quinn also took Fidelity traders on a variety of trips. For example, during the Relevant Period, various brokers took several traders to Super Bowls. Brokers often provided the traders with travel by private jet, lodging at expensive hotels, admission to exclusive pre-game parties, tickets to the Super Bowl, golf greens fees, limousines, and other lavish entertainment. Even when they did not provide private jets, brokers often took traders on trips to Las Vegas and on golf weekends to Florida and other warm-weather locations, usually paying for the traders' lodging and meals and sometimes paying for other travel expenses such as commercial airfare.

24. On numerous occasions, brokers made a private jet available for the personal use of an equity trader (and at times, their families), without accompanying the Fidelity employee on the trip. Some of the private jet trips were short (such as weekend excursions to Nantucket), but others were quite long (such as flights to Florida and the Caribbean).

25. Besides the trips, brokers gave DeSano more than fifty tickets to at least twenty events, including numerous baseball and basketball playoff and regular season games and a Rolling Stones concert. Brokers gave the ten equity traders in the aggregate hundreds of tickets for some of the best seats at sporting events, concerts, and other events, none of which the broker attended with the recipient. The events included the World Series, prominent tennis tournaments (Wimbledon, the U.S. Open, and the French Open), Broadway shows, concerts by nationally-known performers (such as the Rolling Stones and Bruce Springsteen), and dozens of sporting events, including baseball, basketball, football and hockey playoff and regular season games. Most of the tickets were for premium or exclusive seats (such as luxury boxes or seats close to the stage, court or field). Brokers frequently provided multiple tickets to the event, so that the recipient could bring his family or friends.

DeSano Violated Section 17(e)(1) of the Investment Company Act

26. DeSano received a significant amount of travel, entertainment and gifts from brokers during the Relevant Period. He received the personal use of Quinn's private jet for two trips, and he went on six private jet trips with brokers, primarily Quinn. The trips by private jet included the "Fall Classic" golfing excursion in Las Vegas and Mexico in November 2002, Bruderman's bachelor party in Miami in March 2003, and golf trips to locations such as Sea Island, Georgia and West Palm Beach, Florida. Brokers also gave DeSano more than fifty tickets to over twenty events, including several Celtics and Red Sox playoff games. On several occasions, DeSano reimbursed brokers some or all of the costs of the trips and events they provided him.

27. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as DeSano, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company. DeSano's receipt of travel,

entertainment and gifts paid for by brokers doing business with the Fidelity Funds constituted compensation in violation of Section 17(e)(1).

DeSano Failed Reasonably to Supervise the Equity Traders

28. During the Relevant Period, Fidelity had a gifts and gratuities policy for its employees. The policy stated that it was designed to avoid "any actual or apparent conflict of interest or impropriety."

a. The policy prohibited employees from "condition[ing] any business or other transaction on the giving or acceptance of any gift or favor," from "accept[ing] gifts or other gratuities with a value of more than \$100 per calendar year to or from any Company or individual" doing business with Fidelity and from "accept[ing] tickets valued at more than \$100 per calendar year if the one giving does not attend the event with the recipient." Employees were required to submit written requests for approval to receive gifts beyond the \$100 limit.

b. The policy prohibited employees from "soliciting any gift, favor or other form of preferential treatment" and from "accept[ing] transportation (other than local ground transportation), lodging or other travel-related expenses to attend an athletic, cultural, social or entertainment event with a current or prospective vendor, customer, or supplier" unless the employee reimbursed the giver. Further, this section of the policy required "[a]n employee invited to attend such an event (whether attending with the giver or not) [to] either pay his or her own way, or reimburse the vendor, customer or supplier for these expenses."

c. The policy permitted "[o]ccasional business entertainment (such as a meal or a recreational activity) where the giver attends the event with the recipient and the primary purpose is to discuss business or build a business relationship."

29. On an annual basis during the Relevant Period, DeSano and the ten equity traders were asked to acknowledge receipt of Fidelity's code of ethics and certify that they understood the policies that applied to them and conducted themselves in accordance with the policies. Accompanying the acknowledgement form was the actual code of ethics. It typically was an approximately 20-page document that primarily covered personal securities transactions. Each version of the code of ethics during the Relevant Period referred to Fidelity's gifts and gratuities policy by name, summarized its major requirements, and, in one instance, contained a hyperlink to the policy. The ten equity traders each acknowledged receipt and compliance with Fidelity's code of ethics at least once during the Relevant Period.

30. On an annual basis, Fidelity's ethics office provided code of ethics training to employees, including presentation of a slide setting forth the major requirements of Fidelity's gifts and gratuities policy. Each of the ten equity traders attended the code of ethics training at least once during the Relevant Period.

31. DeSano and the ten equity traders each violated Fidelity's gifts and gratuities policy when they accepted certain travel, entertainment and gifts from brokers doing business with Fidelity. For example:

a. Many of the travel and entertainment events and gifts received from brokers were worth more than \$100, yet none of the employees ever submitted a written request for approval.

b. DeSano and the ten equity traders solicited brokers for tickets to particular events. In fact, sometimes brokers were asked for tickets so close to the date of the event that the brokers had to obtain the tickets from ticket agencies at prices well above face value.

c. On many occasions, no reimbursement was made by recipients of private jets, lodging, and other travel expenses, in violation of Fidelity's gifts and gratuities policy. On some occasions, brokers refused to accept reimbursement checks from traders; and on other occasions, the broker accepted a check not intending to cash it and informed the trader the check was just for "paper trail" purposes.

32. As Fidelity's head of equity trading, DeSano's duties included supervision of the traders' compliance with applicable legal requirements and with Fidelity's policies and procedures, including its gifts and gratuities policy.

33. DeSano knew that some traders received travel, entertainment and gifts from brokers. He also knew or should have known that certain traders received adult entertainment from brokers. On three occasions he accompanied up to three traders on trips and twice accompanied a trader to a golf event paid for by brokers. He also communicated regularly with Bruderman and several other traders about trading desk matters, and made sporadic attempts to have the traders tell him about their upcoming trips with brokers. For example, each year he asked the traders about their plans for the Super Bowl.

34. DeSano took insufficient steps to police the traders' receipt of travel, entertainment and gifts from brokers. For example:

a. At one point, DeSano caused Fidelity to issue credit cards to the traders so they could pay for their own business entertainment, but the traders did not use the cards or submit expenses for approval, and he did not follow up. At another point, he suggested to senior management of Fidelity that Fidelity might consider adopting a formal policy concerning its employees' use of private jets provided by brokers and other vendors, but again he did not follow up.

b. In early May 2004, DeSano announced that traders would have to notify him in advance about all trips with brokers. A month later, he announced that traders would have to pay their own way on all future events with brokers. However, he did not enforce

these policies, and traders continued to go on trips without informing him in advance and without reimbursing the brokers.

c. DeSano instructed the traders to reimburse brokers for private jet travel at the rate for first-class commercial airfare to the same destination, but he did not require proof of reimbursement, and, as a result, the traders rarely made reimbursement to brokers for their trips on private jets.

35. Indeed, rather than effectively supervising the traders' receipt of travel, entertainment and gifts from brokers, DeSano's actions contributed to the traders' violative receipt of travel, entertainment, and gifts in several respects. DeSano personally asked brokers for tickets or asked traders to ask brokers for tickets, sometimes for himself and sometimes for other senior Fidelity executives, and he personally went on two trips paid for by brokers without reimbursing his full share of the expenses. Because soliciting brokers for tickets and certain travel at a broker's expense were violations of Fidelity's gifts and gratuities policy, his conduct sent the message that the traders too could violate Fidelity's policy with impunity. In addition, DeSano traveled numerous times with Quinn, the most significant source of travel and gifts for the traders. For example, DeSano attended both the November 2002 "Fall Classic" and part of Bruderman's bachelor party in March 2003, two excursions for which brokers picked up the tab. Finally, DeSano also took steps to conceal his and others' participation in one event paid for by brokers doing business with Fidelity.

36. DeSano failed to monitor traders' receipt of travel, entertainment and gifts from brokers on any systematic basis, and he failed to take reasonable steps to enforce Fidelity's gifts and gratuities policy or to ensure that traders did not receive compensation from brokers within the meaning of Section 17(e)(1) of the Investment Company Act. During the Relevant Period, the ten equity traders willfully violated Section 17(e)(1) by receiving compensation in the form of gifts, travel, and entertainment from brokers. As a result, DeSano failed reasonably to supervise the ten equity traders within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

**DeSano Was a Cause of Fidelity's Failure to Seek
Best Execution for its Clients' Securities Transactions**

37. During the Relevant Period, the ten equity traders directed equity trading business generating millions of dollars in commissions to brokers from whom they received travel, entertainment and gifts. The traders' receipt of travel, entertainment and gifts from brokers doing business with Fidelity created material conflicts of interest. In addition, certain Fidelity traders sent securities transactions to brokers with whom they had a family or romantic relationship. These family and romantic relationships with brokers doing business with Fidelity also created material conflicts of interest.

38. DeSano knew that certain traders did business with brokers from whom they received travel, entertainment or gifts. He also knew that at least two traders did business with brokers with whom they had a family relationship and, in one case, a romantic relationship.

39. Section 206(2) of the Advisers Act provides that an investment adviser shall not "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."⁷ One aspect of an investment adviser's fiduciary duty under Section 206 of the Advisers Act is the duty to seek best execution for its clients' securities transactions. As set forth above, certain Fidelity traders allowed factors other than best execution -- their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers -- to influence their selection of brokers to handle Fidelity's securities transactions. DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act because, as head of the equity trading desk, he did not ensure that factors other than best execution (i.e., certain traders' receipt of travel, entertainment and gifts from, and family or romantic relationships with, brokers) were excluded from the traders' selection of brokers.

**DeSano Was a Cause of Fidelity's Failure to Disclose
Conflicts of Interest in Violation of Section 206(2) of the Advisers Act**

40. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity willfully violated Section 206(2) of the Advisers Act by failing to disclose material conflicts arising from certain traders' receipt of travel, entertainment and gifts from, and certain traders' family and romantic relationships with, brokers doing business with Fidelity. DeSano was a cause of Fidelity's violation because he did not disclose that certain traders received travel, entertainment and gifts from, or had family or romantic relationships with, brokers doing business with Fidelity.

41. During the Relevant Period, DeSano made periodic presentations on behalf of Fidelity concerning Fidelity's equity trading to a committee of the trustees of the Fidelity Funds. At those presentations, DeSano did not disclose that certain equity traders received travel, entertainment and gifts from, or had family or romantic relationships with, brokers doing business with Fidelity. The receipt of such travel, entertainment and gifts from, and relationships with, brokers doing business with Fidelity constituted material conflicts of interest. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and DeSano was a cause of Fidelity's violation.

Violations

42. As described above, DeSano willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered

⁷ A violation of Section 206(2) of the Advisers Act does not require a finding of scienter and may be established by a showing of negligence. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. DeSano was an affiliated person of Fidelity, which is an affiliated person of registered investment companies (the Fidelity Funds), because Fidelity advises those funds. DeSano's receipt of travel, entertainment, and gifts from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

43. As described above, DeSano failed reasonably to supervise ten equity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith), within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

44. As described above, Fidelity violated Section 206(2) of the Advisers Act by failing to seek best execution of its clients' securities transactions because certain Fidelity traders allowed factors other than best execution -- their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers -- to influence their selection of brokers to handle Fidelity's securities transactions, and DeSano was a cause of Fidelity's violation.

45. As described above, Fidelity violated Section 206(2) of the Advisers Act by failing to disclose to its clients material conflicts of interest arising from certain traders' receipt of travel, entertainment and gifts from, and certain traders' family or romantic relationships with, brokers seeking and obtaining business from Fidelity, and DeSano was a cause of Fidelity's violation.

46. As described above, Fidelity violated Section 206(2) of the Advisers Act by failing to disclose during periodic presentations concerning Fidelity's equity trading to a committee of the trustees of the Fidelity Funds that certain equity traders received travel, entertainment and gifts from, and certain traders had family or romantic relationships with, brokers seeking and obtaining orders to buy and sell securities on behalf of the Fidelity Funds, and DeSano was a cause of Fidelity's violation.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in DeSano's Offer.

Accordingly, pursuant to Sections 203(f) and 203(k) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent DeSano cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Investment Advisers Act and Section 17(e)(1) of the Investment Company Act;

B. Respondent DeSano be, and hereby is, barred from association with any investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, with the right to reapply for association after one (1) year to the appropriate self-regulatory organization, or if there is none, to the Commission;

C. Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order; and

D. Respondent DeSano shall, within ten days of the entry of this Order, pay disgorgement of \$106,000 and prejudgment interest of \$36,475, and a civil money penalty in the amount of \$125,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (4) submitted under cover letter that identifies DeSano as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Aguilar and
Commissioner Paredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2816 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28535 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of)

SCOTT E. DeSANO,)
THOMAS H. BRUDERMAN,)
TIMOTHY J. BURNIEIKA,)
ROBERT L. BURNS,)
DAVID K. DONOVAN,)
EDWARD S. DRISCOLL,)
JEFFREY D. HARRIS,)
CHRISTOPHER J. HORAN,)
STEVEN P. PASCUCCHI and)
KIRK C. SMITH,)

Respondents.)

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTIONS
203(f) and 203(k) OF THE INVESTMENT
ADVISERS ACT OF 1940 AND SECTIONS 9(b)
AND 9(f) OF THE INVESTMENT COMPANY
ACT OF 1940 AS TO EDWARD S. DRISCOLL

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll ("Driscoll" or "Respondent Driscoll"), Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Driscoll has submitted an Offer of Settlement ("Offer") 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 him and the subject matter of these proceedings, which are admitted, Respondent Driscoll consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Edward S. Driscoll ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Driscoll's Offer, the Commission finds¹ that:

Settling Respondent

1. **Driscoll**, age 42, lives in Scituate, Massachusetts. Aside from a ten-month stint at another firm, he was an equity trader at FMR Co., Inc. from 1997 until his resignation in March 2005. At all relevant times, he was a sector trader specializing in food and beverage, household items, materials, and capital goods stocks.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

¹ The findings herein are made pursuant to Respondent Driscoll's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

Summary

4. These proceedings concern Driscoll's acceptance of travel, gifts and tickets from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of Fidelity's clients, including the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Driscoll accepted a significant amount of travel and gifts, including travel by private jet and numerous tickets to sporting events that he did not attend with the representatives of the brokerage firms. By accepting the travel, gifts and tickets, Driscoll willfully³ violated Section 17(e)(1) of the Investment Company Act.

5. In addition Driscoll failed to disclose to any manager at Fidelity that during the Relevant Period, a broker doing business with Fidelity facilitated Driscoll's illegal gambling. Fidelity failed to disclose to its clients the material conflicts of interest arising from this conduct. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and Driscoll was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

Background

6. During the Relevant Period, Driscoll worked as a sector trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Driscoll was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Driscoll Accepted Gifts and Travel from Brokerage Firms

7. Driscoll received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period, including the exclusive use of a broker's private jet for a family vacation to DisneyWorld in Florida. In addition, Driscoll accepted numerous tickets to events that the broker did not attend, including primarily Celtics games. Driscoll also went on several trips with brokers, including to the Super Bowl and Las Vegas, certain of which included private jet travel and lodging.

Driscoll Violated Section 17(e)(1) of the Investment Company Act

8. As a result of the conduct described above, Driscoll willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Driscoll was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Driscoll's receipt of gifts and travel from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

Driscoll's Illegal Gambling was Facilitated by a Broker

9. A representative of a brokerage firm doing business with Fidelity facilitated Driscoll's illegal gambling. Driscoll failed to inform any Fidelity manager of that conduct.

Driscoll was a Cause of Fidelity's Violations of Section 206(2) of the Advisers Act for Failing to Disclose Certain Conflicts of Interest

10. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflicts of interest arising from the facilitation of Driscoll's illegal gambling by a broker. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and Driscoll was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Driscoll's Offer.

Accordingly, pursuant to Sections 203(f) and 203(k) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

- A. Respondent Driscoll cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act and Section 206(2) of the Advisers Act;
- B. Respondent Driscoll is censured; and
- C. Respondent Driscoll shall pay disgorgement of \$39,000, prejudgment interest of \$13,549.33 and a civil money penalty in the amount of \$30,000 to the United States Treasury. Payment shall be made in the following installments: (1) \$52,549.33 within ten days of entry of this Order, and (2) \$30,000 within 120 days of entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. 3717, shall be due and payable

immediately, without further application. Payments shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies Driscoll as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar and
Commissioner Fares
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2817 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28536 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of

SCOTT E. DeSANO,
THOMAS H. BRUDERMAN,
TIMOTHY J. BURNIEIKA,
ROBERT L. BURNS,
DAVID K. DONOVAN,
EDWARD S. DRISCOLL,
JEFFREY D. HARRIS,
CHRISTOPHER J. HORAN,
STEVEN P. PASCUCCHI and
KIRK C. SMITH,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
CHRISTOPHER J. HORAN

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan ("Horan" or "Respondent Horan"), Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Horan has submitted an Offer of Settlement ("Offer") 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

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Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent Horan consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Christopher J. Horan ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Horan's Offer, the Commission finds¹ that:

Settling Respondent

1. **Horan**, age 37, lives in Milton, Massachusetts. He was an equity trader at FMR Co., Inc. from 1999 until September 2005, when he was reassigned to other duties that do not involve trading. At all relevant times, he was a sector trader specializing in insurance, aerospace and defense, and restaurant stocks.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

¹ The findings herein are made pursuant to Respondent Horan's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

Summary

4. These proceedings concern Horan's acceptance of travel, lodging and tickets from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Horan accepted a significant amount of travel, including by private jet, lodging, and a number of tickets to sporting events that he did not attend with the representatives of the brokerage firms. By accepting the travel, lodging and tickets, Horan willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Horan worked as a sector trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Horan was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Horan Accepted Gifts and Travel from Brokerage Firms

6. Horan received a significant amount of travel from representatives of brokerage firms during the Relevant Period, consisting of some or all of his lodging and other travel expenses on numerous trips, many of which were by private jet, to destinations such as Las Vegas, Martha's Vineyard, the Pebble Beach golf course in California, and from the Super Bowl in Houston. On three occasions, Horan attended a trip with a broker who provided him with the personal use of a one-way private jet as part of the trip. In addition, Horan received a number of tickets to sporting events – including to certain Super Bowl and playoff games – that he did not attend with the representatives of the brokerage firms.

Horan Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Horan willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company.

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

A violation of Section 17(e)(1) is complete upon receipt of the compensation. Horan was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Horan's receipt of gifts and travel from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Horan's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

- A. Respondent Horan cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;
- B. Respondent Horan is censured;
- C. Respondent Horan shall, within ten days of the entry of this Order, pay disgorgement of \$63,000, prejudgment interest of \$21,678.86 and a civil money penalty in the amount of \$30,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies Horan as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Aguilar and
Commissioner Paredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2818 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28537 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of)
)
)

SCOTT E. DeSANO,)
THOMAS H. BRUDERMAN,)
TIMOTHY J. BURNIEIKA,)
ROBERT L. BURNS,)
DAVID K. DONOVAN,)
EDWARD S. DRISCOLL,)
JEFFREY D. HARRIS,)
CHRISTOPHER J. HORAN,)
STEVEN P. PASCUCCI and)
KIRK C. SMITH,)

Respondents.)
)

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
STEVEN P. PASCUCCI

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci ("Pascucci" or "Respondent Pascucci"), and Kirk C. Smith.

II.

In response to these proceedings, Respondent Pascucci has submitted an Offer of Settlement ("Offer") 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

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to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent Pascucci consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Steven P. Pascucci ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Pascucci's Offer, the Commission finds¹ that:

Settling Respondent

1. **Pascucci**, age 42, is a resident of Concord, Massachusetts. At all relevant times, Pascucci was employed as a primary trader on the equity trading desk of registered investment adviser FMR Co., Inc. located in Boston, Massachusetts. Pascucci has been associated with FMR Co., Inc. since 1997, and was a team leader of the other primary traders.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

¹ The findings herein are made pursuant to Respondent Pascucci's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

Summary

4. These proceedings concern Pascucci's acceptance of travel, gifts and tickets from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Pascucci accepted a significant amount of travel and gifts, including numerous tickets to concerts and sporting events that he did not attend with the representatives of the brokerage firms. By accepting the travel, gifts and tickets, Pascucci willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Pascucci worked as a primary trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Pascucci was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Pascucci Accepted Gifts and Travel from Brokerage Firms

6. Pascucci received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period, consisting primarily of numerous tickets to events that the broker did not attend, including Patriots, Red Sox and Celtics playoff and regular season games and several concerts. Brokers also provided some of Pascucci's lodging and other travel expenses on several trips, including one trip to Dallas involving a stay at the Four Seasons Hotel, attendance at a Dallas Cowboys football game, an introduction to Bill Parcells (then the Cowboys coach), a return flight to Boston on a broker's private jet, and a car service to and from the airport.

Pascucci Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Pascucci willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company.

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

A violation of Section 17(e)(1) is complete upon receipt of the compensation. Pascucci was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Pascucci's receipt of gifts and travel from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

IV.

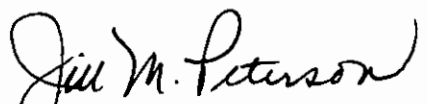
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Pascucci's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

- A. Respondent Pascucci cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;
- B. Respondent Pascucci is censured; and
- C. Respondent Pascucci shall, within ten days of the entry of this Order, pay disgorgement of \$44,339, prejudgment interest of \$15,256.81 and a civil money penalty in the amount of \$30,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies Pascucci as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Aguilar and
Commissioner Parades
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2819 / December 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28538 / December 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of)
)
)

SCOTT E. DeSANO,)
THOMAS H. BRUDERMAN,)
TIMOTHY J. BURNIEIKA,)
ROBERT L. BURNS,)
DAVID K. DONOVAN,)
EDWARD S. DRISCOLL,)
JEFFREY D. HARRIS,)
CHRISTOPHER J. HORAN,)
STEVEN P. PASCUCCHI and)
KIRK C. SMITH,)

Respondents.)
)
)

ORDER MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO SECTION
203(f) OF THE INVESTMENT ADVISERS ACT
OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940 AS TO
KIRK C. SMITH

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith ("Smith" or "Respondent Smith").

II.

In response to these proceedings, Respondent Smith has submitted an Offer of Settlement ("Offer") 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 him and the subject matter of these proceedings, which are admitted, Respondent Smith consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Kirk C. Smith ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Smith's Offer, the Commission finds¹ that:

Settling Respondent

1. **Smith**, age 44, is a resident of Walpole, Massachusetts. At all relevant times, Smith was employed as a sector trader on the equity trading desk of registered investment adviser FMR Co., Inc., located in Boston, Massachusetts. Smith has been associated with FMR Co., Inc. from 1997 to the present.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately \$1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.²

¹ The findings herein are made pursuant to Respondent Smith's Offer and are not binding on any other person or entity in this or any other proceeding.

² On March 5, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity and certain of its employees. See *In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008).

Summary

4. These proceedings concern Smith's acceptance of gifts and travel from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Smith accepted a significant amount of gifts, including a private jet trip to the Caribbean and numerous tickets to sporting and other events that he did not attend with the representatives of brokerage firms. By accepting those gifts and travel, Smith willfully³ violated Section 17(e)(1) of the Investment Company Act.

Background

5. During the Relevant Period, Smith worked as a sector trader on Fidelity's equity trading desk, and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Smith was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Smith Accepted Gifts and Travel from Brokerage Firms

6. Smith received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period. In November 2003, Kevin Quinn, then a registered representative at the brokerage firm Jefferies & Co., Inc., provided Smith the use of a private jet so that Smith and a family member could take a vacation in the Caribbean.⁴ Representatives of brokerage firms also paid additional travel and lodging expenses on Smith's behalf and gave Smith numerous tickets to events that the broker did not attend, including Celtics, Patriots and Red Sox regular season games, various professional playoff games and several college hockey games.

Smith Violated Section 17(e)(1) of the Investment Company Act

7. As a result of the conduct described above, Smith willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

⁴ On December 1, 2006, the Commission instituted settled administrative proceedings against Jefferies, a Jefferies senior executive, and Quinn with respect to Quinn's provision of approximately \$2 million in travel, entertainment and gifts to certain Fidelity equity trading desk employees. See *In the Matter of Jefferies & Co., Inc. et al.*, Release No. 34-54861 (Dec. 1, 2006), and *In the Matter of Kevin W. Quinn*, Release No. 34-54862 (Dec. 1, 2006).

registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Smith was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Smith's receipt of gifts and travel from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Smith' Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Smith cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;

B. Respondent Smith is censured; and

C. Respondent Smith shall, within ten days of the entry of this Order, pay disgorgement of \$56,690, prejudgment interest of \$19,506.89 and a civil money penalty in the amount of \$30,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies Smith as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 15, 2008

In the Matter of

National Lampoon, Inc. and
Advatech Corporation

ORDER OF SUSPENSION
OF TRADING

File No. 500-1

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of the issuers listed below.

National Lampoon, Inc. is incorporated in Delaware and headquartered in Los Angeles, California. The company's common stock is listed on the NYSE Alternext under the ticker symbol "NLN."

Advatech Corporation is incorporated in Florida and headquartered in West Palm Beach, Florida. The company's common stock trades on the grey market under the symbol "ADVA."

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed companies is suspended for the period commencing at 9:30 a.m. EST, December 15, 2008, and terminating at 11:59 p.m. EST, on December 29, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

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*Commissioner Watter and
Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59100 / December 15, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13310

In the Matter of

NeoTactix Corporation,

Respondent.

ORDER INSTITUTING PROCEEDINGS,
MAKING FINDINGS, AND REVOKING
REGISTRATION OF SECURITIES
PURSUANT TO SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against NeoTactix Corporation ("NeoTactix" or "Respondent").

II.

In anticipation of the institution of these proceedings, NeoTactix has submitted an Offer of Settlement (the "Offer") 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 it and the subject matter of these proceedings, NeoTactix consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. NeoTactix is a Nevada corporation located in Irvine, California that provided business development guidance and services for small businesses. The company ceased operations in or about May 2008. The common stock of NeoTactix has

been registered with the Commission under Exchange Act Section 12(g) since August 21, 2001. The Commission issued an order on March 20, 2008 suspending trading in the securities of NeoTactix under Exchange Act Section 12(k). Prior to the suspension, the company's common stock (symbol "NTCX") was quoted on the Over-the-Counter Bulletin Board and the Pink Sheets.

2. While its common stock was registered with the Commission, NeoTactix failed to comply with Exchange Act Section 13(a) and Rules 13a-1, 13a-14 and 13a-15 thereunder in that it failed to make disclosures in its Form 10-K for the fiscal year ended December 31, 2007, filed with the Commission on April 11, 2008, concerning its internal control over financial reporting, as required by Items 601(b)(31) and 308T of Regulation S-K.

3. While its common stock was registered with the Commission, NeoTactix failed to comply with Exchange Act Section 13(a) and Rule 13a-13 thereunder in that it has not filed any periodic or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ended September 30, 2007.

4. While its common stock was registered with the Commission, NeoTactix failed to comply with Exchange Act Section 13(a) and Rule 13a-11 thereunder in that it failed to file a current report on Form 8-K disclosing the resignation of two directors, which occurred in or about May 2008.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Registrant's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933

Release No. 8990 / December 17, 2008

SECURITIES EXCHANGE ACT OF 1934

Release No. 59115 / December 17, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13312

In the Matter of

**MILKIE/FERGUSON
INVESTMENTS, INC., and
DANIEL EDWARD LEVIN,**

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER PURSUANT TO
SECTION 8A OF THE SECURITIES ACT OF
1933 AND SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Daniel Edward Levin ("Levin"), and pursuant to Section 15(b) of the Exchange Act against Milkie/Ferguson Investments, Inc. ("Milkie") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") 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 Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934 ("Order").

III.

On the basis of this Order and Respondents' Offer, the Commission finds that:

RESPONDENTS

1. Milkie is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act, with its principal offices in Dallas, Texas. Milkie has approximately 50 registered sales representatives located in two offices in Dallas and Las Colinas, Texas. Milkie primarily conducts retail brokerage business.

2. Levin has been a registered representative associated with Milkie since December 2004. Levin, 51, is a resident of Dallas, Texas, and has been associated with six registered broker-dealers since 1980. He currently holds series 7, 63, and 65 securities licenses.

FACTS

Background

3. Purchases of mutual fund shares may include the payment of sales loads or commissions paid by the shareholder upon purchases or redemptions. These payments are typically collected by a fund's distributor which, in turn, pays the load to the selling brokers. A "front-end load" is an industry term for a sales charge that certain fund principal underwriters or distributors charge at the time an investor buys shares. When an investor buys shares with a front-end load, the front-end load portion of the offering price is not invested in the fund, but instead is paid to the fund's principal underwriter or distributor. The front-end load usually is expressed as a percentage of the investment amount. Often, front-end loads for shares of equity funds start at 4% to 5.75% of the investment amount.

4. When an investor purchases a mutual fund that charges a front-end load through a broker-dealer, the fund's principal underwriter or distributor pays a part of the front-end load amount to the broker-dealer that sold the fund shares to the investor. The broker-dealer may pay a portion of the front-end load that it receives to the registered representative assigned to the investor's account.

5. Mutual funds that sell shares charging front-end loads typically offer discounts on the front-end load at certain pre-determined levels of investment, which are called "breakpoints." Breakpoints can vary among funds within a mutual fund complex or across fund complexes. In general, an investor can usually procure discounts on sales charges at "breakpoints," or investment levels, of \$50,000, \$100,000, \$250,000, and \$500,000. The discounts on sales charges typically increase at each breakpoint level. At the \$1 million investment level, there often is no sales charge.

6. The specific terms and conditions under which breakpoint discounts may become available are determined by the mutual funds. Generally, an investor can procure a breakpoint discount through either a single purchase large enough to reach a breakpoint or multiple purchases in a single mutual fund or any of the funds in a fund complex, the aggregate value of which is large enough to reach a breakpoint. An investor may aggregate purchases over time to meet applicable breakpoints through a "right of accumulation" ("ROA") or "letter of intent" ("LOI"). An investor may be eligible for a discount through an ROA by aggregating current purchases with certain prior purchases. An LOI is a written statement of intent by the investor to purchase a certain amount of mutual fund shares over what is usually a thirteen-month period.

7. Mutual funds are required to disclose a schedule of available breakpoints in their prospectuses. Mutual funds must also disclose how an investor may qualify for breakpoints in either the prospectuses or in their statements of additional information, both of which are filed with the Commission on Form N-1A.

8. Securities professionals owe a special duty of fair dealing to their customers. Accordingly, broker-dealers and registered representatives who recommend mutual fund shares must disclose information concerning available breakpoint discounts to their retail customers so that customers may evaluate the desirability of making a qualifying purchase. A failure to do so can result not only in the customer being deprived of the benefit of lower costs, but also in the broker-dealer and representative receiving increased compensation at the customer's expense. Mere delivery of a prospectus containing information about available breakpoint discounts is insufficient to satisfy this duty.

Levin Failed to Disclose Material Breakpoint Information

9. In at least seven instances from March 2006 to September 2006, Levin offered and sold mutual fund class "A" shares to retail customers without adequate disclosure of material information about the availability of breakpoint discounts for which customers could have qualified. Specifically, Levin recommended that his customers allocate their investments among seven to ten different fund families. In those instances where Levin's recommended allocation qualified customers for breakpoint discounts, he sometimes advised them that they had received discounts. However, Levin did not adequately disclose, before customers made investment decisions, all breakpoint discounts for which the customers could qualify in the fund families he recommended, nor did he adequately disclose the breakpoint discounts customers could have received by investing larger amounts in fewer fund families. Levin's customers could have qualified for breakpoint discounts totaling up to \$79,981.74. Levin also failed to adequately disclose the financial impact those additional breakpoint discounts could have on the customers' contemplated transactions, and that purchases below the additional breakpoints would result in a greater profit to him. As a result, the customers were not afforded the opportunity to evaluate the desirability of making a qualifying purchase to take advantage of all breakpoint discounts available to them.

10. Securities Act Sections 17(a)(2) and 17(a)(3) make it unlawful for any person in the offer or sale of any securities to obtain money or property by means of a material misrepresentation or omission, or to engage in any transaction, practice, or course of business that operates as a fraud or

deceit on the purchaser. Negligence is sufficient to establish violations of these provisions.¹ As a result of the conduct described above, Levin willfully violated Section 17(a)(2) and (3) of the Securities Act.²

Milkie's Supervisory Procedures over Breakpoint Disclosures were Inadequate

11. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who has failed reasonably to supervise, with a view to preventing and detecting violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision.³ This section also provides an affirmative defense to anyone who can show that (1) there were established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation, and (2) that person has reasonably discharged the duties and obligations incumbent upon them without reasonable cause to believe that the procedures and systems were not complied with.

12. During the relevant period, Milkie had written supervisory procedures ("WSP") that required all registered representatives, including Levin, to disclose all "possible breakpoints" and to "advise customers of the savings available in a purchase above" a breakpoint. Milkie's WSP stated that registered representatives were responsible for documenting that complete disclosure had been made to the customer. However, Milkie had inadequate systems in place to implement procedures to assure that registered representatives provided the required information about breakpoints to customers before they made an investment decision. Specifically, Milkie had no or inadequate systems in place requiring registered representatives to submit documentation of breakpoint disclosures for managerial review. Such systems could reasonably have been expected to have prevented and detected Levin's misconduct. Accordingly, Milkie failed reasonably to supervise Levin within the meaning of Section 15(b)(4)(E) of the Exchange Act.

IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest to impose the sanctions agreed to in Respondents' Offer.⁴

¹ See *Aaron v. SEC*, 446 U.S. 680, 697 & 701-07 (1980).

² A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

³ See *Matter of Smith Barney, Harris Upham & Co., Inc.*, Securities Exchange Act of 1934 Release No. 21813, 32 SEC Docket 999, 1004 (March 5, 1985).

⁴ As part of Respondents' settlement offer, they made appropriate reimbursement to the applicable customers.

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Levin cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

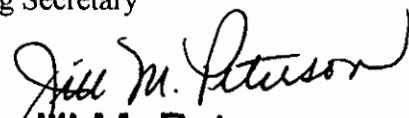
B. Milkie is censured.

C. Respondents shall each, within 10 days of the entry of this Order, pay a civil money penalty pursuant to Section 21B of the Exchange Act in the amount of \$25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Milkie and Levin as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Stephen Korotash, Division of Enforcement, Securities and Exchange Commission, 801 Cherry Street, Suite 1900, Fort Worth, Texas 76102.

D. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 ("Fair Fund distribution"). Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction in any Related Investor Action based on Respondents' payment of disgorgement in this action, argue that they are entitled to, nor shall they further benefit by offset or reduction of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 17, 2008

In the Matter of Yatinoo, Inc.

500-1

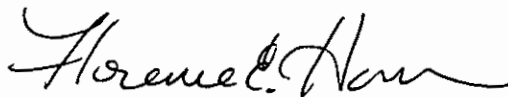
**CORRECTED
ORDER OF SUSPENSION
OF TRADING**

It appears to the Securities and Exchange Commission that the public interest and the protection of investors require a suspension of trading in the securities of Yatinoo, Inc. ("Yatinoo"). Questions have arisen concerning the accuracy and adequacy of publicly-available information about Yatinoo securities, including information in the market place concerning the number of Yatinoo's issued and outstanding shares and market capitalization, and Yatinoo's operations. Questions have also arisen about trading activity in the market for Yatinoo securities. Yatinoo securities are quoted on the Over-the-Counter Bulletin Board under the trading symbol YTNO.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of Yatinoo is suspended for the period from 9:30 a.m. EST on December 17, 2008, through 11:59 p.m. EST on December 31, 2008.

By the Commission.



Florence E. Harmon
Acting Secretary

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**UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION**

**Securities Act of 1933
Release No. 8989 / December 17, 2008**

**Securities Exchange Act of 1934
Release No. 59113 / December 17, 2008**

**ORDER APPROVING PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
BUDGET AND ANNUAL ACCOUNTING SUPPORT FEE FOR CALENDAR YEAR
2009**

The Sarbanes-Oxley Act of 2002 (the "Act") established the Public Company Accounting Oversight Board ("PCAOB") to oversee the audits of public companies and related matters, to protect investors, and to further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB is to accomplish these goals through registration of public accounting firms and standard setting, inspection, and disciplinary programs. Section 109 of the Act provides that the PCAOB shall establish a reasonable annual accounting support fee, as may be necessary or appropriate to establish and maintain the PCAOB. Section 109(h) amends Section 13(b)(2) of the Securities Exchange Act of 1934 to require issuers to pay the allocable share of a reasonable annual accounting support fee or fees, determined in accordance with Section 109 of the Act. Under Section 109(f), the aggregate annual accounting support fee shall not exceed the PCAOB's aggregate "recoverable budget expenses," which may include operating, capital and accrued items. Section 109(b) of the Act directs the PCAOB to establish a budget for each fiscal year in accordance with the PCAOB's internal procedures, subject to approval by the Securities and Exchange Commission (the "Commission").

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On July 18, 2006, the Commission amended its Rules of Practice related to its Informal and Other Procedures to add a rule to facilitate the Commission's review and approval of PCAOB budgets and accounting support fees.¹ This budget rule provides, among other things, a timetable for the preparation and submission of the PCAOB budget and for Commission actions related to each budget, a description of the information that should be included in each budget submission, limits on the PCAOB's ability to incur expenses and obligations except as provided in the approved budget, procedures relating to supplemental budget requests, requirements for the PCAOB to furnish on a quarterly basis certain budget-related information, and a list of definitions that apply to the rule and to general discussions of PCAOB budget matters.

In accordance with the budget rule, in March 2008 the PCAOB provided the Commission with a narrative description of its program issues and outlook for the 2009 budget year. In response, the Commission staff provided to the PCAOB staff economic assumptions and budgetary guidance for the 2009 budget year. The PCAOB subsequently delivered a preliminary budget and budget justification to the Commission. Staff from the Commission's Offices of the Chief Accountant and Executive Director dedicated a substantial amount of time to the review and analysis of the PCAOB's programs, projects and budget estimates; reviewed the PCAOB's estimates of 2008 actual spending; and attended several meetings with management and staff of the PCAOB to develop an understanding of the PCAOB's budget and operations. During the course of the Commission's review, the Commission staff relied upon representations and supporting documentation from the PCAOB. Based on this comprehensive review, the Commission

¹ 17 CFR 202.11 See Release No. 33-8724 (July 18, 2006) [71 FR 41998 (July 24, 2006)].

issued a "pass back" letter to the PCAOB. The PCAOB approved its 2009 budget on November 25, 2008 and submitted that budget for Commission approval.

After considering the above, the Commission did not identify any proposed disbursements in the 2009 budget adopted by the PCAOB that are not properly recoverable through the annual accounting support fee, and the Commission believes that the aggregate proposed 2009 annual accounting support fee does not exceed the PCAOB's aggregate recoverable budget expenses for 2009. The Commission looks forward to the PCAOB's annual updating of its strategic plan and the opportunity for the Commission to review and provide views to the PCAOB on a draft of the updated plan.

As part of its review of the 2009 PCAOB budget, the Commission notes that there are certain budget-related matters that should be addressed or more closely monitored during 2009. These matters relate to the PCAOB's inspections program, its information technology programs, and recommendations of the Department of the Treasury's Advisory Committee on the Auditing Profession that relate to the PCAOB. Because of the importance of each of these matters, the Commission deems it necessary to set forth the following specific measures.

Accordingly, with respect to the PCAOB's 2010 budget cycle, the PCAOB will:

- (1) Include in its quarterly reports to the Commission information on the PCAOB's fulfillment of its 2009 budgeted inspection plan. Such information will include updated statistics relative to the numbers and types of firms budgeted and expected to be inspected in 2009, including by location and by year the inspections are required to be conducted in accordance with the Act and PCAOB rules. This information also will include updates on the

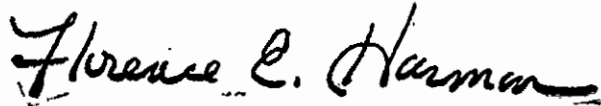
PCAOB's efforts to establish cooperative arrangements with respective non-U.S. authorities for inspections required in those countries;

- (2) Continue to include detailed information about the state of the PCAOB's information technology in its quarterly reports to the Commission, including planned, estimated, and actual costs for information technology projects such as the proposed annual and special reporting system and the proposed inspections information system; and
- (3) Consult with the Commission about the PCAOB's plans for implementing the recommendations of the Department of Treasury's Advisory Committee on the Auditing Profession, including estimated and actual costs for each item proposed to be implemented. The consultation will include the PCAOB submitting a project plan and justification to the Commission and the opportunity for the Commission to provide views to the PCAOB regarding such plan.

The Commission has determined that the PCAOB's 2009 budget and annual accounting support fee are consistent with Section 109 of the Act. Accordingly,

IT IS ORDERED, pursuant to Section 109 of the Act, that the PCAOB budget and annual accounting support fee for calendar year 2009 are approved.

By the Commission.



Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59124 / December 19, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13314

In the Matter of

JOHN M. LUCARELLI,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTIONS 15(b) AND 21C
OF THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against John M. Lucarelli ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

1. Respondent participated in transactions involving the illegal purchase of stock in the April 2004 initial public offering ("IPO") of NewAlliance Bancshares, Inc. ("NewAlliance" or the "bank"). This IPO was the result of the conversion of New Haven, Connecticut-based New Haven Savings Bank ("NHSB") from mutual to stock form of organization. In accordance with Connecticut state banking regulations, NewAlliance gave priority in the IPO to NHSB depositors as of June 30, 2002, who were prohibited from entering into any agreements regarding the sale or transfer of NewAlliance stock. The participants in the transactions were not entitled to receive any stock in the IPO. Nonetheless, using nominees who were eligible NHSB depositors to conceal their participation, certain individuals secretly funded seven NHSB depositors' IPO stock purchases totaling \$4.9 million in violation of Connecticut state banking regulations and the federal securities laws. Respondent participated in the transactions by identifying certain of these nominee depositors, arranging meetings between the depositors and one of the individuals who funded the stock purchases (the "funding source"), and participating in certain of those meetings. As a result of his participation, the funding source provided funds to Respondent. In August 2004, Respondent returned \$88,000 to the funding source.

Respondent

2. From September 2002 through December 2004, Respondent was a vice president of Bank of New York Company, Inc. From August 1998 through August 2002, and again from June 2004 through December 2004, Respondent was a registered representative associated with broker-dealers registered with the Commission. For a portion of the time in which he engaged in the conduct described below, Respondent was seeking to become associated with a broker-dealer registered with the Commission. Respondent (CRD # 3123248), 36 years old, is a resident of Greenwich, Connecticut.

Background

3. During February-March 2004, Respondent located three NHSB depositors who were willing to meet with the funding source to discuss a potential agreement regarding the purchase of NewAlliance stock in the IPO on behalf of or for the benefit of the funding source, who otherwise would have been unable to receive any stock in the IPO. In late February-early March 2004, prior to arranging a meeting between the depositors and the funding source,

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Respondent spoke with each depositor or a relative thereof about, among other things, introducing them to the funding source for the purpose of discussing a possible purchase of NewAlliance stock. Respondent also attended meetings in late February-early March 2004 between the funding source and two of the depositors.

4. After meeting with the funding source, six depositors (the three located by Respondent and relatives thereof) entered into agreements with the funding source pursuant to which the funding source provided each depositor with \$700,000 to purchase NewAlliance stock in the IPO, the depositors agreed to transfer all NewAlliance stock they received in the IPO to the funding source or his designees, and the depositors would receive 20% of the profits from the sale of the NewAlliance stock as determined by the funding source. By entering into these agreements, the funding source violated the federal securities laws. As a result of this conduct, other eligible NHSB depositors who were entitled to receive stock in the IPO were deprived of at least some NewAlliance stock to which they otherwise would have been entitled.

5. Each of the six depositors received 70,000 shares of NewAlliance stock in the IPO. Each of them signed their stock certificates to transfer them to the funding source or his designees. Respondent facilitated the transfer of stock ownership by picking up the stock certificates from the depositors after they had each signed their respective certificates.

6. In connection with the activities described in this Order, Respondent was neither a broker or dealer registered with the Commission nor associated with a broker or dealer registered with the Commission, and his activities were performed away from his employer and its affiliates.

7. As a result of the conduct described above, Respondent aided and abetted and caused the funding source's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

8. As a result of the conduct described above, Respondent violated Section 15(a) of the Exchange Act, which prohibits any natural person not associated with a broker or dealer registered in accordance with Section 15(b) of the Exchange Act from using the mails or any other means or instrumentality of interstate commerce to effect a transaction in, or to induce or attempt to induce the purchase or sale of, a security.

9. Respondent's violations set forth in paragraphs 7 and 8 above were willful.

Undertakings

Respondent shall provide to the Commission, within 10 days after the end of the twelve-month suspension period described above, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

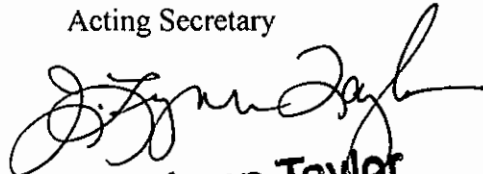
Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 15(a) of the Exchange Act.

B. Respondent be, and hereby is, suspended from association with any broker or dealer for a period of twelve months, effective on the second Monday following the entry of this Order.

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

Commissioner Walter
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59125 / December 19, 2008

Admin. Proc. File No. 3-12941

In the Matter of the Application of

RONALD PELLEGRINO
825 Sudden Valley
Bellingham, WA 98229

For Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY
PROCEEDING

Failure to Supervise

General manager of former member firm of registered securities association failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations and with association rules. Held, association's findings of violation and sanctions imposed sustained.

APPEARANCES:

Ronald Pellegrino, pro se.

Marc Menchel, Alan Lawhead, and Michael J. Garawski, for NASD.

Appeal filed: January 30, 2008
Last brief received: May 22, 2008

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Ronald Pellegrino, a former general securities principal of Metropolitan Investment Securities, Inc. ("MIS"), a former NASD member firm, appeals from NASD disciplinary action. 1/ NASD found that "Pellegrino failed to establish and maintain an adequate supervisory system" at MIS in violation of NASD Rules 3010 and 2110. NASD barred him from serving in a principal capacity. 2/ We base our findings on an independent review of the record.

II.

This case concerns Pellegrino's liability for supervisory failures in connection with sales by MIS registered representatives of securities issued by two MIS affiliates, Metropolitan Mortgage and Securities, Inc. ("Metropolitan") and Summit Securities, Inc. ("Summit"). Although Metropolitan's and Summit's precarious financial position rendered their securities highly risky, MIS registered representatives routinely recommended and sold them to MIS customers seeking conservative investments. NASD found Pellegrino responsible for MIS's inadequate supervision of its sales force, which led to systematic abusive sales practices by the registered representatives and ultimately substantial losses by MIS customers. 3/

1/ On July 26, 2007, the Commission approved a proposed rule change NASD filed to amend its Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of its member firm regulatory functions with NYSE Regulation, Inc. See Securities Exchange Act Rel. No. 56148 (July 26, 2007), 91 SEC Docket 522. Because the disciplinary action taken here was instituted before that date, we continue to use the designation NASD.

2/ NASD Conduct Rule 3010 imposes supervisory requirements on NASD members. NASD Conduct Rule 2110 requires that members "observe high standards of commercial honor and just and equitable principles of trade." A violation of any NASD Conduct Rule, such as Conduct Rule 3010, also constitutes a violation of Rule 2110. Robert E. Strong, Exchange Act Rel. No. 57426 (Mar. 4, 2008), 92 SEC Docket 2875, 2887.

3/ MIS consented to findings that it, acting through its registered representatives, made unsuitable recommendations and misleading sales presentations in violation of NASD Rules 2310 and 2110, among other NASD rule violations. MIS was censured, fined \$500,000, and ordered to pay \$2.8 million in restitution.

A. Background

1. MIS, Metropolitan, and Summit

Metropolitan established MIS in 1979 for the purpose of selling its securities. MIS subsequently became a subsidiary of Summit, which was itself a Metropolitan subsidiary. The main offices of MIS, Metropolitan, and Summit shared the same office building. Metropolitan determined the number of MIS employees and was involved in their hiring and firing. MIS derived the majority of its revenues from the sales of Metropolitan and Summit securities. MIS was the primary, if not sole, vehicle through which Metropolitan and Summit offered and sold their securities to the public. ^{4/}

Metropolitan and Summit offered to the public debentures, investment certificates, and preferred stock (collectively, the "Proprietary Products"). The Proprietary Products "were the majority" of what MIS's registered representatives sold. One representative testified that the "main securities business that [MIS] emphasized was the [P]roprietary [P]roducts," and others agreed that selling the Proprietary Products was MIS's primary mission and "main focus."

At the time Pellegrino joined MIS, C. Paul Sandifur, Jr. was MIS's president and chief executive officer; Reuel Swanson, MIS's chief compliance officer; and Al Olsen, an assistant vice president and supervisory principal. ^{5/} Sandifur, whose father founded Metropolitan, also

^{4/} Pellegrino stipulated to this fact as part of a series of stipulations he executed prior to the hearing in this proceeding, and the record evidence confirms it. He now moves to vacate all the stipulations on the ground that NASD "manipulated" him into executing them. We have held previously that we will "honor stipulations in the absence of compelling circumstances" justifying setting the stipulations aside. Joseph Abbondante, Exchange Act Rel. No. 53066 (Jan. 6, 2006), 87 SEC Docket 203, 207 n.12 (citing James F. Glaza, d/b/a Falcon Fin. Serv., Inc., 57 S.E.C. 907, 914-15 n.7 (2004)), aff'd, 209 Fed. Appx. 6 (2006). The record does not support Pellegrino's assertion of manipulation. At a pre-hearing conference before Pellegrino agreed to the stipulations, the Hearing Officer told Pellegrino explicitly that he did not "have to stipulate to anything that [he] felt uncomfortable about." Although we thus deny the motion to vacate, we note that the assertions made in the stipulations are supported independently by other evidence in the record.

^{5/} NASD brought disciplinary proceedings against Sandifur, Swanson, and Olsen based on their alleged failures to supervise or maintain an effective supervisory system. All three settled without admitting or denying the allegations. Sandifur consented to a bar from association with any NASD member in any capacity, Swanson to a bar from association in a principal capacity and a \$5,000 fine, and Olsen to a suspension from association in a principal capacity for one year and a \$5,000 fine.

(continued...)

controlled both Metropolitan and Summit. Sandifur and Swanson worked on the sixteenth floor of the building Metropolitan and Summit shared with MIS; MIS was located on the second floor. Swanson, in addition to his position at MIS, also served as Metropolitan's corporate secretary and on its Board of Directors. 6/ Swanson saw no conflict of interest between his duties at MIS and Metropolitan "because [MIS was] selling a product Metro needed to continue its operations and the fact that the operation went very smoothly and so forth, was important to Metropolitan."

Olsen supervised MIS's 200 registered representatives. He had no experience in the securities industry prior to his employment with MIS, and MIS never provided him any formal training regarding his supervisory duties. Olsen testified that he "had great difficulty" and "great concerns" about supervising the registered representatives. The majority of the representatives were independent contractors located offsite in seven states. Olsen thought he was "exceeding [his] capability" and was concerned that he "had no staff" and that the representatives were "geographically dispersed." Olsen added that MIS's "first priority was generating sales."

According to their prospectuses, both Metropolitan and Summit "engaged in a nationwide business of acquiring, holding and selling receivables." These receivables included real estate contracts and promissory notes, structured settlements, annuities, lottery prizes, equipment leases, and other instruments. In its Form 10-K/A for the fiscal year ending September 30, 2000, Metropolitan described these receivables as "cash flowing assets." 7/ Metropolitan stated that it "predominantly invests in Receivables where the borrower or the collateral does not qualify for conventional financing or the seller or the buyer chose to use non-conventional financing." The Proprietary Products financed Metropolitan's and Summit's investments in receivables.

The Proprietary Products' debentures and investment certificates represented unsecured general obligations of Metropolitan and Summit. 8/ Metropolitan and Summit issued the debentures and investment certificates pursuant to indentures that did not restrict their ability to issue additional debentures or to incur other debt, including debt senior in right of payment to the

5/ (...continued)

In a separate proceeding by the Commission alleging financial fraud at Metropolitan, Sandifur consented to a permanent injunction against violating the securities laws, disgorgement of \$60,000 plus prejudgment interest, and a civil penalty of \$75,000. SEC v. Sandifur, Litigation Release No. 20379 (Dec. 4, 2007), 92 SEC Docket 340.

6/ Olsen stated that Swanson spent only "a couple hours each day" at MIS.

7/ Summit also described the receivables as "cash flowing assets" in its Form 10-K for the fiscal year ending September 30, 2001, and stated that its goal was "to achieve a positive spread between the return on its Receivables and other investments and its cost of funds."

8/ See Black's Law Dictionary 330 (7th ed. 2000) (stating that a debenture is a debt secured only by the debtor's earning power, not by a lien on any specific asset).

debentures. In their prospectuses, both Metropolitan and Summit stated that their subsidiaries had no obligation to guarantee or otherwise pay amounts due under the debentures, and that the debentures were therefore effectively subordinated to all indebtedness and other liabilities and commitments of Metropolitan's and Summit's subsidiaries. No government entity guaranteed or insured the Proprietary Products.

2. Metropolitan's and Summit's Financial Condition

Although Metropolitan had been profitable for forty-eight consecutive years, in 1999 it began experiencing financial difficulty. For the next several years until it filed for bankruptcy in 2004, its earnings were insufficient to meet fixed charges and preferred stock dividends. On May 11, 2001, two months before Pellegrino joined MIS, Metropolitan issued a prospectus for debentures disclosing that its earnings were insufficient to meet fixed charges and preferred stock dividends by approximately \$7.9 million for the three-month period ending December 31, 2000. The prospectus disclosed that earnings had been insufficient to meet fixed charges and preferred stock dividends by approximately \$17.9 million for the fiscal year ending September 30, 2000 and \$0.8 million for the fiscal year ending September 30, 1999. Metropolitan stated that investors might not receive the full amounts they were entitled to on their debentures if the earnings insufficiency continued. Metropolitan's balance sheet also reflected that it was highly leveraged. As of June 30, 2001, its debt-to-equity ratio was 35 to 1. Its cash inflows were also becoming increasingly dependent on sales of the Proprietary Products.

3. MIS's Sales Practices and Suitability Assessments

Many MIS customers checked boxes on their subscription agreements indicating a low risk tolerance. MIS staff testified that many customers "were unsophisticated," or "not comfortable or knowledgeable about perhaps diversification, asset allocation." Many of these customers were elderly retirees who had invested their savings with MIS and sought income. Pellegrino testified that he did not "think [MIS customers] knew or cared what they had because it paid them their money, and that's all they seemed to care about."

MIS's sales force recommended the Proprietary Products to customers as low-risk investments. For example, customers stated, in complaint letters sent to NASD, that MIS representatives assured them that their investments "were very safe," "were the safest and one of the best investments [they] could make," and "were a safe, extremely low-risk investment." Customers also wrote that their representatives stressed that "the company had never missed even one interest payment in the entire fifty years they've been in business" and that investing in the Proprietary Products "was much like placing money in a bank and collecting the interest" and "was as safe as putting money in the bank."

MIS's 2001 Supervisory Manual stated that "[i]f MIS recommends to a customer the purchase of its own securities or securities of an affiliate . . . MIS must have reasonable grounds to believe that the recommendation is suitable for the customer based upon the customer's investment objectives, financial situation and needs, and other information." MIS staff testified, however, that MIS did not base individual suitability determinations for its customers' Proprietary Product investments on the individual customer's financial situation and investment objectives. Instead, MIS based the suitability of an investment in the Proprietary Products on so-called "MIS Suitability Guidelines" (the "Suitability Guidelines"). The Suitability Guidelines provided that customers could invest in the Proprietary Products as long as an investment in the securities of Metropolitan and Summit combined did not exceed 40% of their net worth, an investment in the securities of either Metropolitan or Summit individually did not exceed 30% of their net worth, and an investment in the preferred stock of either Metropolitan or Summit did not exceed 20% of their net worth. The only other limitation on suitability contained in the Suitability Guidelines was that preferred stock could not be recommended to customers with "low risk tolerance portfolios." Olsen testified that, from his "very first day through every general manager," MIS's sole suitability criteria was that the investor must "meet concentration levels" and could invest in the Proprietary Products "as long as [the investor met] the concentration levels."

B. Pellegrino Joins MIS

Pellegrino joined MIS on July 5, 2001, as the firm's General Manager. As General Manager, MIS's September 2001 Supervisory Manual charged Pellegrino with "responsib[ility] for reviewing the firm's overall supervisory system." A chart of MIS's organizational structure depicted Pellegrino as MIS's highest-ranking officer. ^{9/}

Pellegrino knew Metropolitan and Summit had financial problems when he considered MIS's offer of employment. He testified that when he "first took a look at the prospectuses" that Metropolitan sent him as part of the recruitment process, he thought, "What? Are you kidding. It was all red ink." James Dawson, NASD's district director at the time, told Pellegrino that MIS was "a risky business." Although Pellegrino "saw the losses," he nonetheless accepted the position.

Pellegrino's "[i]nitial impressions of MIS was a very disorganized, dysfunctional firm with some rogue reps, ineffective self-serving management prone to show favoritism, and running a business way too complex for the ability of the managers and staff." He testified that, when he started at the firm, his staff had no background in the securities industry and MIS had no understanding of a broker-dealer's duties to its customers. He realized, within two months of his arrival at MIS, that MIS's supervisory system "was deficient in that it needed improvement."

^{9/} Although indisputably MIS's president, Sandifur was not listed on this chart.

1. Pellegrino's Initial Compliance Efforts

Olsen testified that Pellegrino initially "embraced" Olsen's concerns regarding MIS's lack of supervisory staff and "too large numbers of reps [that were] geographically disbursed [sic]." Early on, Pellegrino took certain steps in response to those concerns. For example, Pellegrino hired two additional individuals as compliance staff. ^{10/} According to Swanson, Pellegrino also "cut down" the number of MIS registered representatives by eliminating representatives who were just "hanging their license" at MIS, who did not obtain a Series 7 license, or who had "background problems." ^{11/} MIS also eliminated representatives in the farthest locations because Pellegrino determined MIS could not supervise them properly. As part of this reduction, in August 2001, Pellegrino terminated the firm's relationship with a group of representatives operating under the name Great Northern Financial Services after MIS compliance staff expressed "serious concern" about their "methods for selling [and] the quality of their representatives."

Pellegrino also instituted a "7-7-0" standard for hiring new registered representatives. According to Pellegrino, in explaining the new standard, he "wanted someone who had a Series 7 license, preferably with some broad experience; 7 years of experience in the industry which would give [him] some comfort that they were well-versed, that they were at least a survivor beyond the first couple of years; and 0 meant 0 compliance or regulatory problems." Pellegrino stated that he "wanted new reps who were clean and diverse in their view and their background." This policy had minimal impact, however, because MIS was eliminating, not hiring, representatives during Pellegrino's tenure.

In addition, Pellegrino established what he referred to as the customer internal audit ("CIA") program. ^{12/} The CIA program involved sending a form to customers who purchased Proprietary Products asking whether they had received a prospectus and understood the risks and contacting customers when there were changes to a customer's financial information. The efficacy of the CIA program depended, therefore, on the willingness of MIS customers to respond as well as the content of their responses.

^{10/} Pellegrino testified, however, that neither of these new compliance staff members had prior compliance experience. One individual conducted branch audits, and the other ran Pellegrino's customer internal audit program. See infra.

^{11/} Although Pellegrino contends that he decreased the number of representatives to under ninety, the testimony at the hearing established that MIS had between 100 to 150 registered representatives during Pellegrino's tenure.

^{12/} Pellegrino stated that the CIA program "was at first random" and "got expanded to include everyone who bought preferred stock."

2. Pellegrino's Failure to Correct MIS's Deficient Supervisory System

Although Pellegrino took these steps to address certain problems at the firm, he did not address the significant deficiencies with MIS's overall supervisory system. For example, soon after joining the firm, Pellegrino recognized problems with Swanson's role as MIS's chief compliance officer. Pellegrino stated that Swanson "was a part-timer at best and a chief compliance officer in name only" and that Swanson's position with Metropolitan while serving as MIS's chief compliance officer represented a "conflict[] of interest." According to Pellegrino, he and Sandifur discussed replacing Swanson as chief compliance officer in August 2001 and February 2002. Pellegrino testified, however, that Sandifur "wouldn't let" him replace Swanson because Swanson had "been around forever."

In August 2002, the Washington State Department of Financial Institutions ("DFI") demanded that Pellegrino remove Swanson as chief compliance officer. The DFI became concerned about Swanson's performance after finding, during an examination, that he "had approved several types of [customer] correspondence containing problematic statements," and "recommend[ed] that Mr. Swanson no longer have responsibility for reviewing advertising or correspondence." Despite his earlier efforts to remove Swanson, Pellegrino asked the DFI "to reconsider its position." The DFI refused to allow Swanson to continue as chief compliance officer, citing a concern "that Mr. Swanson's duties as an officer of MIS and Metropolitan Mortgage may interfere with the best execution of any compliance duties assigned to him."

Although Pellegrino ultimately obeyed the DFI's directive and replaced Swanson with Olsen, he did not relieve Olsen of his existing responsibilities as supervisor of the registered representatives. Subsequently, Olsen told Pellegrino that he doubted his ability to handle both positions, 13/ but Pellegrino ignored his concerns.

3. Pellegrino Focuses on Sales and Disregards "Red Flags" of Compliance Problems

a. Metropolitan's and Summit's Financial Condition Continues Deteriorating

Pellegrino acknowledged that the financial statements of Metropolitan and Summit "concerned" him. Metropolitan's and Summit's financial condition continued deteriorating throughout Pellegrino's tenure. Metropolitan's earnings were insufficient to meet fixed charges and preferred stock dividends by about \$40.2 million for the year ending September 30, 2001, \$3.4 million for the year ending September 30, 2002, and \$6.9 million for the three-month period ending December 31, 2002. Summit's earnings were insufficient to meet fixed charges and preferred stock dividends by about \$7.6 million for the year ending September 30, 2001. The Proprietary Products' prospectuses contained this negative financial information. Pellegrino

13/ Olsen sent Pellegrino an e-mail memorializing his concerns because he felt performing both functions was "perhaps more than a single person should do" and he "wanted it on the record that this [was] an issue with [him]."

testified that, at least as of March 2002, he considered preferred stock high risk and the debentures and investment certificates medium to high risk.

b. MIS Customers Do Not Understand the Risks of the Proprietary Products

In August 2001, NASD's Dawson warned Pellegrino that MIS's registered representatives were minimizing the risk associated with the Proprietary Products by comparing them to certificates of deposit and telling customers not to "bother looking at the prospectus." Pellegrino testified that his own discussions with customers left him unsure whether they "fully understood what they owned," and caused Pellegrino to doubt that they appreciated the associated risks.

In August 2002, Pellegrino retained Public Opinion Strategies ("POS"), a survey research company, to conduct focus groups with Metropolitan investors. In its report, POS concluded that MIS's customers did "not see [MIS] or its investment products as being high risk." Instead, POS found that investors viewed Metropolitan as "conservative" and "stable." POS noted that "debenture holders are not expert investors" and "place a significant amount of trust in their investment advisor." Pellegrino acknowledged at the hearing that POS's findings indicated that the average Metropolitan investor wanted a low-risk investment, believed Metropolitan to be conservative, and had a low level of awareness about the Proprietary Products. 14/

A subsequent survey of 150 MIS customers, in November 2002, confirmed that they underestimated the risks of the Proprietary Products. Although the survey found that "minimizing risk [was] the most important investment priority for Metropolitan customers," customers described Metropolitan as "financially strong," and a large majority believed that the debentures were "relatively risk free" -- over 75% of customers thought that their investment in Metropolitan or Summit was "more secure than conventional stocks and securities." At the hearing, Pellegrino acknowledged that the survey evidenced that the average Metropolitan investor generally believed Metropolitan was a conservative product, wanted a low-risk investment, and considered the Proprietary Products relatively risk free.

14/ Pellegrino testified that POS also conducted focus groups with individuals who did not invest in the Proprietary Products. Unlike the longtime MIS customers, Pellegrino stated that the non-MIS customers "reacted really strongly to the prospectus [for the Proprietary Products] and really strongly negatively to the prospectus." Rather than recognizing that these reactions indicated that existing customers failed to appreciate the increasingly risky nature of the Proprietary Products, Pellegrino stated that this reaction "gave [him] some comfort that the prospectus was an effective document."

Despite this obvious conflict between the actual riskiness of the Proprietary Products and customer perceptions of the level of riskiness, Pellegrino never asked Olsen to take further action in response to the POS findings. Pellegrino admitted that the POS findings did not prompt him to ask Olsen to look into whether MIS's registered representatives were misrepresenting the risks associated with the Proprietary Products. The record contains no evidence of other steps Pellegrino took to address the POS findings.

c. Pellegrino Focuses on Improving Sales

The evidence indicates that, rather than responding to the issuers' deteriorating financial condition and customers' flawed perceptions of the Proprietary Products' risks by implementing enhanced suitability procedures, Pellegrino focused on improving sales. He testified that he "inherited suitability guidelines that had been in place for years" and "had no reason to question the validity of those guidelines." According to Olsen, Pellegrino "became much more sales driven, sales oriented" as his tenure progressed and ultimately "viewed compliance, operational issues as more [of] an irritant to achieving the level of sales success that he was trying to achieve." Chris Sullivan, MIS's representative services coordinator, testified that, during his tenure at MIS, Pellegrino set a goal of \$10 million in Proprietary Products raised per month and wanted 80% of funds in existing matured debentures reinvested in the Proprietary Products.

As part of his sales efforts, Pellegrino instituted contests to boost the registered representatives' efforts to push sales of Metropolitan and Summit preferred stock. Pellegrino also created a newsletter called "Hotline" that contained scripts to assist representatives in overcoming investor objections. Among other things, the scripts emphasized that the Proprietary Products lacked market volatility. Additionally, Pellegrino hired Bruce Bushman to be MIS's national sales manager in February 2002; Sullivan testified that Bushman "show[ed] individuals ways to come over [sic] objections for" the Proprietary Products.

Pellegrino also devised an abbreviated subscription agreement form (the "EZ Form") in order to ease the purchase of additional Proprietary Products by existing customers. The EZ Form allowed customers to reinvest in the Proprietary Products by affirming that their personal financial information had not changed since their prior investment and then selecting the term and rate at which they wanted to reinvest. Pellegrino acknowledged that the completed EZ Form did not refer to the customer's risk tolerance or investment objectives. Olsen testified that the EZ Form was "designed specifically to increase sales."

Pellegrino also created a report on customers' "buying power" (the "Buying Power Report") that determined for the representatives which of their clients could purchase more Proprietary Products and still stay within the Suitability Guidelines' concentration ratios. The Buying Power Reports "were sent to each representative so they would have a list . . . of their clients who essentially had room to invest more in the [P]roprietary [P]roducts." Olsen worried that the Buying Power Reports were "another step towards [sales of the Proprietary Products] being the primary priority rather than the needs of that investor."

Pellegrino's efforts to boost sales also entailed downplaying the issuers' financial performance. In an e-mail to Metropolitan's chief financial officer, Pellegrino wanted to "build our 'spin' for the FY Q2 loss in Metro." ^{15/} In another e-mail, Pellegrino noted that the "reps have to deal with a prospectus that is downright ugly in the amount and detail of risk disclosures," that it was "very difficult to overcome potential investor objections," and that MIS's "direction has been to focus the reps on the turnaround of the company."

The compliance meetings and training sessions that Pellegrino instituted also focused more on sales than compliance. Although MIS held what it called an "Annual Compliance Meeting" in September 2002, the meeting, which lasted two full days, devoted only two hours to compliance, and just ten minutes were spent discussing suitability. Olsen's compliance presentation at the meeting, moreover, reinforced MIS's focus on concentration of Proprietary Products holdings as the sole suitability determinant. Although a video of Olsen's presentation reveals that he directed the representatives to make "fair and balanced presentations," the only guidance he provided on suitability was when he described suitability as strictly a "mathematical equation," *i.e.*, relying on the concentration levels. Olsen testified further that, even though he used the term "balanced presentation" at the meeting, other portions of the meeting might have given the representatives a mixed message. The record contains no evidence that Olsen provided appropriate guidance to the representatives, at this meeting or otherwise, regarding the kind of disclosures required to ensure that they made "balanced presentations."

Pellegrino also instituted monthly two-day training sessions for MIS's sales force, which Pellegrino called "Back to Basics." The "Back to Basics" sessions devoted only a small portion of time to compliance, with the primary emphasis being on sales. Sullivan testified that the first day focused on operations and technology and the second day focused on "sales training." The sessions did nothing to alter MIS's traditional approach to suitability determinations. For example, a slide presented at the sessions answered the question of "How much can my clients buy?" with respect to a particular Proprietary Product by summarizing the Suitability Guidelines' maximum concentration levels. Bushman, the national sales manager, ran the sessions, and Sullivan testified that Bushman focused "primarily on the sales of the [P]roprietary [P]roducts." He testified further that Bushman presented Metropolitan's financials in a positive light and did not make its losses "real upfront" to the representatives. He described the review of the issuers' financial performance as "here is the financials of the issuer and then here is their past track record of financials" and "here is how we can explain current financials." Another representative testified that Bushman "glossed over" the downside to the Proprietary Products. ^{16/}

^{15/} Pellegrino testified that this e-mail reflected "a really bad choice of words."

^{16/} Pellegrino states in his brief that this representative's testimony "is disputed by other testimony" from the same registered representative, that this representative did not attend "required training and compliance meetings," and that this representative testified against
(continued...)

In meetings with MIS's registered representatives, Metropolitan executives similarly discussed Metropolitan's losses but highlighted its future prospects, stating that Metropolitan had "turned the corner." Although Pellegrino instituted quarterly conference calls for the representatives with Metropolitan officers in order to explain the issuer's financial situation, including its losses, the executives emphasized that the financials were "going to look really a lot better" in the future. Pellegrino admitted Metropolitan's tendency was to "downplay" liquidity concerns and that the discussion of the company's future "was biased in a positive fashion."

Pellegrino's sales efforts worked. The money MIS raised from sales of the Proprietary Products increased each year of Pellegrino's tenure; MIS raised \$400 million from sales of the Proprietary Products in 2000, \$500 million in 2001, and \$700 million in 2002. Sullivan described Pellegrino as "[p]retty aggressive in terms of marketing," and Olsen described Pellegrino as "phenomenally successful" in generating sales.

C. NASD's Investigation, Pellegrino's Response, and the Firms' Collapse

On January 6, 2003, Pellegrino received a request for information from NASD and a notice that NASD would "soon begin an onsite examination of" MIS focusing on MIS's sales of Metropolitan's securities. Subsequently, Pellegrino took steps to address some of MIS's significant compliance failures that he had failed to address during the preceding year and a half. In its January 31, 2003 Compliance Manual, for example, MIS amended the Suitability Guidelines to bar investors desiring low risk from investing in the Proprietary Products.

Also on January 31, 2003, Pellegrino drafted and distributed to the representatives a memorandum entitled "Balanced Presentation and Discussion of Risk Factors." The memorandum stated that a "registered representative must first make sure that the investment is suitable based on the specific investment objectives and risk tolerance of the client" and that a "well-informed customer is in everyone's best interests." ^{17/} Sullivan described the memorandum's directive as "definitely a change" and something that Pellegrino emphasized "need[ed] to be done now." Olsen testified, however, that Pellegrino implemented this memorandum after, and in response to, NASD's investigation.

^{16/} (...continued)

Pellegrino because Pellegrino fired him. Pellegrino does not substantiate his assertions with evidence in the record, however, and no such evidence discredits this representative.

^{17/} The memorandum also stated that a "balanced presentation" was "one in which all factors relating to the potential risks and rewards of an investment are equally and completely disclosed to the prospect" and that a balanced presentation "would not favor the positive attributes of a proposed investment over the potential negative attributes."

In June 2003, shortly after Pellegrino gave testimony in NASD's investigation, Pellegrino finally relieved Olsen of his dual responsibilities for compliance and supervision of the firm's registered representatives. He hired Karen Arseneault as chief compliance officer because, according to Pellegrino, he "was concerned about [Olsen's] performance." Unlike Olsen, Arseneault had significant industry compliance experience, having worked previously at NASD as well as at other member firms. Pellegrino testified that "it would be an accurate statement to say that there would be no comparison in [his] mind between [Arseneault's] experience level and [Olsen's]." Arseneault's tenure at MIS began after the period at issue in this case.

On December 15, 2003, MIS ceased operations. Metropolitan and Summit issued press releases on December 26, 2003, advising investors that it had suspended dividends and payments of interest and principal on the Proprietary Products. In February 2004, Metropolitan, Summit, and MIS all filed for bankruptcy, and NASD cancelled MIS's registration in April 2005. Swanson testified that debenture holders might receive up to 30% of their investment back. He did not believe preferred stockholders would "get anything." 18/

NASD's investigation disclosed that, between October 2001 and March 2003, MIS registered representatives made at least 165 sales of the Proprietary Products totaling \$4.1 million to customers who had invested more than 20% of their net worth in the Proprietary Products and who had indicated on their subscription agreements that they had a low risk tolerance or preservation of capital as their sole or primary investment objective. In twelve of these transactions, the representatives sold customers preferred stock despite the Suitability Guidelines' proscription on recommending preferred stock to low-risk investors. 19/

In 2003 and 2004, NASD received hundreds of customer complaints regarding MIS. As indicated, MIS customers complained that, among other things, the representatives who sold them the Proprietary Products presented the investments as "safe," "secure," and "conservative." 20/ Many of these customers had invested their life savings in MIS.

18/ The record does not otherwise address the extent of MIS customers' losses.

19/ Although NASD only focused on transactions of customers for whom it had subscription agreements, MIS's records show that many other customers with a low risk tolerance or preservation of capital as their sole or primary investment objective invested at least 20% of their net worth in the Proprietary Products, totaling roughly \$17 million.

20/ One customer wrote that her representative "assured [her] that [Metropolitan] was doing well and would earn good interest for [her] investment dollars," another customer wrote that he "was only given positive information as to the risk factors involved," and another wrote that his representative said "that the risk for loss on the principal was non-existent." One customer stated explicitly that his representative "made no attempt to inform [him] of Metropolitan's worsening financial condition."

III.

A. NASD Rule 3010(a) requires that a member "establish and maintain" a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [NASD Rules]." 21/ In addition to an adequate supervisory system, "[t]he duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." 22/ "Once indications of irregularity arise, supervisors must respond appropriately." 23/ "In large organizations it is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention." 24/ "Assuring proper supervision is a critical component of broker-dealer operations." 25/ "The standard of 'reasonable' supervision is determined based on the particular circumstances of each case." 26/ MIS's Supervisory Manual provided explicitly that Pellegrino was "responsible for reviewing the firm's overall supervisory system." 27/

21/ NASD Rule 3010(b) requires that a member "establish, maintain, and enforce written procedures" that are reasonably designed to achieve compliance with the securities laws. Although NASD's National Adjudicatory Council ("NAC") "reverse[d] the Hearing Panel's finding that Pellegrino implemented appropriate written supervisory procedures," it did not address whether MIS's procedures satisfied Rule 3010(b) or find that Pellegrino violated Rule 3010(b). Pellegrino's conduct with respect to that rule is thus not before us.

22/ Michael T. Studer, 57 S.E.C. 1011, 1023-24 (2004).

23/ La Jolla Capital Corp., 54 S.E.C. 275, 285 (1999).

24/ Wedbush Sec., Inc., 48 S.E.C. 963, 967 (1988).

25/ Richard F. Kresge, Exchange Act Rel. No. 55988 (June 29, 2007), 90 SEC Docket 3072, 3083.

26/ John A. Chepak, 54 S.E.C. 502, 513 n.27 (2000) (citing Christopher J. Benz, 52 S.E.C. 1280, 1284 (1997), petition denied, 168 F.3d 478 (3d Cir. 1988) (Table)).

27/ "A determination that a respondent has violated NASD's supervisory rule is not dependent on a finding of a violation by those subject to the respondent's supervision." Robert J. Prager, Exchange Act Rel. No. 51974 (July 6, 2005), 85 SEC Docket 3413, 3432-33 & n.52 (citing NASD Notice to Members 98-96 (Dec. 1998) (stating that a violation of Rule 3010 can occur in the absence of an underlying rule violation)).

Pellegrino notes that the DFI found, in an administrative proceeding against one MIS registered representative, Ross Bruner, that Bruner did not violate state law provisions prohibiting fraud, unsuitable recommendations, and dishonest and unethical sales

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B. 1. Pellegrino did not exercise reasonable supervision in light of the circumstances under which he allowed MIS's registered representatives to recommend the Proprietary Products. Metropolitan and Summit reported substantial losses throughout Pellegrino's tenure, and Pellegrino's conversations with customers informed him that MIS's customers did not appreciate the risks associated with the Proprietary Products. The POS findings also indicated that the average Metropolitan investor had a low risk tolerance, believed Metropolitan was a conservative investment, and considered the Proprietary Products relatively risk free. Although Pellegrino himself considered the Proprietary Products medium to high risk investments, Olsen confirmed that Pellegrino never asked him to undertake an investigation in response to POS's findings, and no evidence exists of any other measures taken to address the overwhelming evidence that customers fundamentally misunderstood the riskiness of the Proprietary Products. This inaction constituted a failure to supervise reasonably because Pellegrino knew the registered representatives were recommending risky securities to investors who wanted, and thought they were getting, low-risk investments. 28/

Pellegrino defends the reasonableness of his supervision by claiming that some investors appreciated the risks. He notes that "the proprietary securities sold by MIS were . . . offered by prospectus only," that the "risk factors were clearly laid out in bold fonts in each prospectus," and

27/ (...continued)

practices. He contends that the DFI's findings "show Rule 2110 and Rule 2310 conformity by this former rep as a result of MIS training during the relevant period." The DFI's opinions make no findings regarding NASD Rules 2310 and 2110 and no mention of the training Bruner received. One registered representative's compliance with NASD rules has no bearing on either NASD rule violations committed by other representatives or the reasonableness of supervision with a view to preventing rule violations. As noted above, the evidence indicates that MIS registered representatives made numerous unsuitable recommendations and misleading sales presentations to their customers.

28/ See Prager, 85 SEC Docket at 3432 (finding that "red flags and suggestions of irregularities" demanded "inquiry as well as adequate follow-up and review"); George J. Kolar, 55 S.E.C. 1009, 1016 (2002) (stating that "[d]ecisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations"); Quest Capital Strategies, Inc., 55 S.E.C. 362, 371 (2002) (stating that "supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention"); James J. Pasztor, 54 S.E.C. 398, 412-13 (1999) (finding that supervisor "should have recognized from many red flags" that representative "was effecting wash trades and matched orders" and "[a]t a minimum . . . should have conducted an independent investigation to determine whether these trades, which [supervisor] recognized were a matter of concern, violated the federal securities laws"); Michael E. Tennenbaum, 47 S.E.C. 703, 711 (1982) (finding failure to supervise where, despite specific warnings of possible misconduct, supervisor "failed to take or recommend any action to investigate [the] activities").

that customers' awareness of these risk factors "was clearly acknowledged by the POS survey." The POS's findings revealed unequivocally that MIS investors generally did not understand the risks of the Proprietary Products. For example, the POS survey indicated that between 60% to 70% of investors believed the Proprietary Products were relatively risk free, and 75% of customers thought that their "Metropolitan/Summit Securities investment [was] more secure than conventional stocks and securities." In these circumstances, Pellegrino could not, as he did, ignore the POS findings simply because some customers appreciated the risks. Even if customers were receiving prospectuses, Pellegrino had solid information that investors desiring low risk were buying high-risk products. These facts called for an inquiry into and supervision of the sales efforts of the registered representatives.

Nor does the delivery of a prospectus demonstrate reasonable supervision over the representatives making the recommendations. Pellegrino's citation to the prospectus is especially misplaced because Dawson warned him that MIS registered representatives told customers not to "bother looking at the prospectus." Pellegrino himself sought to build "spin" for the losses and "focus[] the reps on the turnaround of the company" in light of a "downright ugly" prospectus.

Finally, the delivery of a prospectus and the disclosure of risks does not demonstrate that an MIS registered representative's recommendation to any particular customer was suitable or that the individual customer was able to take the risks involved with the Proprietary Products. 29/

Instead of correcting the misunderstanding of the overwhelming majority of customers, moreover, Pellegrino intensified the firm's sales efforts. As part of these efforts, he allowed individuals at Metropolitan and MIS to present the representatives with a positive assessment of the issuers' finances despite their deteriorating condition. Pellegrino's sales efforts exacerbated, rather than alleviated, the risk of unsuitable recommendations the POS findings revealed. 30/

29/ James B. Chase, 56 S.E.C. 149, 159 (2003) (finding that representative "did not satisfy the suitability requirement simply by informing [investor] of the risks of investing in [the speculative stock]" on the ground that "[m]ere disclosure of risks is not enough" because a "registered representative must 'be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks'" (citation omitted); Larry Ira Klein, 52 S.E.C. 1030, 1036 (1993) (finding unethical sales practices despite representative's argument that he "delivered a prospectus to [investor] that disclosed the risks of investing" because representative's "delivery of a prospectus to [investor] does not excuse his failure to inform her fully of the risks of the investment package he proposed").

30/ Pellegrino notes that NASD issued a "Notice to Members" in 2004 discussing "sales practices obligations in the sale of bonds and bond funds." See NASD Notice to Members 04-30 (2004), available at www.finra.org. NASD issued the notice because it was "concerned that many investors may not fully appreciate the risks and costs associated with such products," and the notice cautioned firms who sold such products "to

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2. Pellegrino's failure to correct the registered representatives' exclusive reliance on the Suitability Guidelines when making a suitability determination constituted further unreasonable supervision. MIS staff testified consistently that MIS did not make individual suitability determinations for customers based on their financial situation and investment objectives. Instead, Pellegrino knew that MIS's Suitability Guidelines -- which based suitability exclusively on concentration levels -- were the sole suitability guidance the registered representatives received and effectively constituted MIS's sole suitability determinant. At MIS's annual compliance meeting in September 2002, for example, Olsen reiterated that suitability was strictly a "mathematical equation." ^{31/} Although concentration levels should be considered in assessing suitability, they cannot be the sole suitability determinant, particularly where, as here, the recommended securities carry substantial risks. The evidence indicates that, as a result of MIS's exclusive reliance on the Suitability Guidelines, the firm's representatives made numerous unsuitable recommendations during the time Pellegrino served as MIS's general manager by recommending substantial investments in the Proprietary Products to investors with a low risk

^{30/} (...continued)

take appropriate steps to ensure that their registered representatives understand and inform their customers about the risks as well as the rewards of the products they offer and recommend." Id. Pellegrino contends, in reliance on the notice, that a finding "that the majority of MIS accounts did not appreciate the risk in the securities[] is consistent with that of debt purchasers at all member firms, and not specific to MIS." The extent of concerns among customers is not clear from the NASD notice, while at least 60% of MIS customers did not understand the risks of the Proprietary Products; however, even if Pellegrino's assertion was true, it does not establish reasonable supervision. "[W]e have repeatedly held that the fact that a practice is common or widespread in an industry does not make such conduct proper or legal." Ko Sec., Inc., 56 S.E.C. 1126, 1132 (2003) (citing cases), petition denied, 122 Fed. Appx. 364 (9th Cir. 2005) (Unpublished).

^{31/} Pellegrino cites Olsen's testimony that the meeting informed MIS's representatives that MIS expected balanced presentations. A ritualistic incantation of the words "fair and balanced," however, did not satisfy Pellegrino's duty to ensure that registered representatives made suitable recommendations, particularly where Olsen also described suitability as a "mathematical equation." Even assuming that the representatives were told to provide a balanced presentation, Pellegrino could not rely on the representatives' voluntary compliance with that directive; he had a duty to monitor and review the representatives' activities to verify that they made suitable recommendations. See Bradford John Titus, 52 S.E.C. 1154, 1160 (1996) (stating that the duty of supervision "includes monitoring compliance with a supervisor's instructions").

tolerance and conservative investment objectives. ^{32/} Pellegrino knew of the registered representatives' reliance on the Suitability Guidelines but failed to take corrective action.

Although the firm's written procedures instructed the representatives to make individual suitability determinations based on a customer's investment objectives, financial situation, and needs, "the presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not assure compliance." ^{33/} The evidence demonstrated that the representatives did not make individual suitability determinations for customers based on their financial situation and investment objectives and instead based suitability exclusively on the concentration levels in the Suitability Guidelines. Pellegrino did not ensure that the registered representatives complied with the suitability requirements. MIS did amend the Suitability Guidelines to prohibit selling the Proprietary Products to low-risk investors in January 2003, but reasonable supervision required that he act sooner, especially in light of red flags such as Metropolitan's and Summit's deteriorating financial condition and his increasing awareness that investors did not appreciate the Proprietary Products' risks. ^{34/}

^{32/} See, e.g., Chase, 56 S.E.C. at 156-57 (finding that "high concentration of investments in one or a limited number of securities is not suitable for investors" seeking limited risk); Daniel Richard Howard, 55 S.E.C. 1096, 1099-1101 (2002) (finding "the speculative securities" recommended by applicant unsuitable for elderly investor "whose primary need was additional income and who sought investments that carried minimal risk"), aff'd, 77 Fed. Appx. 2 (1st Cir. 2003).

NASD found that MIS registered representatives made "at least 165 unsuitable recommendations, in violation of NASD Rules 2310 and 2110." NASD found further that the representatives "made misleading statements about the risks involved" in the Proprietary Products and that, in so doing, they "were at least negligent." Although we find that the evidence supports these findings of underlying violations by MIS registered representatives, we note that, as discussed above, we need not make such findings to support findings of supervisory failures by Pellegrino.

^{33/} Kresge, 90 SEC Docket at 3089 n.37 (quoting Rita H. Malm, 52 S.E.C. 64, 69 & n.17 (1994)); see also Gary E. Bryant, 51 S.E.C. 463, 470 (1993) (finding that a firm's procedures "must assure that restrictions issued are not ignored" and that a failure to establish such procedures "is symptomatic of a failure to supervise reasonably"); Frank J. Custable, Jr., 51 S.E.C. 855, 861 (1993) (finding a failure to supervise reasonably where applicants "failed to apply even their standard supervisory procedures").

^{34/} Pellegrino challenges the notion that the EZ Form "reinforced the position of MIS management that the concentration (ratio) standard was the primary suitability consideration in MIS." The EZ Form, however, did not refer to either the customer's risk

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Pellegrino argues the "concentration ratios were not the sole basis for [a] suitability determination" but instead were "a measurement to additionally be used by the rep, and was mandated by the NASD and WA DFI." Although the concentration ratios may have originally been intended as an additional suitability measurement, they did not function this way during Pellegrino's tenure. Instead, as noted above, the evidence demonstrated that during Pellegrino's tenure MIS based suitability exclusively on the concentration ratios. Pellegrino cannot blame this process on NASD or DFI. Although the record indicates that NASD and DFI recommended that MIS not sell the Proprietary Products to investors who had exceeded a certain level of concentration in the Proprietary Products, no evidence suggests that either NASD or DFI approved concentration in the Proprietary Products as the sole measure of suitability, particularly in light of the increasingly dire financial situation of the issuers.

3. Pellegrino also acted unreasonably in addressing significant personnel problems at the firm. Rule 3010(a)(2) requires that members designate appropriately registered principals to carry out their supervisory responsibilities, 35/ and Rule 3010(a)(6) provides that, as part of their supervisory system, members shall make reasonable efforts to determine that all supervisory personnel are qualified through experience or training to execute their assigned responsibilities.

Although Pellegrino realized within two months at MIS that its supervisory system "was deficient in that it needed improvement," he waited to replace Swanson until a year into his tenure. Pellegrino acknowledged that Swanson "was a part-timer at best and a chief compliance officer in name only" and that Swanson's position as both an officer of Metropolitan and chief compliance officer of MIS presented a conflict of interest. Pellegrino acquiesced, however, when Sandifur wanted to retain Swanson as chief compliance officer because he had "been around forever." After the DFI initially recommended that Pellegrino replace Swanson, moreover, Pellegrino resisted. He did not remove Swanson until the DFI ordered the switch. Pellegrino contends that Sandifur prevented him from replacing Swanson, but Sandifur's recalcitrance does not explain Pellegrino's resistance to the DFI's recommendation that Swanson be removed. Nor does it absolve Pellegrino of responsibility for establishing an adequate supervisory system. 36/

34/ (...continued)
tolerance or investment objectives, and Pellegrino admitted in his testimony that it was not possible to discern this information from the form.

35/ Chepak, 54 S.E.C. at 506.

36/ See George Lockwood Freeland, 51 S.E.C. 389, 392 (1993) (finding that registered securities principal was required to insist on firm owner's cooperation and compliance with applicable requirements or resign and that until doing so he remained responsible for his duties); see also Pasztor, 54 S.E.C. at 409 n.28 (rejecting applicant's contention that he was "relieved of responsibility because he had to report to [firm's president who] could
(continued...)

The supervisory system remained weak after Pellegrino replaced Swanson with Olsen. Pellegrino designated Olsen as MIS's chief compliance officer without relieving him of responsibility for supervising approximately 100 registered representatives. Olsen himself expressed concern to Pellegrino about acting as both the chief compliance officer and representative supervisor. Olsen thought that performing both functions "was perhaps more than a single person should do." He admitted that he "had great difficulty and great concerns" about supervising the representatives even before he became chief compliance officer as well.

We have held repeatedly, furthermore, that it is "not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised." 37/ Pellegrino does not point to any steps he took to monitor Olsen's execution of his dual roles. Pellegrino acted unreasonably by overburdening Olsen and by failing to oversee Olsen's discharge of his duties. 38/ Although Pellegrino eventually replaced Olsen as chief compliance officer after becoming concerned with his performance, he did not hire Arseneault to be MIS's chief compliance officer until June 2003, after the period at issue in this case.

Pellegrino argues that "Olsen was capable and ready" to be MIS's chief compliance officer because he "attended NASD Annual Compliance Meetings," "had more staff assigned to compliance," "conversed regularly with other compliance professionals," "consulted with [NASD's] District office," "discussed suitability very clearly" at MIS's 2002 annual compliance meeting, and had "access to Ms. Arseneault" before she joined MIS officially. Whether or not Olsen's attendance at NASD compliance meetings, performance at MIS's 2002 compliance meeting, and conversations with Arseneault and other compliance professionals qualified him to be MIS's chief compliance officer, we believe it was unreasonable to require Olsen both to supervise the representatives and act as chief compliance officer at the same time. Olsen himself

36/ (...continued)
 overrule his decisions" because applicant had an obligation to monitor subordinate's performance and could not shift that responsibility to firm's president).

37/ Harry Gliksmann, 54 S.E.C. 471, 484-85 (1999), aff'd, 24 Fed. Appx. 702 (9th Cir. 2001).

38/ Cf. Kresge, 90 SEC Docket at 3086, 3088 (finding that member's "supervisory system was not reasonably designed to achieve compliance with applicable federal securities laws and regulations and NASD rules" because, among other findings, supervisor had worked at the firm for only six months when he became responsible for a branch office and supervisor was already "overwhelmed" with his other responsibilities").

questioned the reasonableness of this supervisory structure, and Pellegrino does not cite any steps he took in response to Olsen's concerns or to monitor Olsen's performance of both functions. 39/

C. Pellegrino contends that several supervisory actions -- such as instituting the "7-7-0" standard, adding compliance staff, and reducing the number of registered representatives -- demonstrate that he performed reasonable supervision. 40/ We must consider, however, whether his supervision "was reasonably designed to prevent the violations at issue, not weigh [his] supervisory performance in other areas against [his] deficiencies in the area under review." 41/ The 7-7-0 standard, for example, had minimal impact because MIS was eliminating, not hiring, registered representatives during this period. None of the steps Pellegrino took created a supervisory system reasonably designed to prevent the misconduct at issue here because they did not remedy the obvious potential for unsuitable recommendations and misleading sales presentations by MIS's existing sales force. Rather than altering the criteria for investing in the Proprietary Products in response to the issuers' declining financial condition, Pellegrino retained the concentration ratios in the Suitability Guidelines as the sole suitability determinant and focused on boosting sales. He failed to conduct any investigation in light of the POS findings revealing that customers did not appreciate the risks of the Proprietary Products. He also retained Swanson, a "part-time" chief compliance officer, until August 2002, and replaced Swanson with Olsen without relieving Olsen of his duties as representative supervisor. In these circumstances, the other supervisory steps Pellegrino executed do not render his supervision reasonable. 42/

39/ See Castle Sec. Corp., 53 S.E.C. 406, 413 (1998) (finding supervision unreasonable where applicant put an inexperienced individual in charge of compliance and supervision and did not monitor his performance or ensure that he understood the scope of his duties).

40/ Pellegrino cites other purported compliance measures that the record does not support. No evidence substantiates his assertions that "all customer complains were promptly and thoroughly investigated" and that "[t]here were reps put on heightened supervision." Olsen testified that the "weekly" compliance meetings Pellegrino cites "didn't go on for an extended period of time." Another measure Pellegrino cites, his initiation of "customer contact by phone or in person," actually constituted a red flag because Pellegrino stated in his investigative testimony that conversations with customers led him to believe that the customers did not appreciate the risks of the Proprietary Products.

41/ Quest Capital Strategies, 55 S.E.C. at 374.

42/ Cf. Albert Vincent O'Neal, 51 S.E.C. 1128, 1135 (1994) (stating that, under the Exchange Act, "the test is whether O'Neal's supervision was reasonably designed to prevent the violations at issue, not (as O'Neal would have it) whether, if all the many other supervisory functions he performed were taken into account, his overall supervisory performance somehow earned him a hypothetical passing grade"); see also George J. Kolar, 55 S.E.C. 1009, 1020 (2002) (rejecting supervisor's claim that he enacted

(continued...)

Although Pellegrino does highlight some compliance measures that support his contention that MIS's procedures "would have improved in later years had the firm survived," these measures were insufficient to demonstrate reasonable supervision during his tenure. For example, the record substantiates Pellegrino's implementation of the "CIA" program. As discussed, however, although Pellegrino's implementation of the CIA program was a step in the right direction, its efficacy in identifying compliance problems was limited because of its dependence on the customers' own assessments of the risks involved. ^{43/} Moreover, Pellegrino did not amend the Suitability Guidelines to prohibit any investments in the Proprietary Products for low-risk investors, distribute a memorandum emphasizing the importance of a balanced presentation and a discussion of risk factors with customers, or hire a more competent compliance director allowing him to relieve the overburdened Olsen until 2003, after learning that the firm was subject to an NASD investigation. We recognize, as Pellegrino urges, that MIS had a deficient supervisory system before he joined the firm, but reasonable supervision required that Pellegrino correct the deficiencies promptly. ^{44/} Pellegrino's failure to take such steps until after NASD's investigation began demonstrates unreasonable supervision. ^{45/}

Pellegrino faults NASD, the DFI, and a "barrage of new rules and regulation[s]" that required MIS's compliance for his supervisory failures. Although Pellegrino blames NASD for not informing MIS of its deficient practices and not taking earlier action against MIS, as well as the DFI for failing to inform MIS of a letter it wrote to the Commission in September 2002 alerting the Commission to Metropolitan's precarious financial condition, we have held repeatedly that "members and their associated persons 'cannot shift their burden of compliance to NASD.'" ^{46/} "A regulatory authority's failure to take early action neither operates as an estoppel

^{42/} (...continued)
reasonable supervisory procedures because the "routine surveillance measures cited by [respondent] were clearly inapplicable to the situation that he confronted").

^{43/} See Quest, 55 S.E.C. at 373 ("As we have previously pointed out, '[s]upervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers . . . may fail to realize that they have been mistreated.") (quoting Reynolds & Co., 39 S.E.C. 902, 917 (1960)).

^{44/} Cf. Tennenbaum, 47 S.E.C. at 711 (finding a failure to supervise where supervisor, rather than respond to "specific warnings that [representative] might be engaging in excessive trading," "engaged in 'foot-dragging'").

^{45/} Cf. Kresge, 90 SEC Docket at 3087 (finding a failure to supervise where supervisor's actions occurred "after NASD had begun its investigation").

^{46/} Id. (quoting B.R. Stickle & Co., 51 S.E.C. 1022, 1025 (1994)).

against later action nor cures a violation." 47/ Pellegrino was "not justified in relying on [NASD's or DFI's] silence." 48/ The record demonstrates, moreover, that NASD was not silent but warned Pellegrino of potential misconduct by MIS registered representatives. In any event, given the significant and obvious compliance deficiencies, Pellegrino must have been aware of them. As for MIS's need to comply with any "new rules and regulations," the evidence showed that Pellegrino chose not to investigate red flags of possible misconduct rather than being constrained from doing so by any lack of resources. We have held, moreover, that a "supervisor must act to ensure that each associated person is receiving appropriate supervision despite constraints on the supervisor's powers." 49/ Pellegrino was required to provide "effective staffing" and "sufficient resources" to ensure proper supervision. 50/

IV.

Pellegrino raises a number of procedural objections to this proceeding. He argues that the NASD's National Adjudicatory Council ("NAC") subcommittee reviewing the Hearing Panel's decision "was not prepared" at the oral argument. The transcript of the oral argument, however, refutes this assertion. The subcommittee members questioned Pellegrino about his testimony at the hearing as well as the brief he submitted to the NAC before the oral argument. 51/ We do not address whether a panel's preparation for an oral argument could justify a procedural objection.

47/ Stephen J. Horning, Exchange Act Rel. No. 56886 (Dec. 3, 2007), 92 SEC Docket 207, 221; see also Malm, 52 S.E.C. at 75 n.40 (rejecting applicant's contention that "because NASD noted no markup, pricing or other 'exceptions' during its audit . . . NASD was subsequently precluded from bringing markup or supervisory charges").

48/ See Apex Fin. Corp., 47 S.E.C. 265, 267 (1980) (finding that "applicants were not justified in relying on the agencies' silence" where applicant contended that he "asked for these agencies' comments on the offerings, none were forthcoming, and he therefore assumed that no regulatory provisions were being violated").

49/ Pasztor, 54 S.E.C. at 408 n.27 (citing Douglas Conrad Black, 51 S.E.C. 791, 795 (1993)).

50/ Stuart K. Patrick, 51 S.E.C. 419, 422 (1993) ("Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.") (quoting Mabon Nugent & Co., 50 S.E.C. 142, 143 (1989)), aff'd, 19 F.3d 66 (2d Cir. 1994)).

51/ Cf. Rafael Pinchas, 54 S.E.C. 331, 347 (1999) (rejecting applicant's contention that a "hearing panel member fell asleep during the hearing" because nothing in the record suggested "that the panel did anything other than give their full attention to the matter").

Pellegrino argues further that the "NAC, like the Hearing Panel, [gave] no standing to the best evidence in this entire matter, an actual video recording of the compliance meeting in October 2002." 52/ Although Pellegrino did not introduce this video at the hearing, the NAC admitted it into the record after Pellegrino's appeal of the hearing panel's decision, and it cited the video in its opinion. We have also considered the video as part of our de novo review of the proceeding, which cures any issue that might have existed below, 53/ and for the reasons stated above do not find that it alters our conclusions. 54/

Pellegrino also objects to the actions of counsel for NASD's Department of Enforcement. He contends that counsel brought the enforcement action in an "overzealous, career enhancing, and excessive" manner, called him "every vile name associated with being a scandalous offender," and gave a closing argument that "smear[ed]" Pellegrino "with an intentional purpose to discredit and place [him] into the category of the day's worse corporate criminals." The record establishes that Pellegrino received a fair hearing. Although counsel argued strenuously that Pellegrino failed to act appropriately at MIS, she did not smear Pellegrino, call him vile names, or compare him to corporate criminals. Counsel, moreover, did not make the findings Pellegrino appeals; the Hearing Panel and the NAC rendered the decisions sanctioning Pellegrino. Our de novo review further dissipates even the possibility of unfairness. 55/

Pellegrino complains further that NASD opposed the introduction of Dawson's testimony at the hearing, and he "challenge[s] [NASD]" to "contact[] the former District Director regarding conversations between he and [Pellegrino] and then provide a sworn affidavit to the" Commission. Before the hearing, Pellegrino sought an order pursuant to NASD Rule 9252 requiring NASD to make Dawson, an NASD employee, available for testimony. According to Pellegrino, Dawson would testify that he thought Pellegrino did a good job at MIS.

52/ The record indicates that the compliance meeting actually took place in September 2002.

53/ See Robert Bruce Orkin, 51 S.E.C. 336, 344 (1993) ("Furthermore, our de novo review of this matter cures whatever bias or disregard of precedent or evidence, if any, that may have existed below."), aff'd, 31 F.3d 1056 (11th Cir. 1994).

54/ See supra text following note 15 and accompanying note 31.

55/ See Robert Tretiak, 56 S.E.C. 209, 232 (2003) (rejecting applicant's contention "that counsel for the NASD made false and inflammatory remarks and displayed bias and prejudice" where counsel "acted within the bounds of appropriate advocacy" and, in any event, "the hearing panels and the NAC, not counsel, made the final decisions in both disciplinary matters, and our de novo review dissipates even the possibility of unfairness"); Stephen Russell Boadt, 51 S.E.C. 683, 685 (1993) (rejecting applicant's contention that "the instant sanction is the result of a vendetta against him by the Regional Counsel" because "even if we were to find that Regional Counsel were biased, that would not suggest that the fairness of the hearing itself was compromised").

Rule 9252 provides that a request that NASD compel testimony will only be granted if, among other things, the information sought is relevant, material, and non-cumulative. The Hearing Officer denied Pellegrino's motion on the ground that the testimony Pellegrino sought was not relevant and material. The Hearing Officer held that whether Dawson "stated that Respondent was doing a good job after the relevant period is not material or relevant to the allegations of this proceeding" because "the Hearing Panel is charged with determining whether Respondent discharged his supervisory duties adequately" and the "Hearing Panel will not base its decision on the beliefs of Mr. Dawson." The Hearing Officer also noted that Pellegrino could testify as to his conversations with Dawson, which Pellegrino did. 56/ We do not believe Dawson's non-appearance at the hearing prejudiced Pellegrino or denied him due process. 57/

Pellegrino also notes that "[i]t has been nearly five years that [he has] been stuck in the FINRA/NASD enforcement process" and that he does not "believe any independent, rational view of this timeline could be called fair or timely." Pellegrino establishes no prejudice from the

56/ Although Pellegrino contends that he has "been rebuffed at every attempt to bring" into the record his efforts "to establish a dialogue and relationship with the NASD and the District Director," he does not deny that he had the opportunity to, and did, testify about these conversations. Pellegrino stated that he talked with Dawson as part of "an ongoing effort to communicate, to update, [and] to ask questions" and that Dawson "acknowledged that [Pellegrino] had stepped out and always had been open and asked for direction and for help on anything that was of issue to the district office." This testimony is undisputed, and we accept it here.

57/ Cf. Guang Lu, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket 2639, 2650-51 (rejecting due process challenge to NASD's denial of applicant's motion to compel the production of certain documents, including documents in a proceeding by the Maryland Securities Division against applicant, because the "Maryland Securities Division case was not material to NASD's proceeding against [applicant]" as "NASD had the independent burden of proving its allegations against [applicant]"), petition denied, 179 Fed. Appx. 702 (D.C. Cir. 2006); A.S. Goldman & Co., 55 S.E.C. 147, 168-69 (2001) (rejecting due process challenge to NASD's denial of applicants' motion to compel the testimony of twelve other market makers in a security whom applicants contended would testify that applicant firm did not dominate the market in the security because the "testimony of other market makers as to their perception of the marketplace or the bona fides of their quotes is not probative of the issue of [the applicant firm's] domination and control of the market for" the security); U.S. Sec. Clearing Corp., 52 S.E.C. 92, 100-01 (1994) (rejecting due process challenge to NASD's refusal to allow applicants "to call two NASD employees as witnesses or admit an affidavit regarding a meeting Applicants had with these two individuals" where applicants asserted that the NASD employees "wanted to put [applicant] out of business" on the ground that "this testimony is irrelevant to the issues of" the applicants' violations because "these violations are amply supported by the record" and applicant "was permitted to testify at the hearing about these conversations").

length of the proceeding. 58/ We do not believe, moreover, that the approximately five-year period during which NASD conducted an investigation, filed a complaint, held a hearing, issued a decision, and entertained an appeal was unreasonable in light of the voluminous record. 59/

VI.

Under Section 19(e)(2) of the Securities Exchange Act of 1934, we may reduce or set aside sanctions imposed by NASD if we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 60/ NASD's Sanction Guidelines for a failure to supervise recommend a fine between \$5,000 and \$50,000 and, in egregious cases, a suspension of up to two years or a bar in any or all capacities. 61/ In this case, NASD deemed Pellegrino's supervisory failures egregious and barred him from serving in a principal capacity. 62/

Several aggravating factors suggest that the bar in a principal capacity is not excessive or oppressive. The Sanction Guidelines provide that a principal consideration in determining the appropriate sanction is whether the respondent ignored "red flags" that should have resulted in additional supervisory scrutiny. As noted above, Pellegrino ignored several red flags.

Another principal consideration affecting the sanction for a failure to supervise is the nature, extent, size, and character of the underlying misconduct. Pellegrino's supervisory failures resulted in MIS's registered representatives making numerous unsuitable recommendations and misleading customers as to the risks of the Proprietary Products over an extended period. Moreover, Pellegrino did not simply enable this underlying misconduct by supervising unreasonably; he facilitated this misconduct by promoting sales of the Proprietary Products to MIS customers rather than improving compliance. As a result, MIS customers incurred significant losses. At the hearing, it was estimated that debenture holders would receive only 30% of their investment back, and that preferred stockholders would lose their entire investment.

58/ Cf. Mark H. Love, 57 S.E.C. 315, 323 (2004) (evaluating whether length of delay in filing NASD complaint prejudiced applicant and finding no prejudice where applicant's ability to present a defense was not harmed by the passage of time since the alleged misconduct).

59/ Cf. C. James Padgett, 52 S.E.C. 1257, 1278 (1997) (rejecting contention that proceeding was not resolved within a reasonable time where proceeding was contested vigorously by the parties and the record was "immense"), aff'd, 159 F.3d 637 (D.C. Cir. 1998) (Table).

60/ 15 U.S.C. § 78s(e)(2). Pellegrino does not claim, and the record does not show, that NASD's action imposed an undue burden on competition.

61/ NASD Sanction Guidelines 108.

62/ NASD did not impose monetary sanctions in light of Pellegrino's personal bankruptcy.

Most of MIS's customers were elderly retirees. The nature, extent, size, and character of the underlying misconduct aggravates Pellegrino's violations. 63/

The third principal consideration in the sanction guideline for failing to supervise is the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls. As noted above, Pellegrino failed to enforce MIS's written supervisory procedures with respect to suitability determinations. The evidence established that Pellegrino failed to take reasonable steps to monitor and have MIS perform appropriate individual suitability determinations based on each investor's personal financial needs as prescribed in MIS's supervisory and compliance manuals; MIS based suitability solely on the Suitability Guidelines.

As further support for its sanction, NASD noted that Pellegrino did not take responsibility for his misconduct. Pellegrino states that he "cannot and will not admit responsibility for something that is untrue." The record, however, supports findings that Pellegrino committed supervisory violations. Pellegrino's refusal to recognize his misconduct "reveal[s] a fundamental misunderstanding of his supervisory duties." 64/ The principal bar "will protect investors from dealing with securities professionals who are not adequately supervised." 65/

Although Pellegrino does not address the appropriate sanction in his briefs explicitly, he asserts that he "was at the wrong place at the wrong time." The circumstances that existed at MIS before Pellegrino's arrival cannot mitigate Pellegrino's supervisory failures because Pellegrino recognized the problems MIS faced yet did not make a sufficient effort to try to correct those deficiencies. Instead, Pellegrino allowed MIS's supervisory system to remain inadequate during his more than two-year tenure as MIS's General Manager. A supervisor is "required to fulfill the obligations attached to his office for as long as he occupie[s] the

63/ In his reply brief, Pellegrino states that he "continue[s] to try and help those customers who suffered financial losses from the collapse of the issuers." He attaches to this brief a letter regarding his cooperation in a class action lawsuit by injured investors. The letter notes that Pellegrino has provided cooperation to the plaintiffs "[p]ursuant to the terms of a Settlement Agreement." We do not believe Pellegrino's cooperation pursuant to a settlement agreement justifies reducing the sanctions here. Cf. Thomas J. Donovan, Exchange Act Rel. No. 52883 (Dec. 5, 2005), 86 SEC Docket 2652, 2662 ("In any event, we do not consider Donovan's after-the-fact efforts to help Knight recover some of its losses to have much relevance to our determination of the public interest.").

64/ Horning, 92 SEC Docket at 226.

65/ Id.

position." 66/ Pellegrino did not fulfill his obligations. 67/ In this situation, we cannot find that the environment Pellegrino entered when he joined MIS warrants lesser sanctions. 68/

In addition, Pellegrino argued emphatically in his closing argument that he "did the best job [he] could to the best of [his] ability." We agree that Pellegrino made compliance efforts. He added compliance staff, reduced the number of MIS registered representatives, and instituted the 7-7-0 standard for hiring new representatives. These efforts do not mitigate Pellegrino's misconduct significantly, however, because they did not redress the risk of unsuitable recommendations stemming from the representatives' exclusive reliance on the Suitability Guidelines as a measure of suitability. The measures that Pellegrino took in response to NASD's investigation, furthermore, such as the distribution of the "Balanced Presentation and Discussion of Risk Factors" memorandum and the proscription on selling the Proprietary Products to low-risk investors, occurred too late to constitute substantial mitigation, especially as they were prompted by the investigation. Other compliance measures, such as the CIA review, do not justify lesser sanctions in light of their obvious inadequacy in the face of red flags. Instead of responding to these red flags, Pellegrino instituted measures that promoted sales of the Proprietary Products, thereby exacerbating the risk of unsuitable recommendations by representatives who were relying exclusively on the Suitability Guidelines in making those sales. Pellegrino's efforts do not mitigate his failure to act in the face of patent irregularities. 69/

66/ See Kirk A. Knapp, 50 S.E.C. 858, 864 (1992) (finding firm president "required to fulfill the obligations attached to his office for as long as he occupied the position").

67/ We do not find mitigating Pellegrino's testimony that he considered resigning but worried about finding other employment in the job market following September 11, 2001.

68/ Pellegrino notes that Sandifur settled a Commission enforcement action and was barred from serving as an officer or director of a public company for five years and fined \$150,000. We have held repeatedly, however, that "the appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings or against other individuals in the same proceeding." Benz, 52 S.E.C. at 1285 (citing Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973); Hiller v. SEC, 429 F.2d 856, 585-59 (2d Cir. 1970)). "This is especially true with regard to settled cases, where, as we have frequently pointed out, pragmatic factors may result in lesser sanctions." Anthony A. Adonnino, 56 S.E.C. 1273, 1295 (2003), aff'd, 111 Fed. Appx. 46 (2d Cir. 2004).

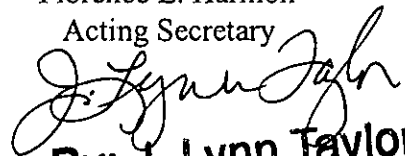
69/ Michael H. Hume, 52 S.E.C. 243, 248-49 (1995) (finding sanctions not excessive or oppressive despite supervisor's argument that "he did the best job he could" because supervisor failed to act in the face of "irregularities that he himself detected").

In barring Pellegrino in a principal capacity, NASD noted that it was "tailoring [its] sanctions to address Pellegrino's egregious supervisory failures." 70/ In declining to bar Pellegrino in all capacities, NASD determined that an additional sanction would have limited remedial value because Pellegrino's misconduct occurred "in his capacity as a supervisor, not as a general securities representative." 71/ The principal bar serves to "secure compliance with the rules, regulations, and policies of" NASD "without imposing sanctions unnecessary to remedy the misconduct." 72/ NASD appropriately tailored the sanction of a principal bar to remedy and deter Pellegrino's misconduct, and the sanction is not excessive or oppressive. 73/

An appropriate order will issue. 74/

By the Commission (Chairman COX and Commissioners CASEY, AGUILAR, and PARADES); Commissioner WALTER not participating.

Florence E. Harmon
Acting Secretary


By: J. Lynn Taylor
Assistant Secretary

70/ The Hearing Panel had imposed a six-month suspension in all capacities. The NAC modified this sanction to the bar in a principal capacity. As discussed below, we believe the principal bar is more appropriately tailored to address Pellegrino's misconduct.

71/ NASD also noted, as do we, that terminating the firm's association with the Great Northern representatives was mitigating.

72/ Sisung Sec. Corp., Exchange Act Rel. No. 56741 (Nov. 5, 2007), 91 SEC Docket 3050, 3064 (quoting Boruski v. SEC, 289 F.2d 738, 740 (2d Cir. 1961)).

73/ See General Sec. Corp. v. SEC, 583 F.2d 1108, 1109-10 (9th Cir. 1978) (finding Commission decision affirming bar in a principal capacity imposed by NASD "sound and rational" where Commission noted that the sanctions NASD imposed "afforded some leniency in that 'no fine was assessed and the sanction imposed on [applicant] was appropriately tailored to fit his failings as a manager and supervisor'").

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59125 / December 19, 2008

Admin. Proc. File No. 3-12941

In the Matter of the Application of

RONALD PELLEGRINO
825 Sudden Valley
Bellingham, WA 98229

For Review of Disciplinary Action Taken by

NASD

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES
ASSOCIATION

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

ORDERED that the disciplinary action taken by NASD against Ronald Pellegrino be, and
it hereby is, sustained.

By the Commission.

Florence E. Harmon
Acting Secretary


By: J. Lynn Taylor
Assistant Secretary

*Commissioner Walter
not participating*

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES AND EXCHANGE ACT OF 1934
Rel. No. 59137 / December 22, 2008

Admin. Proc. File No. 3-12952

In the Matter of the Application of

JASON A. CRAIG
57401 Robert Street
Washington Township, MI 48094

For Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY
PROCEEDINGS

Violations of Rules of Fair Practice

Misstatements on Form U4

Registered representative of member firm of registered securities association submitted a Form U4 that failed to disclose prior felony charges and a misdemeanor conviction. Held, association's findings of violation and sanction imposed are sustained.

APPEARANCES:

Jason A. Craig, pro se.

Marc Menchel, Alan Lawhead, and Jennifer C. Brooks for Financial Industry Regulatory Authority, Inc.

Appeal filed: February 6, 2008
Last brief received: June 19, 2008

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I.

Jason A. Craig ("Craig"), a former registered representative of NASD member firm Hantz Financial Services, Inc. ("Hantz"), seeks review of NASD disciplinary action. 1/ NASD found that Craig willfully failed to disclose four felony charges and one misdemeanor conviction on his Uniform Application for Securities Industry Registration ("Form U4") in violation of NASD Membership Rule IM-1000-1 and Conduct Rule 2110. NASD barred Craig in all capacities. 2/ We base our findings on an independent review of the record.

II.

Craig's Criminal History

It is undisputed that, at the time Craig sought to associate with Hantz, he had five felony charges and one misdemeanor conviction on his criminal record, all of which occurred in Michigan. On August 30, 2002, Craig was charged with possession of a controlled substance, a felony offense. 3/ On May 27, 2003, Craig was charged with the felony of uttering and publishing. 4/ Craig altered credit-union checks originally payable to creditors to make them payable to himself. The charge was reduced to misdemeanor larceny, and Craig pled guilty to that offense on July 24, 2003. 5/ On September 20, 2003, Craig was again charged with possession of a controlled substance, a felony. 6/ On July 19, 2004, Craig was charged with two

1/ On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Because the disciplinary action here was instituted before that date, we continue to use the designation NASD.

2/ NASD also assessed costs in the amount of \$2,050.72.

3/ This charge was reduced to a misdemeanor to which Craig pled guilty in January 2003. After Craig completed probation in June 2005, the court set aside the guilty plea and dismissed the case.

4/ Uttering and publishing involves forging, altering, or counterfeiting a record or document with the intent to injure or defraud. See Mich. Comp. Laws § 750.249.

5/ The court later set aside this conviction on March 22, 2006.

6/ The disposition of this charge is not apparent from the record.

additional offenses: a felony "no-account check violation" charge for writing checks drawn on a financial institution at which he had no account and a felony charge for forging a driver's license. In January 2007, the court allowed Craig to plead guilty to misdemeanor disorderly conduct for these offenses.

Craig Interviews with Hantz and Completes Form U4

Craig first registered as a general securities representative in 2000. In August 2004, Craig applied for a registered-representative position with Hantz. On August 4, 2004, Craig interviewed with Hantz's director of recruiting, Linda Horney ("Horney"). Craig also met with other Hantz employees on August 10, 2004 as part of a half-day interview session. During these interviews, Craig did not mention his criminal history.

On August 18, 2004, Craig had a final interview with Senior Vice President Linda McClain ("McClain"). In this meeting, McClain offered Craig a position and asked him if anything in his background would prevent Hantz from hiring him. In response to this question, Craig answered "no." On August 24, 2004, Craig again met with Horney to complete his Form U4 and other required paperwork. Craig then told Horney that he had been charged with one felony. Horney directed Craig to disclose that information on his Form U4 and to provide a description of the charge on the attached Disclosure Reporting Page. Question 14A(1)(b) asked Craig, "Have you ever been charged with a felony?" Craig answered "yes" and explained on the Disclosure Reporting Page that he had been charged with possession of marijuana and cocaine on August 8, 2002 and that the charge was still pending. At the hearing, Craig testified that he was referring to the August 30, 2002 felony charge for possession of a controlled substance, but had provided the wrong date.

Craig did not disclose or provide details about any of the other four felony charges. Craig also failed to disclose his misdemeanor conviction on his Form U4. Question 14B(1)(a) asked Craig, "Have you ever been convicted of or pled guilty . . . to a misdemeanor involving . . . wrongful taking of property?" Craig answered "no" to this question, despite having been convicted of misdemeanor larceny on July 24, 2003. Craig also answered "no" to Question 14B(1)(b), which asked, "Have you ever been charged with a misdemeanor specified in 14B(1)(a)?"

Hantz Terminates Craig for Failure to Disclose Criminal History

Craig began working for Hantz on September 20, 2004. As part of his orientation, Hantz fingerprinted Craig and mailed the prints to NASD for a routine background check. Soon thereafter, NASD notified Hantz about a May 2003 felony arrest that did not appear on Craig's

Form U4. ^{7/} When Horney questioned Craig about the charge, Craig told Horney that he must have provided the wrong date on his Form U4. Horney also asked Craig for documentation about the charge, which Craig never provided.

On October 7, 2004, NASD notified Hantz of two additional, undisclosed charges that appeared in Craig's background check. ^{8/} Horney testified that when she asked Craig about these charges, Craig became "very nervous" and "confused" and could not explain why he failed to disclose them. Horney then referred the matter to McClain, who met with Craig on the same day. Craig told McClain that his attorney had advised him that the charges were expunged and that he did not need to disclose them. However, Craig was unable to provide McClain with any details of the charges. McClain terminated Craig's employment in that meeting. A few days later, Craig's attorney called McClain and told her that the charges had never been expunged.

NASD Proceedings

On November 8, 2004, NASD staff sent Craig a request for information and documentation regarding the disclosures he made on his Form U4. Craig responded in writing, stating that he was unaware that he needed to disclose his criminal record and that he had misread the questions. Craig did not provide any documentation with respect to his criminal record in his response. On August 30, 2005, NASD filed a complaint against Craig alleging failure to disclose on his Form U4 four felony charges and one misdemeanor conviction. Craig admitted to this criminal background in his answer, but argued that his conduct did not violate NASD rules.

On August 28, 2006, the Hearing Panel found that Craig had willfully violated NASD Membership Rule IM-1000-1 and Conduct Rule 2110. The Hearing Panel also found not credible Craig's testimony that he did not disclose all of the felony charges and the conviction on Form U4 because he believed they either were, or shortly would be, expunged. The Hearing Panel found that Craig's conduct was egregious and barred him in all capacities. Craig then appealed to the National Adjudicatory Council ("NAC"), which on December 27, 2007, affirmed the Hearing Panel's findings of violation and sanctions imposed. This appeal followed.

^{7/} This arrest led to the September 2003 charge for possession of a controlled substance. See supra text accompanying note 6.

^{8/} NASD notified Hantz of the August 2002 offense for felony possession of a controlled substance and the May 2003 offense for felony uttering and publishing.

III.

Membership Rule IM-1000-1 prohibits the filing, in connection with membership or registration as a registered representative, of information so incomplete or inaccurate as to be misleading. ^{9/} This rule applies to Form U4, which is used by NASD and other self-regulatory organizations to determine the fitness of applicants for registration as securities professionals. ^{10/} The candor and forthrightness of applicants is critical to the effectiveness of this screening process. ^{11/} Every person submitting Form U4 has the obligation to ensure that the information provided on the form is true and accurate. ^{12/} Filing a misleading Form U4, in addition to violating Membership Rule IM-1000-1, violates the standard of just and equitable principles of trade to which every person associated with a NASD member is held. ^{13/}

It is undisputed that, on August 24, 2004, Craig signed and submitted a Form U4 in connection with his registration with Hantz that failed to disclose four of the five felonies with which he was charged and to disclose that Craig had been convicted of misdemeanor larceny. In so doing, he violated Membership Rule IM-1000-1.

Craig provided shifting and evolving explanations for his failure to disclose the criminal charges against him. The first time Horney asked Craig about the undisclosed August 2002 charge, Craig explained that he had provided the wrong date on his Form U4. When Horney confronted Craig about the two additional charges that NASD found, Craig became "nervous" and could not explain why he had not disclosed them. That same day, Craig admitted to McClain that he had been charged with various crimes but explained that his attorney told him not to disclose them because they had been expunged. At the hearing, Craig testified that he did not disclose all of the felony charges and the conviction on Form U4 because he believed they were, or shortly would be, expunged.

^{9/} NASD Manual at 3111.

^{10/} Daniel Richard Howard, 55 S.E.C. 1096, 1101 (2002), aff'd 77 Fed. Appx. 2 (1st Cir. 2003) (unpublished); Rosario R. Ruggiero, 52 S.E.C. 725, 728 (1996); Thomas R. Alton, 52 S.E.C. 380, 382 (1995), aff'd 105 F.3d 664 (9th Cir. 1996); see also Guang Lu, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket 2639, aff'd 179 Fed. Appx. 702 (D.C. Cir. 2006).

^{11/} Alton, 52 S.E.C. at 382.

^{12/} Guang Lu, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket at 2639, 2648 (citing Robert E. Kauffman, 51 S.E.C. 838, 840 (1993), aff'd 40 F.3d 1240 (3d Cir. 1994)).

^{13/} Alton, 52 S.E.C. at 382 (citing Kauffman, 51 S.E.C. at 840; Roy Ray Seaton, 47 S.E.C. 131, 133-34 (1979)); NASD Manual (2001 ed.) at 4111.

The Hearing Panel found Craig's testimony not credible. "Credibility determinations of an initial fact finder are entitled to considerable weight because they are based on hearing the witnesses' testimony and observing their demeanor." 14/ Such determinations "can be overcome only where the record contains substantial evidence for doing so." 15/

Horney's and McClain's consistent testimony further supports the Hearing Panel's credibility finding. Both witnesses testified that Craig was evasive and could not explain his failure to disclose his criminal record on multiple occasions. 16/ We have considered the totality of the record and find no reason to overturn the Hearing Panel's credibility determination.

Craig claimed at various points that he thought the criminal charges had been or shortly would be expunged, a claim the Hearing Panel also found to be not credible. However, even absent such a credibility finding, Craig's claims regarding expungement are unavailing. Subsequent expungement after the filing of the Form U4 is inconsequential because "[t]he question presented is the status of his conviction on the date he made the representations on the Form U-4." 17/ Moreover, even if Craig's convictions had been expunged at the time he filed his Form U4, NASD required Craig to provide proof of the expungement so that NASD could determine whether Craig should report the charges. 18/

14/ Joseph Abbondante, Exchange Act Rel. No. 53066 (Jan. 6, 2006), 87 SEC Docket 203, 209 n.21 petition denied, 209 Fed. Appx. 6 (2d Cir. 2006) (unpublished); see also Laurie Jones Canady, 54 S.E.C. 65, 78 n.23 (1999).

15/ Canady, 54 S.E.C. at 78 (citing Anthony Tricarico, 51 S.E.C. 457, 460 (1993); Universal Camera v. NLRB, 340 U.S. 474 (1950)).

16/ See Canady, 54 S.E.C. at 79 n.25 (citing Frank J. Custable, Jr., 51 S.E.C. 643, 648 (1993)).

17/ Alton, 52 S.E.C. at 383 n.8 (holding that vacation of conviction three weeks after filing of Form U4 was irrelevant).

18/ See NASD, Form U4 and U5 Interpretive Questions, [http://www.NASD.org/Regulatory Systems/CRD/FilingGuidance/p005243](http://www.NASD.org/RegulatorySystems/CRD/FilingGuidance/p005243); see also Alton v. SEC, 105 F.3d at 664 n.1 (noting that, because Form U4 asks whether an applicant has been convicted, any subsequent expungement may be irrelevant).

NASD found that Craig's conduct was willful. 19/ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." 20/ The laws do not require that the actor "also be aware that he is violating one of the Rules or Acts." 21/ We thus need to find only that Craig voluntarily committed the acts that constituted the violation, not that Craig was aware of the rule he violated or that he acted with a culpable state of mind. The evidence shows that Craig provided voluntarily false answers on his Form U4 and thus willfully violated Membership Rule IM-1000-1 and Conduct Rule 2110.

Craig claims that he was unaware of his larceny conviction because he did not have an attorney present when the judge actually entered the conviction. The record in this case shows that Craig had an attorney present when he pled guilty to misdemeanor larceny on July 24, 2003. At that hearing, the judge told Craig that if he completed community service, the judge would strike the conviction from Craig's record. Craig failed to complete the community service, and the judge imposed the conviction on July 7, 2004. Craig did not have an attorney present at the July 7, 2004 hearing. However, Craig testified that he was aware of what he had to do to be relieved of his plea and of the status of his community service. If Craig had any doubt about the disposition of his conviction, it was his duty to determine whether the information he was providing on Form U4 was complete and accurate. 22/

Equally unpersuasive is Craig's argument that he believed he needed to disclose only his first felony charge because Hantz's background check would uncover the rest of his criminal history. Form U4 clearly requires the applicant to list all felony charges and misdemeanor charges and convictions relating to the wrongful taking of property. The effectiveness of the form depends on applicants' candid disclosures. 23/ Moreover, Craig cannot shift his responsibility to comply with NASD rules to his firm. 24/

19/ Craig argues that he had no motive to file an incomplete Form U4 because he would not have risked his ability to work in the securities industry in order to obtain a position with Hantz. Motive, however, is not necessary to find that misconduct occurred. See Tricarico, 51 S.E.C. 457, 459 n.3 (1993) (citing Kenneth Sonken, 48 S.E.C. 832, 835-36 (1987)).

20/ Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000).

21/ Id.

22/ See James Alan Schneider, 52 S.E.C. 840, 843 (1996), aff'd, 118 F.3d 1577 (3d Cir. 1997).

23/ Alton, 52 S.E.C. at 382.

24/ See, e.g., Jay Alan Ochanpaugh, Exchange Act Rel. No. 54363 (Aug. 25, 2006), 88 SEC Docket 2653, 2660-61 (citing Joseph G. Chiulli, 54 S.E.C. 515, 523 (2000)).

Craig contends that he did not understand the questions on the Form U4, that he did not know that he needed to disclose misdemeanors, and that his fatigue, due to completing the form after an eleven-hour work day, magnified his confusion. We have previously held that "[i]gnorance of the [NASD]'s rules is no excuse for their violation. Participants in the securities industry must take responsibility for compliance and cannot be excused for lack of knowledge, understanding or appreciation of these requirements." 25/

We find that Craig's failure to disclose on his Form U4 his four felony charges and his misdemeanor larceny conviction willfully violated Membership Rule IM-1000-1 and Conduct Rule 2110.

IV.

We sustain NASD sanctions unless we find, giving due regard to the public interest and the protection of investors, that the sanctions are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition. 26/ NASD barred Craig in all capacities. We sustain the sanction because it is neither excessive nor oppressive and will protect investors and the public interest.

NASD's determination to bar Craig is consistent with NASD Sanction Guidelines. 27/ For filing a false, misleading, or inaccurate Form U4, the Guidelines recommend a fine between \$2,500 and \$50,000 and a suspension for five to thirty business days. 28/ Where an individual engaged in egregious conduct, such as misconduct involving inaccurate or misleading filings that fail to disclose a statutory disqualification, the Guidelines recommend up to a two-year

25/ See Richard J. Lanigan, 52 S.E.C. 375, 378 n.13 (1995) (citing David A. Gingras, 50 S.E.C. 1286, 1291 n.12 (1992); Kirk A. Knapp, 51 S.E.C. 115, 129 (1992)).

26/ Securities Exchange Act of 1934, Section 19(e)(2), 15 U.S.C. § 78s(e)(2). Craig does not claim, nor does the record show, that NASD's action imposed an unnecessary or inappropriate burden on competition.

27/ NASD promulgated the Sanction Guidelines in an effort to achieve greater consistency, uniformity, and fairness in the sanctions that are imposed for violations. NASD Sanction Guidelines at 1 (2007 ed.). Since 1993, NASD has published and distributed the Sanction Guidelines so that members, associated persons, and their counsel will have notice of the types of disciplinary sanctions that may be applicable to various violations. Id. The Guidelines are not NASD rules that are approved by the Commission, but NASD-created guidance for NASD Adjudicators—which the Guidelines define as Hearing Panels and the NAC. Id. Although the Sanction Guidelines do not bind the Commission, they serve as a benchmark in reviewing sanctions under Exchange Act Section 19(e)(2).

28/ NASD Sanction Guidelines at 73-74.

suspension or a bar in any or all capacities. 29/ In determining the proper sanction, the Guidelines provide three "Principal Considerations": (1) the nature and significance of the information at issue; (2) whether the failure resulted in a statutorily disqualified individual becoming associated with a firm; and (3) whether the member firm's conduct resulted in harm to a registered person, another member firm, or any other person or entity. 30/

The information Craig withheld was significant. Form U4 "is a critical tool for self-regulatory organizations to determine the fitness of applicants for registration as securities professionals." 31/ Member firms use Form U4 to screen applicants for employment and to establish procedures to supervise employees with criminal or disciplinary histories. Information concerning Craig's criminal history would have been significant to Hantz in determining whether to employ Craig and, if it did, what supervisory procedures were necessary to protect investors.

Craig also failed to disclose that he was statutorily disqualified. Any person who has been convicted of a misdemeanor involving the larceny of funds within the ten years preceding the filing of a Form U4 is statutorily disqualified. 32/ A person who is statutorily disqualified cannot become associated with a NASD member unless that member applies for and receives a waiver from NASD. 33/ Craig's failure to provide accurate information on his Form U4 resulted in a statutorily disqualified person becoming associated with a member firm without proper approval or supervision.

Craig's conduct was egregious and intentional. Craig asserted in his brief to us that he believed his criminal charges would be a "problem" and that he deliberately failed to disclose them. 34/ He had several opportunities to disclose his criminal history to Hantz and failed to do so, even when directly asked by Horney and McClain. After Craig submitted his Form U4,

29/ Id.

30/ Id. NASD does not allege that Principal Consideration (3) is applicable to this case.

31/ Toth, Exchange Act Rel. No. 58074 (July 1, 2008), ___ SEC Docket ___, appeal filed, No. 08-3289 (3d Cir. July 31, 2008); see also Howard, 55 S.E.C. at 1103 n.16 (noting the "important function served by the information made available through Form U-4").

32/ Securities Exchange Act of 1934, Sec. 3(a)(39)(F), 15 U.S.C. § 78c(39)(F); NASD By-Laws, Art. III Sec. 4(g) (adopting SEC definition).

33/ NASD By-Laws, Art. III Sec. 3.

34/ NASD Sanction Guidelines at 74; see also Alton, 52 S.E.C. 380 (barring and fining applicant \$50,000 for failing to disclose a felony conviction of perjury even though it was vacated three weeks after completing the Form U4).

Horney twice approached him about the undisclosed charges and requested documentation on their status. Despite these requests, Craig claimed ignorance and never provided documentation. 35/

Craig also tried to shift blame to Horney for his incomplete disclosures. Craig testified that he did not have all of the information with him that he needed to complete his Form U4 and that Horney instructed him to complete the form to best of his ability. However, the Hearing Panel found Craig not to be credible. Moreover, if Craig did not have the information he needed or was unsure of how to answer a question, he should have postponed completing his Form U4 until he could provide accurate responses. 36/ Craig's failure to take responsibility for his conduct makes recurrence more likely.

Craig raises a number of facts that he alleges mitigate his conduct. He argues that the lawyer who represented him in front of the Hearing Panel provided him with ineffective assistance of counsel. Craig claims that his lawyer did not warn Craig that the Hearing Panel could impose higher sanctions than the settlement NASD offered him. 37/ Craig also argues that his lawyer did not adequately prepare for the hearing. We have reviewed the record and find that NASD provided Craig with a fair proceeding, as required under Section 15A(b)(8) of the Securities Exchange Act of 1934. 38/ Through his attorney, Craig had the opportunity to present evidence and arguments in his favor, to testify, and to cross-examine witnesses. Moreover, there is no right to counsel in NASD disciplinary proceedings and Craig must accept the consequences of the actions of the agent whom he freely selected. 39/ Furthermore, the Sanction Guidelines,

35/ Craig claims that he provided Horney with his attorney's phone number so that she could obtain the necessary documentation. Regardless of whether Craig gave Horney his attorney's number, it was Craig's responsibility to ensure that Hantz had all of the required information. See, e.g., Dennis A Pearson, Exchange Act Rel. No. 54913 (Dec. 11, 2006), 89 SEC Docket 1627, 1633-34 (holding that an associated person cannot satisfy an information request simply by referring the matter to an attorney).

36/ See Schneider, 52 S.E.C. at 843 (holding that applicant should have checked with proper authority if he was unsure how to respond accurately to a question on Form U4).

37/ According to Craig, NASD initially offered to settle the action with an 18-month suspension and a \$10,000 fine.

38/ 78 U.S.C. § 78o-3(b)(8).

39/ Link v. Wabash R. Co., 370 U.S. 626, 633-34 (1962); Mark H. Love, 57 S.E.C. 315, 326 (2004).

which are publicly available, state that imposing lower sanctions in settlement provides parties with incentives to settle, thus avoiding cost- and time-consuming adversary proceedings. 40/

Craig next argues that his sanction should be reduced because Hantz, in an unrelated proceeding, received a lower punishment. Craig claims that NASD imposed a \$500,000 fine on Hantz and suspended its owner for thirty days after Hantz falsely represented itself as an independent-investment firm. However, the sanctions Hantz received for an unrelated violation have no bearing on the sanction NASD imposed upon Craig. In any event, because "the appropriate remedial action depends on the facts and circumstances of each particular case," the proper sanction "cannot be precisely determined by comparison with action taken in other cases." 41/

Craig asserts that we should reduce the sanction because he repaid the bank for his no-account check violation and the credit union for his larceny conviction. The Sanction Guidelines allow restitution to be considered if the respondent voluntarily and reasonably attempted, prior to detection or intervention, to reimburse the harmed parties. 42/ However, Craig reimbursed the bank only pursuant to his sentence for the no-account check violation. Likewise, Craig repaid the credit union for the altered checks only after the credit union sent him a letter demanding restitution. Craig's restitution, made after detection, is not mitigating.

Craig further requests that his sanctions be reduced because he claims that, since the incident at issue here, he has not been arrested in four years and has remained sober. Craig also states that he cares for his mother, who is ill. Craig's current actions do not outweigh the need to protect the investing public. 43/ Craig's intentional failure to disclose material information on Form U4 and his subsequent obfuscation raise serious doubts about Craig's ability to meet the high standards of those employed in the securities industry. The fact that three of Craig's felony

40/ NASD Sanction Guidelines at 1; see also Dennis Todd Lloyd Gordon, Exchange Act Rel. No. 57655 (Apr. 11, 2008), __ SEC Docket __ ("It is well established that those who offer to settle may properly receive lesser sanctions than they otherwise might have."); Howard R. Perles, 55 S.E.C. 686, 710 (2002) (citing Richard J. Puccio, 52 S.E.C. 1041, 1045 (1996)).

41/ Pac. On-Line Trading & Sec., Inc., 56 S.E.C. 1111, 1123 (2003) (citing John R. D'Alessio, 56 S.E.C. 396, 427 (2003), aff'd, 380 F.3d 112 (2d Cir. 2004); Butz v. Glover Livestock Comm'n Co., Inc., 411 U.S. 182, 187 (1973)); see also Alton, 52 S.E.C. at 387 n.27 (citation omitted); Hiller v. SEC, 429 F.2d 856, 858-59 (2d Cir. 1970); First Choice Securities Corp., 50 S.E.C. 1167, 1172 (1992)).

42/ NASD Sanction Guidelines at 6.

43/ See Lee Gura, 57 S.E.C. 972, 976-77 (2004).

charges and his misdemeanor conviction involved the wrongful taking of property and forgery are further evidence of his inability to meet these standards. 44/

Craig also argues as mitigating his lack of disciplinary history and the "amount of time, money, and loss of work" suffered as a result of his conduct. We have held that a lack of disciplinary history is insufficient to mitigate sanctions. 45/ We also do not consider mitigating the economic disadvantages Craig alleges he suffered because they are a result of his misconduct. 46/

We find that a bar in this case is remedial and not punitive. The information Craig failed to disclose was material in determining whether Craig could fulfill the high standards of conduct demanded of associated persons. By not disclosing the information, Craig impeded Hantz from adequately screening his application and deprived Hantz of its duty to protect the investing public. Hantz could not accurately determine whether Craig was suitable for employment or

44/ See Brian G. Allen, 50 S.E.C. 509, 510 (1991) ("There can hardly be more serious conduct in the securities business than forgery and theft.").

45/ See John D. Audifferen, Exchange Act Rel. No. 58230 (July 25, 2008), __ SEC Docket __ (citing Michael A. Rooms, Exchange Act Rel. No. 51467 (Apr. 1, 2005), 85 SEC Docket 444, aff'd, 444 F.3d 1208, 1214 (10th Cir. 2006) (lack of disciplinary history is not a mitigating factor in NASD disciplinary proceeding); Robert J. Prager, Exchange Act Rel. No. 51974 (July 6, 2005), 85 SEC Docket 3413, 3436 n.66 (rejecting argument that respondent's lack of disciplinary history serves as a mitigating factor)). In addition, Craig has filed affidavits from a potential employer offering to supervise Craig should the bar be lifted. These affidavits, as well as an affidavit from Craig regarding his rehabilitation, an excerpt from his investigative testimony, and a toxicity report, were never admitted into evidence. The NAC declined to admit this new evidence on appeal. The NAC determined, under NASD Rule 9346(b), that Craig failed to provide good cause for failing to introduce the evidence in front of the Hearing Panel. Craig has not sought to adduce this evidence before the Commission.

46/ Hans N. Beerbaum, Exchange Act Rel. No. 55731 (May 9, 2007), 90 SEC Docket 1863, 1871-72.

whether he needed heightened supervision. The bar will prevent Craig from making incomplete and inaccurate disclosures in the future and will impress upon others the importance of the accuracy of the information in Form U4. 47/

Accordingly, we find this sanction satisfies the standards of Exchange Act Section 19(e) in that it is neither excessive nor oppressive.

An appropriate order will issue. 48/

By the Commission (Chairman COX and Commissioners CASEY, AGUILAR, and PAREDES); Commissioner WALTER not participating.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

47/ Paz Secs., Inc. v. SEC, 494 F.3d 1059, 1066 (D.C. Cir. 2007) ("Although general deterrence is not, by itself, sufficient justification for expulsion or suspension . . . it may be considered as part of the overall remedial inquiry.") (quoting McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005)).

48/ We have considered all of the arguments advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59137 / December 22, 2008

Admin. Proc. File No. 3-12952

In the Matter of the Application of

JASON A. CRAIG
57401 Robert Street
Washington Township, MI 48094

For Review of Disciplinary Action Taken by

NASD

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY NASD

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

ORDERED that the disciplinary action taken by NASD against Jason A. Craig be, and it hereby is, sustained.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59133)

Order Granting Application for a Temporary Conditional Exemption Pursuant to Section 36(a) of the Exchange Act by the International Securities Exchange, LLC Relating to the Acquisition by International Securities Exchange Holdings, Inc. of an Electronic Communications Network

December 22, 2008

I. Introduction

On December 3, 2008, the International Securities Exchange, LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Rule 0-12¹ under the Securities Exchange Act of 1934 ("Exchange Act"), an application for an exemption under Section 36(a)(1) of the Exchange Act² from the rule filing requirements of Section 19(b) of the Exchange Act³ with respect to the acquisition by International Securities Exchange Holdings, Inc. ("ISE Holdings"), the parent of ISE, of an equity interest in Direct Edge Holdings, LLC ("DE Holdings").⁴ DE Holdings is the sole owner of Direct Edge ECN LLC ("DECN"), a registered broker-dealer and electronic communications network ("ECN"). This order grants the request for temporary exemptive relief, subject to the satisfaction of certain conditions, which are outlined below.

II. Application for Temporary Conditional Exemption from Section 19(b) Rule Filing Requirements

On December 3, 2008, the ISE requested that the Commission grant a temporary exemption, subject to certain conditions, under Section 36 of the Exchange Act from the rule

¹ 17 CFR 240.0-12.

² 15 U.S.C. 78mm(a)(1).

³ 15 U.S.C. 78s(b).

⁴ See letter from Michael J. Simon, General Counsel and Secretary, ISE, to Florence Harmon, Acting Secretary, Commission, dated December 3, 2008 ("Exemption Request").

filing procedures of Section 19(b) of the Exchange Act in connection with ISE Holdings' acquisition of an equity interest in DE Holdings and the operation of DECN as a facility of ISE.⁵

According to the Exemption Request, on August 22, 2008, ISE Holdings, DE Holdings, ISE Stock Exchange, LLC ("ISE Stock"), a Delaware limited liability company that operates a marketplace for the trading of U.S. cash equity securities by Equity Electronic Access Members ("Equity EAMs") of ISE (the "Facility"),⁶ and certain other parties entered into a Transaction Agreement whereby, among other things: (1) ISE Holdings will purchase a 31.54% equity interest in DE Holdings, the sole owner of DECN, a registered broker-dealer and ECN; and (2) ISE Stock will merge into Maple Merger Sub, a wholly-owned subsidiary of DE Holdings ("Merger Sub"), which will operate the Facility following the closing of the transaction (the "Closing"). After the Closing, the Facility will continue to be a facility of ISE.

DECN's current relationship with ISE is limited to participating in ISE as an Equity EAM of ISE, and DECN displays its limit orders on the Facility in the same manner as other ECNs that display their limit orders on the Facility. Neither ISE Holdings nor ISE currently has an ownership interest in DECN. After the Closing, DECN will continue to operate as an ECN and to submit limit orders to the Facility for display and execution.

Following the Closing, DECN also will become a facility, as defined in Section 3(a)(2) of the Exchange Act, of ISE because it will be an affiliate of ISE used for the purpose of effecting and reporting securities transactions. Specifically, (1) DECN will continue to operate as an ECN and will continue to submit its limit orders to the Facility for display and execution;⁷ and (2)

⁵ See Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c3(a)(2) (definition of "facility").

⁶ ISE Stock operates the Facility under the rules of the ISE as a facility, as defined in Section 3(a)(2) of the Exchange Act, of ISE.

⁷ In its Exemption Request, ISE stated that it would be impracticable for DECN to display its limit orders other than on the Facility. See Exemption Request at 3.

DECN will become an affiliate of ISE through ISE Holdings' equity interest in DE Holdings. Because DECN will be a facility of ISE, ISE would be obligated, under Section 19(b) of the Exchange Act, to file with the Commission proposed rules governing the operation of DECN's systems and subscriber fees. In its Exemption Request, ISE states that if the Commission does not grant the exemption, ISE will be forced to terminate DECN's operations upon Closing because DECN may not operate as a facility of ISE without the ISE's filing with the Commission proposed rules governing the operation of DECN's systems and subscriber fees.⁸ ISE also stated that it would be unduly burdensome and inefficient to require DECN's operating rules to be separately subjected to the Section 19(b) rule filing and approval process because DECN would operate only temporarily as a facility of ISE while the Commission considers the Form 1 Applications, as discussed below.

In its Exemption Request, ISE noted that DECN's average daily "touched" volume in U.S. listed equity securities accounts for 10% of the average daily U.S. traded volume in such securities.⁹ Accordingly, ISE believes that the termination of DECN's operations potentially could harm investors, disrupt the functioning of an orderly market, and eliminate a point of access to the markets.¹⁰

ISE noted, further, that DE Holdings has been engaged with the Commission in the filing of two Form 1 applications (the "Form 1 Applications") to register two of DE Holdings' wholly-owned subsidiaries (the "Exchange Subsidiaries") as national securities exchanges.¹¹ According

⁸ See Exemption Request at 3.

⁹ Average daily touched volume includes trades matched on DECN and orders routed to other market centers for execution. See Exemption Request at note 4 and accompanying text.

¹⁰ See Exemption Request at 3.

¹¹ See Exemption Request at 2.

to ISE, DECN intends to file a "Cessation of Operations Report" with the Commission and to cease operations as an ECN shortly following any Commission approval of the Form 1 Applications.¹² Also, according to the ISE, approval of the Form 1 Applications would allow the Exchange Subsidiaries to operate in place of DECN.¹³ Because DECN would cease to operate as an ECN if the Commission approves the Form 1 Applications, ISE expects that DECN would operate as a facility of ISE for a relatively brief period of time.¹⁴

ISE has asked the Commission to exercise its authority under Section 36 of the Exchange Act and grant the ISE a temporary, 180-day exemption from the Section 19(b) rule filing requirements that would apply to DECN as a facility of ISE. The temporary exemption would commence immediately upon the Closing and would allow DECN to continue to operate following the Closing, subject to certain conditions, while DE Holdings prepares the Form 1 Applications. ISE believes that the temporary exemption will help to ensure an orderly transition from DECN to the proposed Exchange Subsidiaries.¹⁵

ISE stated, in addition, that the exemption will not diminish the Commission's ability to monitor ISE and DECN. In this regard, ISE noted that to the extent that ISE makes changes to its systems, including the Facility, during the exemption period, or thereafter, it remains subject to Section 19(b) and thus obligated to file proposed rule changes with the Commission.¹⁶

¹² Id.

¹³ Id. If the Commission approves the Form 1 Applications, each of the Exchange Subsidiaries would be registered as a national securities exchange under Section 6 of the Exchange Act. In addition, following any Commission approval of the Form 1 Applications and the Exchange Subsidiaries' commencement of operations as national securities exchanges, DE Holdings would no longer operate DECN as an ECN and the Facility would cease operations.

¹⁴ Id.

¹⁵ Id.

¹⁶ See Exemption Request at 3.

Further, in the Exemption Request, ISE committed to satisfying certain conditions, which are outlined below. For example, as a condition to the exemption, ISE will be required to submit proposed rule changes with respect to any material changes to DECN's functions during the exemption period.¹⁷ ISE noted, however, that neither ISE nor DECN anticipates any material changes to DECN's functionality during the exemption period.¹⁸

III. Order Granting Temporary Conditional Section 36 Exemption

In 1996, Congress gave the Commission greater flexibility to regulate trading systems, such as DECN, by granting the Commission broad authority to exempt any person from any of the provisions of the Exchange Act and to impose appropriate conditions on their operation.¹⁹ Specifically, NSMIA added Section 36(a)(1) to the Exchange Act, which provides that "the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."²⁰ In enacting Section 36, Congress indicated that it expected that "the Commission will use this authority to promote efficiency, competition and capital formation."²¹ It particularly intended to give the Commission sufficient flexibility to respond to changing market and competitive conditions:

¹⁷

Id.

¹⁸

See Exemption Request at note 3.

¹⁹

15 U.S.C. 78mm(a). Section 36 of the Exchange Act was enacted as part of the National Securities Markets Improvements Act 1996, Pub. L. No. 104-290 ("NSMIA").

²⁰

15 U.S.C. 78mm(a)(1).

²¹

H.R. Rep. No. 104-622, 104th Cong., 2^d Sess. 38 (1996).

The Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the SEC general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues relating to the securities markets more generally. For example, the SEC could deal with the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework.²²

In 2004, the Commission exercised its Section 36 exemptive authority to grant a temporary exemption, subject to certain conditions, from the Section 19(b) rule filing requirements in connection with the acquisition by The Nasdaq Stock Market, Inc. ("Nasdaq") of Brut, LLC, the operator of the Brut ECN.²³ ISE's requested relief for a temporary exemption from the Section 19(b) rule filing requirements in connection with ISE Holdings' acquisition of an equity interest in DE Holdings is subject to certain conditions, as set forth below, that are substantially similar to the conditions included in the Nasdaq Order.

Section 19(b)(1) of the Exchange Act requires a self-regulatory organization ("self-regulatory organization" or "SRO"), including ISE, to file with the Commission its proposed rule changes accompanied by a concise general statement of the basis and purpose of the proposed rule change. Once a proposed rule change has been filed with the Commission, the Commission is required to publish notice of it and provide an opportunity for public comment. The proposed rule change may not take effect unless approved by the Commission by order, unless the rule change is within the class of rule changes that are effective upon filing pursuant to Section 19(b)(3)(A) of the Act.²⁴

²² S. Rep. No. 104-293, 104th Cong., 2^d Sess. 15 (1996).

²³ See Securities Exchange Act Release No. 50311 (September 3, 2004), 69 FR 54818 (September 10, 2004) ("Nasdaq Order").

²⁴ 15 U.S.C. 78s(b)(3)(A).

Section 19(b)(1) of the Exchange Act defines the term “proposed rule change” to mean “any proposed rule or rule change in, addition to, or deletion from the rules of [a] self-regulatory organization.” Pursuant to Section 3(a)(27) and 3(a)(28) of the Exchange Act, the term “rules of a self-regulatory organization” means (1) the constitution, articles of incorporation, bylaws and rules, or instruments corresponding to the foregoing, of an SRO, and (2) such stated policies, practices and interpretations of an SRO (other than the Municipal Securities Rulemaking Board) as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules. Rule 19b-4(b) under the Exchange Act,²⁵ defines the term “stated policy, practice, or interpretation” to mean generally “any material aspect of the operation of the facilities of the self-regulatory organization or any statement made available to the membership, participants, or specified persons thereof that establishes or changes any standard, limit, or guideline with respect to rights and obligations of specified persons or the meaning, administration, or enforcement of an existing rule.”

The term “facility” is defined in Section 3(a)(2) of the Exchange Act, with respect to an exchange, to include “its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.”

In its Exemption Request, ISE acknowledged that following the Closing, DECN will become a facility of ISE because it will be an affiliate of ISE used for the purpose of effecting

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17 CFR 240.19b-4(b).

and reporting securities transactions.²⁶ Specifically, (1) DECN will continue to operate as an ECN and will continue to submit limit orders to the Facility, a facility of ISE, for display and execution; and (2) DECN will become an affiliate of ISE through ISE Holdings' equity interest in DE Holdings.²⁷ Absent an exemption, Section 19(b) of the Exchange Act and Rule 19b-4 thereunder would require ISE to file proposed rules with the Commission to allow ISE to operate DECN as a facility.

ISE noted in its Exemption Request that DE Holdings is preparing Form 1 Applications for the Exchange Subsidiaries and that DECN would cease operations as an ECN shortly after any Commission approval of the Form 1 Applications and the Exchange Subsidiaries' commencement of operations as national securities exchanges.²⁸ Accordingly, ISE expects that DECN would operate as a facility of ISE for a relatively brief period of time.²⁹

The Commission believes that it is appropriate to issue a temporary exemption, subject to the conditions described below, to allow DECN to operate as a facility of ISE without being subject to the rule filing requirements of Section 19(b) of the Exchange Act for a temporary period.³⁰ Accordingly, the Commission has determined to grant ISE's request for a temporary exemption, subject to certain conditions, for a period not to exceed 180 days from the date of the Closing. The Commission finds that the temporary conditional exemption from the provisions of Section 19(b) of the Exchange Act is appropriate in the public interest and is consistent with the protection of investors. In particular, the Commission believes that the temporary exemption

²⁶ See Exemption Request at 1.

²⁷ See Exemption Request at 1 – 2.

²⁸ See Exemption Request at 2.

²⁹ Id.

³⁰ In granting this relief, the Commission makes no finding regarding whether ISE's operation of DECN as a facility would be consistent with the Exchange Act.

should help promote efficiency and competition in the market by allowing DECN to continue to operate as an ECN for a limited period of time while DE Holdings prepares the Form 1 Applications. In this regard, the Commission notes ISE's belief that it would be unduly burdensome and inefficient to require DECN's operating rules to be separately subjected to the Section 19(b) rule filing and approval process because DECN would operate only temporarily as a facility of ISE while the Commission considers the Form 1 Applications.³¹ To provide the Commission with the opportunity to review and act upon any proposal to change DECN's fees or to make material changes to DECN's operations as an ECN during the period covered by the temporary exemption, as well as to ensure that the Commission's ability to monitor ISE and DECN is not diminished by the temporary exemption, the Commission is imposing the following conditions while the temporary exemption is in effect.³² The Commission believes such conditions are necessary and appropriate in the public interest for the protection of investors. Therefore, the Commission is granting to ISE a temporary exemption, pursuant to Section 36 of the Exchange Act, from the rule filing requirements imposed by Section 19(b) of the Exchange Act as set forth above, provided that ISE and DECN comply with the following conditions:

- (1) DECN remains a registered broker-dealer under Section 15 of the Exchange Act³³ and continues to operate as an ECN;
- (2) DECN operates in compliance with the obligations set forth under Regulation ATS;
- (3) DECN and ISE continue to operate as separate legal entities;

³¹ In addition, the Commission notes that the rules governing the operation of the Exchange Subsidiaries will be subjected to public comment and Commission review and approval as part of the exchange registration process.

³² See Exemption Request at 3.

³³ 15 U.S.C. 78o.

- (4) ISE files a proposed rule change under Section 19 of the Exchange Act³⁴ if any material changes are sought to be made to DECN's operations. A material change would include any changes to a stated policy, practice, or interpretation regarding the operation of DECN or any other event or action relating to DECN that would require the filing of a proposed rule change by an SRO or an SRO facility;³⁵
- (5) ISE files a proposed rule change under Section 19 of the Exchange Act if DECN's fee schedule is sought to be modified; and
- (6) ISE treats DECN the same as other ECNs that participate in the Facility, and, in particular, ISE does not accord DECN preferential treatment in how DECN submits orders to the Facility or in the way its orders are displayed or executed.³⁶

In addition, the Commission notes that the Financial Industry Regulatory Authority is currently the Designated Examining Authority for DECN.

³⁴ 15 U.S.C. 78s.

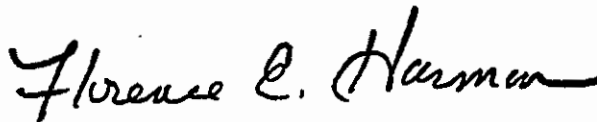
³⁵ See Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. The Commission notes that a material change would include, among other things, changes to DECN's operating platform; the types of securities traded on DECN; DECN's types of subscribers; or the reporting venue for trading that takes place on DECN. The Commission also notes that any rule filings must set forth the operation of the DECN facility sufficiently so that the Commission and the public are able to evaluate the proposed changes.

³⁶ See Exemption Request at 3.

For the reasons discussed above, the Commission finds that the temporary conditional exemptive relief requested by ISE is appropriate in the public interest and is consistent with the protection of investors.

IT IS ORDERED, pursuant to Section 36 of the Exchange Act,³⁷ that the application for a temporary conditional exemption is granted for a period of 180 days following the Closing, as defined above.

By the Commission.



Florence E. Harmon
Acting Secretary

³⁷

15 U.S.C. 78mm.

*Commissioners Walter
and Aguilar
not participating*

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59141 / December 22, 2008

Admin. Proc. File No. 3-12596

In the Matter of

SALVATORE F. SODANO
c/o William R. Baker III
Latham & Watkins, LLP
555 Eleventh Street NW, Suite 1000
Washington, DC 20004-1304

ORDER REVERSING INITIAL DECISION AND REMANDING FOR FURTHER
PROCEEDINGS

I.

Background

The Commission's Division of Enforcement (the "Division") appeals from the decision (the "Initial Decision") of an administrative law judge. ^{1/} The Initial Decision dismissed charges that Salvatore F. Sodano, the former Chairman and Chief Executive Officer ("CEO") of the American Stock Exchange LLC (the "Amex"), violated Section 19(h)(4) of the Securities Exchange Act of 1934. ^{2/}

^{1/} Salvatore F. Sodano, Initial Decision Rel. No. 333 (Aug. 20, 2007), 91 SEC Docket 1313.

^{2/} 15 U.S.C. § 78s(h)(4). Section 19(h)(4) states, in relevant part, "The appropriate regulatory agency for a self-regulatory organization is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title, to remove from office or censure any officer or director of such self-regulatory organization, if such appropriate regulatory agency finds, on the record after notice and opportunity for hearing, that such officer or director has willfully violated any provision of this title, the rules or regulations thereunder, or the rules of such self-regulatory organization, willfully abused his authority, or without reasonable justification or excuse has failed to enforce compliance . . . in the case of a national securities exchange, with any such provision by any member or person associated with a member."

The Order Instituting Proceedings ("OIP") alleges that Sodano, during his tenure as an Amex officer and director, "without reasonable justification or excuse, failed to enforce compliance with the Exchange Act, the rules and regulations thereunder, and the Amex's rules." 3/ The Division seeks a censure of Sodano for these alleged violations. Prior to a hearing on the merits, the law judge granted Sodano's motion for summary disposition of the proceeding. The Initial Decision concluded that Exchange Act Section 19(h)(4) authorizes the Commission to censure only persons who are currently officers or directors of self-regulatory organizations ("SROs"). Since Sodano resigned from his positions as Amex Chairman and CEO in 2005, and the disciplinary proceeding was instituted on March 22, 2007, the Initial Decision found that the Commission lacked authority under Section 19(h)(4) to censure Sodano and accordingly dismissed the charges.

The sole question before us is whether Exchange Act Section 19(h)(4) authorizes the Commission to censure former SRO officers and directors. We have infrequently exercised our authority under Section 19(h)(4). We recently entered a settled proceeding that, without an admission or denial of the findings, censured James Crofwell pursuant to Exchange Act Section 19(h)(4). 4/ Crofwell had resigned his position as President of the Boston Stock Exchange four years prior to the settlement. We also instituted settled proceedings censuring two other SRO officers pursuant to Section 19(h)(4); both of those officers still held their positions at the time the settlements were reached. 5/ Sodano's case is the first litigated matter pursuant to our authority under Section 19(h)(4).

3/ In September 2000, the Commission instituted a settled administrative proceeding against the Amex in which the Commission found, among other things, that the Amex had failed to enforce adequately certain option order handling rules including critical customer-protection rules relating to firm quote and trading ahead. Certain Activities of Options Exchanges, Securities Exchange Act Rel. No. 43268 (Sept. 11, 2000), 73 SEC Docket 697. The Division alleged in its OIP against Sodano that the regulatory deficiencies of the Amex identified in the settled matter and their continuation after the Commission ordered the Amex to enhance and improve its regulatory programs for enforcing the option trading rules resulted from Sodano's failure to pay adequate attention to and dedicate sufficient resources to regulation. Salvatore F. Sodano, Exchange Act Rel. No. 55509 (Mar. 22, 2007), 90 SEC Docket 876.

4/ Boston Stock Exchange, Inc., Exchange Act Rel. No. 56352 (Sept. 5, 2007), 91 SEC Docket 1443.

5/ William N. Briggs, Exchange Act Rel. No. 40506 (Sept. 30, 1998), 68 SEC Docket 367 (censuring Chief Financial Officer of Philadelphia Stock Exchange and prohibiting him from serving in that capacity for a two-year period) and National Stock Exchange and David Colker, Exchange Act Rel. No. 51714 (May 19, 2005), 85 SEC Docket 1249 (censuring President and CEO of National Stock Exchange for failure to enforce compliance with National Stock Exchange rules pertaining to market orders and trading ahead).

II.

Statutory Language*The Terms "Officer or Director"*

The Supreme Court has made clear that, in interpreting the applicability of any statute, we should look first to the language of the statute. ^{6/} If the language of a statute entrusted to our administration is ambiguous, our interpretation of the text is entitled to deference by reviewing courts, as long as the interpretation is reasonable. ^{7/} The text of Section 19(h)(4) neither expressly limits its application to one who "is" an officer or director (which might indicate a Congressional intent to limit the reach of the statute to current officers and directors), nor expressly states that it applies to "former" SRO officers and directors. ^{8/} It permits us to sanction "any" SRO officer or director if "such" officer or director has engaged in one of the kinds of misconduct specified in the statute. The adjective "any" is an inclusive term broadly interpreted as "one or some indiscriminately of whatever kind." ^{9/} The use of the word "any"

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- ^{6/} Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992) (stating, "[I]n interpreting a statute, a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there When the words of a statute are unambiguous, then this first canon is also the last: judicial inquiry is complete."). Further, where statutory language is clear and unambiguous, even "contradictory indications in the statute's legislative history will not be allowed to alter the plain meaning of the text." Ratzlaf v. U.S., 510 U.S. 135, 147-48 (1994). See also Barnhill v. Johnson, 503 U.S. 393, 401 (1982).
- ^{7/} SEC v. Zandford, 535 U.S. 813, 819-20 (2002) (citing U.S. v. Mead Corp., 533 U.S. 218, 229-30 and n. 12 (2001)). See also Fin. Planning Ass'n v. SEC, 482 F.3d 481, 487 (D.C. Cir. 2007).
- ^{8/} Sodano cites Driver v. Helms, 577 F.2d 147 (1st Cir. 1978), where the court excluded former officers from a statute applying to "officers or employees of the United States." In Driver, however, the venue statute in question applied to "a civil action in which each defendant is an officer or employee of the United States." (Emphasis added) In contrast, Section 19(h)(4) does not specify that the individual subject to Commission sanctions "is" an officer or director of the SRO.
- ^{9/} See Ali v. Federal Bureau of Prisons, 128 S. Ct. 831, 833 (2008) (citing U.S. v. Gonzales, 520 U.S. 1, 5 (1997) ("Read naturally, the word 'any' has an expansive meaning, that is, 'one or some indiscriminately of whatever kind'") (citing Webster's Third New International Dictionary 97 (1976))); Fin. Planning Ass'n, 482 F.3d at 488
- (continued...)

before “officer or director” therefore suggests our authority under Section 19(h)(4) to sanction SRO officers or directors is not restricted by whether they are currently or formerly holders of those positions and does not except from its purview former SRO officers and directors.

Sodano notes that Section 19(h)(4) gives the Commission the authority to sanction “if [the Commission] finds, on the record, after notice and opportunity for hearing, that such officer or director [has engaged in specified misconduct].” Sodano asserts that this language makes clear that Section 19(h)(4) “unambiguously applies only to someone who can be accurately described as ‘such officer or director’ at the time of the hearing.” However, the statute does not include the words “at the time of the hearing,” the modifier urged by Sodano. We believe that “after notice and opportunity for hearing” is a predicate to the Commission making its findings, not a statement of when the respondent must be an officer or director for jurisdictional purposes. Sodano’s interpretation of this phrase would require us to prosecute a case through to the conclusion of a hearing before knowing whether we had jurisdiction over the respondent, an unreasonable result we are not required to reach. 10/

Sodano contends that, in Lewis v. Varnes, 11/ the court adopted a “plain meaning of ‘director or officer’” under Section 16(b) of the Exchange Act. The basis for the decision in Lewis demonstrates that it does not assist our analysis here. In that case, the court found that the right to recover short swing profits from a retired director pursuant to Section 16(b) applies only to matching trades where at least the first of the two trades was made prior to the director’s retirement. The court rejected appellant’s contrary position that neither of the trades had to occur during the director’s tenure as inconsistent with the language of the statute. The court concluded, based on precedent, that Congress intended Section 16(b) to be applied as a “‘a relatively arbitrary rule capable of easy administration.’” As a result, a flexible approach to the application

9/ (...continued)
 (“The word ‘any’ is usually understood to be all-inclusive”) (citing New York v. EPA, 443 F.3d 880, 885 (D.C. Cir. 2006)). But see Nixon v. Missouri Municipal League, 541 U.S. 125, 126 (2004) (“‘any’ can and does mean different things depending upon the setting”).

10/ See, e.g. Zandford, supra n.7, 535 U.S. at 819-20 (finding that a reasonable Commission interpretation of ambiguous statutory language will receive deference from reviewing courts); Georgetown Univ. Hospital v. Sullivan, 934 F.2d 1280, 1282 (D.C. Cir. 1991) (favoring “the more reasonable interpretation of ambiguous statutory language”).

11/ 505 F.2d 785, 787-89 (2d Cir. 1974).

of Section 16(b) "would actually contravene the Congressional purpose and imply ambiguities in the statute that do not exist." 12/

Here, our reading of Section 19(h)(4) is consistent with the language of the statute. Furthermore, there is no indication that Congress intended Section 19(h)(4) to be applied as an arbitrary rule. Rather, as discussed below, legislative history indicates Congress intended the statute to provide the Commission with sufficient flexibility to oversee SROs. 13/

Verb Tense

Section 19(h)(4) authorizes sanctions in the public interest if we find, among other things, that the officer or director "willfully abused his authority or without reasonable justification or excuse has failed to enforce compliance" with SRO rules. Each of the verbs describing the conduct subject to sanction is in the past tense, indicating that the statute is intended to remedy past action. A plain reading of these phrases is that such misconduct could have occurred during a former officer or director's tenure. Thus, for example, once an SRO officer or director "has failed" to enforce compliance with SRO rules, a violation of Section 19(h)(4) over which we have jurisdiction has occurred, regardless of whether that officer or director remains in his or her position at the time of the subsequent disciplinary proceeding.

Sodano argues that the use of the past tense in Section 19(h)(4) is irrelevant, stating that "statutes always penalize acts that occurred in the past." This assertion is not accurate. For example, Exchange Act Section 21(d) authorizes the Commission to seek an injunction in the appropriate court "whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation" of relevant provisions. 14/ In any event, Sodano does not dispute that the use of the past tense is consistent with a reading of the statute to include Commission censure authority over former SRO officers and directors.

12/ Lewis, 505 F.2d at 789. Sodano correctly observes that the Supreme Court adopted a "literal" reading of Section 16(b) in Reliance Elec. Co. v. Emerson Elec. Co. 404 U.S. 418, 423-24 (1972). That case involved the applicability of the short-swing profits provision to "beneficial owners," not to officers and directors as in Lewis v. Varnes. The Court relied on the text of Exchange Act Section 16(b), which states, "This subsection shall not be construed to cover any transaction where [the] beneficial owner [of more than ten percent of any class of any security] was not such [beneficial owner] both at the time of the [relevant] purchase and sale, or sale and purchase. . . ." As Lewis v. Varnes highlights, there is no similar exemptive language in Section 16(b) for a person who is an "officer" or "director."

13/ See n.21 *infra* and accompanying text.

14/ 15 U.S.C. § 78u(d).

The Initial Decision noted that Exchange Act Section 3(a)(7) defines the term "director" as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or not." ^{15/} The Initial Decision concluded that the use of present tense verb forms in this definition indicates an intention that, absent a clear statement in the text of a statute that the statute applies to former directors, the term "director" should be interpreted to mean only sitting directors. However, we believe that the use of the present tense in a definitional section like Section 3(a)(7) is less relevant than Section 19(h)(4)'s use of the past tense describing the misconduct to be sanctioned, coupled with the adjective "any" in describing which officers and directors are subject to Section 19(h)(4). There is no dispute that, at the time of the alleged violations, Sodano was, in fact, "performing the functions" of a director of a corporation for the Amex.

Sanctions

Section 19(h)(4) permits the Commission to impose on SRO officers and directors removal from office or censure. While only a sitting officer or director may be removed from office, the same is not true of a censure. A censure serves a separate and distinct remedial purpose from that served by removal from office because a censure notifies the public of the officer or director's past misconduct, regardless of whether the individual currently remains an SRO officer or director.

The Initial Decision relied on Black's Law Dictionary's definition of "censure": "an official reprimand or condemnation." ^{16/} The Initial Decision stated, "[g]iven this definition and the order in which the remedies are listed, it is plain from the statutory construction that Congress's inclusion of censure in Section 19(h)(4) provides a less severe alternative remedy when sanctioning an incumbent officer and director."

We do not believe the Black's definition resolves the issue. The statute as written merely provides censure as an alternative to removal. While we agree that censure is a less severe alternative to removal, that does not compel the conclusion that Congress intended censure to be available only in cases where removal is also available, *i.e.*, where the officer or director still holds office. A construction that is at least equally sensible is that censure was intended as an alternative where removal is no longer necessary or available due to the resignation of the officer or director. Censure can still serve the remedial purpose of alerting the public, including other SROs and their officers and directors, of the unacceptability of the conduct at issue, a purpose that cannot be achieved in those circumstances where removal is unavailable due to the resignation of the officer or director.

^{15/} 15 U.S.C. § 78c(a)(7). The Exchange Act does not define "officer."

^{16/} Black's Law Dictionary 237 (8th ed. 2004).

Sodano agrees with the Initial Decision that, because one of the two sanctions authorized under Section 19(h)(4) -- removal from office -- can only apply to current SRO officers and directors, the other sanction available, censure, must also be limited to current SRO officers and directors. Sodano cites the theory of statutory interpretation that words grouped in a list should be given similar meaning. 17/ The theory cited by Sodano, however, "is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress." 18/ The word "censure" is not "capable of many meanings." The question at issue is not the meaning of the word "censure" itself, but rather the types of persons on whom the sanction may be imposed under Section 19(h)(4). 19/

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We conclude that the language of Section 19(h)(4) favors a reading that our authority extends to former, as well as current, SRO officers and directors. The use of the adjective "any" in describing the officers and directors subject to the statute, the use of past tense verbs in describing conduct covered by the provision, and the inclusion of a sanction that clearly may be applied to former officers and directors all support the inference that the respondent's current status as an SRO officer or director is not relevant. The statute is not without ambiguity, however. In circumstances where a statute is not clear on its face, the Supreme Court instructs us that we should interpret the statute based on available guidance from the legislative history. 20/

17/ See Dole v. United Steel Workers of America, 494 U.S. 26, 36 (1990) ("[T]he traditional canon of construction, *noscitur a sociis*, dictates that [the] 'words grouped in [the] list should be given related meaning' (quoting Massachusetts v. Morash, 490 U.S. 107, 114-15 (1989))).

18/ Washington State Dept. Of Social and Health Services v. Guardianship Estate of Keffeler, 537 U.S. 371, 384-85 (2003) (citing Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961)).

19/ Even if we accepted Sodano's argument that *noscitur a sociis* applied here, this would not lead to the conclusion that Section 19(h)(4) applies only to current SRO officers and directors. Because the "list" of sanctions available under Section 19(h)(4) includes only removal from office and censure, Sodano urges a reading of Section 19(h)(4) under which censure is "given a related meaning" to removal from office, which, by definition, only applies to current SRO officers and directors. Censure, however, can be "related" to removal in the sense that they are both options provided to the Commission for sanctioning any SRO officer or director for past misconduct. The sanctions are connected by a disjunctive; there is no basis for concluding that one can be imposed only where the other can.

20/ Blum v. Stenson, 465 U.S. 886, 896 (1984).

III.

Legislative History of Section 19(h)(4)

Section 19(h)(4) was added to the Exchange Act as part of the 1975 amendments to the federal securities laws. ^{21/} Prior to 1975, then-Section 19(a)(3) of the Exchange Act authorized the Commission to suspend or expel members or officers of SROs for violations of the Exchange Act and the rules and regulations thereunder. New Section 19(h)(4) deleted the reference to members in then-Section 19(a)(3), and added: (a) directors to the scope of the provision's applicability; (b) the authority to censure officers and directors (the sanction at issue in this proceeding); and (c) as bases for the imposition of sanctions, violations of the rules of the SRO, willful abuse of authority, and failure to enforce compliance with the above-referenced statutes and rules by a member or associated person.

The legislative history of the 1975 amendments is silent on the specific question of whether our authority under Exchange Act Section 19(h)(4) to censure extends to former, as well as current, SRO officers and directors. However, the Senate Report, in its general discussion of Exchange Act Section 19, states, "In order to enhance the oversight powers of the Commission . . . and to provide [it] with greater regulatory flexibility, the bill would significantly increase the regulatory options available to [the Commission] to deal with perceived self-regulatory shortcomings." ^{22/} In its general introductory discussion of the full 1975 amendments, the Senate Report states that "[t]he SEC would be expected to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need." ^{23/}

The realization of these goals is evident in these amendments to Section 19(h)(4). In creating Section 19(h)(4) from pre-existing Section 19(a)(3), the 1975 amendments focused the Commission's authority on the self-regulators themselves, deleting "members" (whose conduct is more fully addressed by other provisions of the Exchange Act), and adding directors, thereby bringing all those with authority over the SROs within the Commission's oversight. The amendments expanded the Commission's sanctioning authority to include not just violations of the securities statutes, but misconduct pertinent to the governance and mission of the SROs: violations of the rules of the SRO, willful abuse of authority, and failure to enforce compliance. The amendments also enhanced the Commission's sanctioning options by adding censure.

^{21/} See S. Rep. No. 94-75 (1975), reprinted in 1975 U.S.C.C.A.N. 179.

^{22/} 1975 U.S.C.C.A.N. at 213.

^{23/} Id. at 181.

These amendments reflect the Congressional goal of enhancing Commission oversight so "that there is no gap between self-regulatory performance and regulatory need." ^{24/} Our construction of Section 19(h)(4) as authorizing actions against former as well as current SRO officers and directors is both reasonable and consistent with the Congressional goals of increasing our regulatory options for dealing with possible SRO shortcomings. In particular, Section 19(h)(4) is the only federal securities law provision under which the Commission can sanction an SRO officer or director for willful abuse of authority or failure to enforce compliance (the basis of the charges against Sodano). ^{25/} The goal of enhanced Commission oversight of SROs would be frustrated if our authority to sanction errant officers and directors could be thwarted by their resignation before the conclusion of proceedings against them. ^{26/} As discussed above, nothing in the language of the statute requires such a restrictive view of our authority. ^{27/}

This construction of the statute and its history is also consistent with Supreme Court precedent urging that the securities laws should be "construed flexibly, not technically and restrictively." ^{28/} We are mindful of the Supreme Court's cautionary language in Aaron v. SEC,

^{24/} Id.

^{25/} Sodano contends that the Division's argument that his position would permit an SRO officer or director to avoid "any form of punishment" by resigning from his or her position is without merit because many other securities law provisions would apply to the conduct. Sodano is incorrect.

^{26/} In general, statutory interpretation should "favor an interpretation which would render the statutory design effective in terms of the policies behind its enactment." Nat'l Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 689 (D.C. Cir. 1973) (citing Bird v. United States, 187 U.S. 118 (1903)).

^{27/} Sodano cites our decision in George C. Kern, Jr., 50 S.E.C. 596 (1991), in support of his claim that the legislative history of the 1975 amendments does not support the conclusion that Congress broadened the scope of Section 19(h)(4) to include former officers and directors of SROs. At issue in Kern was whether Exchange Action Section 15(c)(4), 15 U.S.C. § 78o(c)(4), permitted orders of general future compliance or was limited to orders to correct existing violations. In concluding that the statute was limited to correcting existing violations, we cited specific language in the legislative history stating that the purpose of the amendment to Section 15(c)(4) was to compel corrective filings to existing, misleading public reports. 50 S.E.C. at 601. Here, the legislative history lacks specific language supporting either interpretation. We therefore have looked to the general purposes of the amendments.

^{28/} Zandford, 535 U.S. at 819 (citing Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963))).

cited by Sodano, that “generalized references to the remedial purposes of the securities laws will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit.” ^{29/} However, in Aaron, the Supreme Court found, “[t]he language of [Securities Act of 1933] Section 17(a)(1), ^{30/} which makes it unlawful ‘to employ any device, scheme, or artifice to defraud,’ plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct.” ^{31/} By contrast, the language, statutory scheme, and legislative history of Section 19(h)(4) evince a Congressional intent to expand our authority and close regulatory gaps in our oversight of SROs, and reasonably permit the conclusion that the statute applies to former SRO officers and directors.

Sodano argues that the censure remedy was intended to provide the Commission with a less severe sanction option to removal from office for current SRO officers’ and directors’ violations of Section 19(h)(4), relying on the 1975 Senate Report statement that the provisions of amended Exchange Act Section 19(h)(1) “to censure and place restrictions on the activities, functions, and operations of a self-regulatory agency . . . are intended to provide more usable sanctions than the SEC’s traditional ‘big stick.’” ^{32/}

However, Exchange Act Section 19(h)(1) pertains to the Commission’s authority to sanction an SRO itself, while Section 19(h)(4) authorizes the Commission to sanction the individual SRO officers and directors. Congress may well have believed that the inclusion of censure as an alternative to suspension and deregistration of an SRO as an entity under Section 19(h)(1) furthered the goals of the 1975 amendments. Unlike an SRO officer or director who resigns from the position, a deregistered or suspended SRO would face significant hurdles before it could re-enter the industry. Congressional recognition that the Commission needs an alternative sanction to forced deregistration of an SRO does not provide instructive guidance about whether Congress intended to limit the applicability of the censure remedy under Section 19(h)(4) to current SRO officers and directors.

Sodano argues that Congress’s decision not to include an industry bar among the remedies available under Section 19(h)(4) “provides additional evidence of [Congressional] intent to limit the provision to active officers and directors.” Sodano attempts to distinguish

^{29/} Aaron v. SEC, 446 U.S. 680, 695 (1980) (citing Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979) (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978))).

^{30/} 15 U.S.C. § 77q(a)(1).

^{31/} Id. at 696. See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199-201 (1976) (finding that Exchange Act Section 10(b) does not apply to negligent acts and rejecting a reading of the statute that would encompass negligent acts because the Court found that the language of the statute “clearly connotes intentional misconduct”).

^{32/} 1975 U.S.C.C.A.N. at 212.

between "typical penalties that the securities laws use to *punish past misconduct*" (emphasis in Sodano's brief) such as disgorgement, civil fines, and industry bars, and those he characterizes as "corrective, or forward-looking in character" such as the removal and censure provided for in Section 19(h)(4), which he claims "serve a similar prophylactic purpose." He provides no basis for this purported distinction. While removal and censure serve the prophylactic purpose of preventing the respondent from committing further misconduct, they also both punish past misconduct, and the D.C. Circuit has concluded that censure is also a penalty. 33/

Sodano contends that:

[the SRO industry] is not a large and anonymous industry like broker-dealers or investment advisers, where such tactics [as resigning to avoid sanctions and then re-entering the industry with a new firm] are within the realm of possibility. If an officer or director of an SRO did resign in the face of imminent Section 19(h)(4) proceedings, doing so would essentially represent a decision to voluntarily accept the harshest punishment authorized by that section -- removal from office -- and would be understood that way by the securities industry and the regulatory community.

We disagree. If an officer's resignation successfully avoided enforcement action by the Commission, it would hamper the possibility of the Commission making public findings of misconduct and informing the public of the standard of conduct expected of an SRO officer or director.

1987 Securities Law Amendments

As part of the 1987 amendments to the federal securities laws, 34/ Congress amended Exchange Act Section 15(b)(6) 35/ and Section 203(f) of the Investment Advisers Act of 1940 36/ in order to make clear the Commission's authority to impose sanctions pursuant to those provisions on individuals both currently and formerly associated with broker-dealers or

33/ See *Johnson v. S.E.C.*, 87 F.3d 484, 487 (D.C. Cir. 1996) (finding that five-year statute of limitations applies to Commission proceedings to censure and suspend respondent because such actions fit the "'common-sense' definition of a 'penalty'").

34/ See S. Rep. No. 100-105 (1987), reprinted in 1987 U.S.C.C.A.N. 2089.

35/ 15 U.S.C. § 78o(b)(6).

36/ 15 U.S.C. § 80b-3(f).

investment advisers, respectively. 37/ The legislative history of the 1987 amendments suggests that, in amending those provisions, Congress was concerned that Exchange Act Section 15(b)(6) and Advisers Act Section 203(f) could be interpreted to "allow persons who had violated the federal securities laws to avoid administrative sanctions merely by leaving the business and stating that they were no longer associated with a broker-dealer, municipal securities dealer, or investment adviser and were not seeking to become so associated." 38/

Sodano points to these amendments as evidence that, when Congress wants to extend the Commission's jurisdiction to individuals no longer occupying a particular position, it knows how to do so. Sodano contends that Congress would have changed the language of Section 19(h)(4) similarly if it intended for Section 19(h)(4) to apply to former SRO officers and directors. He argues that Congress's failure to make such changes "was conspicuous and no mere oversight," given the extensive list of additional changes to the securities laws proposed in the 1987 amendments. 39/

We disagree. As an initial matter, there is nothing in the legislative history of the 1987 amendments to suggest that Congress considered the reach of the Commission's authority under Section 19(h)(4) at the time of the 1987 amendments. 40/ The Commission brought no disciplinary proceedings under Section 19(h)(4) before the 1990s. In contrast, prior to the

37/ Prior to the 1987 amendments, Exchange Act Section 15(b)(6) authorized the Commission to impose sanctions on "any person associated, or seeking to become associated, with a broker or dealer" if the Commission found that the imposition of sanctions was in the public interest and such a person had engaged in violative conduct. The 1987 amendments expressly amended the statute to include any person who, "at the time of the alleged misconduct . . . was associated or seeking to become associated with a broker or dealer." The 1987 amendments also made analogous revisions to Advisers Act Section 203(f).

38/ 1987 U.S.C.C.A.N. at 2111.

39/ In support of his contention that "Congress demonstrably conducted a thorough and comprehensive review of the securities laws" at the time of the 1987 amendments, Sodano notes the inclusion in the 1987 amendments of corrections of several minor typographical errors in the Exchange Act. The legislative history does not indicate how these errors were brought to Congress's attention, leading to their inclusion in the amendments.

40/ See *Aaron v. SEC*, 446 U.S. 680, 695 n.11 (rejecting as support for Commission's interpretation of statute the fact that Congress failed to act after being expressly informed of such interpretation when significant amendments to the securities laws were enacted because "legislative consideration of those statutes was addressed principally to matters other than those at issue here").

passage of the 1987 amendments, the Commission was aware of arguments by respondents suggesting a narrow reading of Sections 15(b)(6) and 203(f). ^{41/} Moreover, the language of the pre-1987 versions of Sections 15(b)(6) and 203(f) differed from Section 19(h)(4). The pre-1987 versions of Sections 15(b)(6) and 203(f) applied to "any person associated or seeking to become associated" with a broker-dealer or investment adviser, respectively, whereas Section 19(h)(4) applies to "any officer or director of [an SRO]."

IV.

Our review of the statute and the authorities discussed above leads to our conclusion that Section 19(h)(4) authorizes the Commission to censure both current and former SRO officers and directors. As a result, we reverse the Initial Decision dismissing the proceeding against Sodano. In accordance with this determination, we remand this proceeding to the administrative law judge for a hearing that will consider the underlying charges against Sodano, ^{42/} which were never reached because the Initial Decision dismissed the proceeding on Sodano's motion for summary disposition. ^{43/}

Accordingly, it is ORDERED that the initial decision be, and it hereby is, reversed and that this proceeding be remanded to the administrative law judge for further proceedings consistent with this order.

By the Commission.



Florence E. Harmon
Acting Secretary

^{41/} See John Kilpatrick, 48 S.E.C. 481, 487 (1986).

^{42/} On November 15, 2007, Sodano filed a motion seeking oral argument, which we deny. Rule 451(a) of our Rules of Practice, 17 C.F.R. § 201.451(a), provides that "[m]otions for oral argument with respect to whether to affirm all or part of an initial decision by a hearing officer shall be granted unless exceptional circumstances make oral argument impractical or inadvisable." However, given the age of this proceeding, we believe that oral argument would be inadvisable in light of our determination to remand this proceeding to create a further record; Sodano may request oral argument if he is aggrieved by the results from the subsequent hearing.

^{43/} We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 59155 / December 23, 2008

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2912 / December 23, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13318

In the Matter of

Ira Yohalem, CPA,

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 4C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Ira Yohalem, CPA ("Respondent" or "Yohalem") pursuant to Section 4C¹ of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.²

¹ Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

² Rule 102(e)(1)(ii) provides, in pertinent part, that:

The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds³ that:

A. SUMMARY

Yohalem was a partner and served as chairman of the executive committee of Yohalem Gillman & Co. ("Yohalem Gillman"), an accounting firm that audited and reviewed the financial statements of a Massachusetts-based public company (hereinafter referred to as "Company A") from at least 2000 through 2004 (the "Relevant Period"). In 2001 and 2003, an officer, director, and significant shareholder of Company A made two investments totaling \$160,000 in restaurants of which Yohalem was a managing partner. As a result of receiving the investments, Yohalem engaged in improper professional conduct by failing to maintain independence from Yohalem Gillman's audit client under generally accepted auditing standards ("GAAS"), ethics and independence standards, and Regulation S-X.

B. RESPONDENT

Yohalem, a resident of New York, New York, has been a CPA for over 30 years; he has been licensed as a CPA by the state of New York since 1967. Yohalem is currently a partner of an accounting firm which combined businesses with Yohalem Gillman in or around January 2005. Yohalem was not involved in the audits or reviews of Company A's financial statements during the Relevant Period.

C. FACTS

1. Company A is a Delaware corporation headquartered in Massachusetts, and its common stock was registered with the Commission pursuant to Section 12 of the Exchange Act at all relevant times.

³ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2. At all relevant times, Yohalem Gillman audited and reviewed the financial statements which were included in Company A's filings with the Commission on Forms 10-QSB and 10-KSB.

3. At all relevant times, Yohalem chaired Yohalem Gillman's executive committee and with others rated the performance of the Yohalem Gillman partners, including the engagement partners who provided auditing and review services to Company A. Yohalem and the engagement partners who provided auditing and review services to Company A worked out of the same office in New York, as did other Yohalem Gillman personnel.

4. On February 14, 2001, a significant shareholder, officer, and director of Company A ("the Company A Director") invested \$100,000 in a restaurant of which Yohalem was a managing partner. Yohalem was aware of this investment.

5. On October 3, 2003, Yohalem sent a letter offering an investment opportunity to the Company A Director in another restaurant of which Yohalem was a managing partner.

6. On October 29, 2003, the Company A Director invested \$60,000 through his family's limited partnership pursuant to the October 3, 2003 offer. Yohalem was aware of this investment.

7. Also on October 29, 2003, Yohalem signed and submitted an independence disclosure statement to Yohalem Gillman's managing partner. The independence statement, as regularly used by Yohalem Gillman, required Yohalem to report, among other things, "[a]ny investment, business venture or other financial interest in common with clients or their management, principals or affiliates, or relating to any enterprise or venture with which any such parties are affiliated or in which they have any interest." Nonetheless, Yohalem failed to disclose either of the investments by the Company A Director.

8. GAAS requires auditors to maintain strict independence from their audit clients. Rule 101 of the Code of Professional Conduct of the American Institute of Certified Public Accountants ("AICPA"), states, in pertinent part, that a "member in public practice shall be independent in the performance of professional services."

9. At the time of the events described above, the applicable Commission auditor-independence rule, Regulation S-X, Section 210.2-01(c)(3), stated, in pertinent part:

- (a) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the accounting firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.

10. Yohalem had a business relationship with a person in a decision making capacity associated with Yohalem Gillman's audit client, Company A, because the Company A Director was an officer, director, and substantial stockholder of Company A. Yohalem was a covered person as defined in Rule 2-01(f)(11)⁴ because he was in Yohalem Gillman's chain of command⁵ since he, as a member of the executive committee, rated the performance of the engagement partners on Company A's audits and reviews. Furthermore, Yohalem was a covered person because Yohalem and the engagement partners who provided auditing and review services to Company A worked out of the same office in New York, as did other Yohalem Gillman personnel.

11. Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice provide, in pertinent part, that the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter to have engaged in improper professional conduct.

Based on the foregoing, the Commission finds that Yohalem engaged in improper professional conduct pursuant to Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Yohalem's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Yohalem is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After one year from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or

⁴ Rule 2-01(f)(11) defines a covered person as "the following partners, principals, shareholders, and employees of an accounting firm: (i) The 'audit engagement team'; (ii) The 'chain of command'; (iii) Any other partner . . . who has provided ten or more hours of non-audit services to the audit client . . .; and (iv) Any other partner, principal or shareholder from an 'office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit."

⁵ Rule 2-01(f)(8) defines the "chain of command" as "all persons who: (i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive; (ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or (iii) Provide quality control or other oversight of the audit."

review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: *Jill M. Peterson*
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933

Release No. 8991 / December 23, 2008

SECURITIES EXCHANGE ACT OF 1934

Release No. 59157 / December 23, 2008

In the Matter of

**UBS Financial Services, Inc.
and UBS Securities LLC**

Respondents.

**ORDER UNDER SECTION 27A(b)
OF THE SECURITIES ACT OF 1933
AND SECTION 21E(b) OF THE
SECURITIES EXCHANGE ACT OF
1934, GRANTING WAIVERS OF
THE DISQUALIFICATION
PROVISIONS OF SECTION
27A(b)(1)(A)(ii) OF THE
SECURITIES ACT OF 1933 AND
SECTION 21E(b)(1)(A)(ii) OF THE
SECURITIES EXCHANGE ACT OF
1934 AS TO UBS FINANCIAL
SERVICES, INC. AND UBS
SECURITIES LLC**

UBS Financial Services, Inc. and UBS Securities LLC (the "UBS Firms") have submitted a letter on behalf of themselves and any of their current and future affiliates, dated November 6, 2008, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from their settlement of an injunctive action filed by the Commission.

On December 11, 2008, the Commission filed a civil injunctive action in the United States District Court for the Southern District of New York, charging the UBS Firms, both registered broker-dealers, with violations of the broker-dealer anti-fraud provisions. In its complaint, the Commission alleged that the UBS Firms misled tens of thousands of their customers regarding the fundamental nature and increasing risks associated with auction rate securities ("ARS") that the UBS Firms underwrote, marketed and sold. On December 23, 2008, pursuant to the UBS Firms' Consent, the Court entered a Judgment permanently enjoining the UBS Firms from violating Section 15(c) of the Exchange Act. The Judgment provides that the UBS Firms will, among other things, offer to buy back at par certain ARS from certain customers.

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The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." Section 27A(e) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in the UBS Firms' letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Judgment is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to the UBS Firms and any current or future affiliates resulting from the entry of the Judgment is hereby granted.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Act of 1933
Release No. 8992 / December 23, 2008

In the Matter of

**UBS Securities LLC and
UBS Financial Services, Inc.**

Respondents.

**ORDER UNDER RULE 602(e) OF THE
SECURITIES ACT OF 1933 GRANTING A
WAIVER OF THE RULE 602(b)(4) and
602(c)(2) DISQUALIFICATION PROVISIONS.**

I.

Respondents UBS Securities LLC and UBS Financial Services, Inc. (the "UBS Firms") have submitted a letter, dated November 6, 2008, requesting a waiver of the Rule 602(b)(4) and 602(c)(2) disqualifications from the exemption from registration under Regulation E arising from the UBS Firms' settlement of an injunctive action commenced by the Commission.

II.

On December 11, 2008, the Commission filed a civil injunctive action in the United States District Court for the Southern District of New York, charging the UBS Firms, both registered broker-dealers, with violations of the broker-dealer anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act"). In its complaint, the Commission alleged that the UBS Firms misled tens of thousands of their customers regarding the fundamental nature and increasing risks associated with auction rate securities that the UBS Firms underwrote, marketed and sold. On December 23, 2008, pursuant to the UBS Firms' consent, the Court entered a Judgment permanently enjoining the UBS Firms from violating Section 15(c) of the Exchange Act.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if the issuer or any of its affiliates is subject to any order, judgment, or decree of a court "temporarily or permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities." See Rule 602(b)(4) of the Securities Act of 1933 ("Securities Act"). The Regulation E exemption is also not available for the securities of an issuer if an investment adviser or underwriter

of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." See Rule 602(c)(2). Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(c).

IV.

Based upon the representations set forth in Respondents' request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act, a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Judgment.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rule 602(b)(4) and 602(c)(2) under the Securities Act resulting from the entry of the Judgment is hereby granted.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Act of 1933

Release No. 8994 / December 23, 2008

In the Matter of

Citigroup Global Markets, Inc.

Respondent.

**ORDER UNDER RULE 602(e) OF THE
SECURITIES ACT OF 1933 GRANTING A
WAIVER OF THE RULE 602(b)(4) and
602(c)(2) DISQUALIFICATION PROVISIONS.**

I.

Respondent Citigroup Global Markets, Inc. ("CGMI") has submitted a letter, dated October 31, 2008, requesting a waiver of the Rule 602(b)(4) and 602(c)(2) disqualifications from the exemption from registration under Regulation E arising from CGMI's settlement of an injunctive action commenced by the Commission.

II.

On December 11, 2008, the Commission filed a civil injunctive action in the United States District Court for the Southern District of New York, charging CGMI, a registered broker-dealer, with violations of the broker-dealer anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act"). In its complaint, the Commission alleged that CGMI misled tens of thousands of its customers regarding the fundamental nature and increasing risks associated with auction rate securities that CGMI underwrote, marketed and sold. On December 23, 2008, pursuant to CGMI's consent, the Court entered a Judgment permanently enjoining CGMI from violating Section 15(c) of the Exchange Act.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if the issuer or any of its affiliates is subject to any order, judgment, or decree of a court "temporarily or permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities." See Rule 602(b)(4) of the Securities Act of 1933 ("Securities Act"). The Regulation E exemption is also not available for the securities of an issuer if an investment adviser or underwriter

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of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." See Rule 602(c)(2). Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

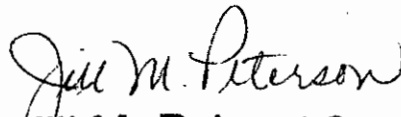
IV.

Based upon the representations set forth in Respondent's request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act, a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Judgment.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rule 602(b)(4) and 602(c)(2) under the Securities Act resulting from the entry of the Judgment is hereby granted.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8993 / December 23, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 59158 / December 23, 2008

In the Matter of

Citigroup Global Markets, Inc.,

Respondent.

**ORDER UNDER SECTION 27A(b)
OF THE SECURITIES ACT OF 1933
AND SECTION 21E(b) OF THE
SECURITIES EXCHANGE ACT OF
1934, GRANTING WAIVERS OF
THE DISQUALIFICATION
PROVISIONS OF SECTION
27A(b)(1)(A)(ii) OF THE
SECURITIES ACT OF 1933 AND
SECTION 21E(b)(1)(A)(ii) OF THE
SECURITIES EXCHANGE ACT OF
1934 AS TO CITIGROUP GLOBAL
MARKETS, INC. AND ITS
AFFILIATES**

Citigroup Global Markets, Inc. ("CGMI") has submitted a letter on behalf of itself and any of its current and future affiliates, dated October 31, 2008, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from its settlement of an injunctive action filed by the Commission.

On December 11, 2008, the Commission filed a civil injunctive action in the United States District Court for the Southern District of New York, charging CGMI, a registered broker-dealer, with violations of the broker-dealer anti-fraud provisions. In its complaint, the Commission alleged that CGMI misled tens of thousands of its customers regarding the fundamental nature and increasing risks associated with auction rate securities ("ARS") that CGMI underwrote, marketed and sold. On December 23, 2008, pursuant to CGMI's Consent, the Court entered a Judgment permanently enjoining CGMI from violating Section 15(c) of the Exchange Act. The Judgment provides that CGMI will, among other things, offer to buy back at par certain ARS from certain customers.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect

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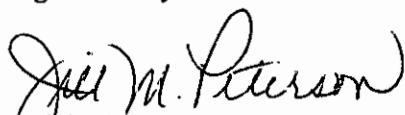
to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]” Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived “to the extent otherwise specifically provided by rule, regulation, or order of the Commission.” Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in CGMI’s letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Judgment is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to CGMI and any current or future affiliates resulting from the entry of the Judgment is hereby granted.

By the Commission.

Florence E. Harmon
Acting Secretary


By: **Jill M. Peterson**
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 200

[Release No. 34- 59150 ; File No. S7-33-08]

Proposed Amendment to Existing Regulation Concerning Records Services, Fee Schedule

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is soliciting comments on a proposed amendment to its regulation governing the fees for records services.

The Commission's schedule of fees for records services will be updated using a formula for the calculation of fees under the Freedom of Information Act ("FOIA") and language that directs FOIA requesters to the Commission's Web site. Using a formula, instead of set rates, will allow the Commission to charge fees that reflect its allowable direct costs.

DATES: Comments should be received on or before [insert date 30 days following publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-33-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100

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F Street, N.E., Washington, DC 20549-1090.

All submissions should refer to File Number S7-33-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, N.E., Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Melinda Hardy, Assistant General Counsel, Office of the General Counsel, (202)551-5149; Securities and Exchange Commission, 100 F Street N.E., Washington, DC 20549-9612.

SUPPLEMENTARY INFORMATION

I. Discussion

The fees the Commission charges for searching, reviewing, and duplicating records pursuant to FOIA requests are set forth in 17 CFR 200.80e [Schedule of fees for records services]. The Commission believes it is appropriate to update its fee schedule for searching and reviewing records to comply with guidelines promulgated by the Office of Management and Budget, Uniform Freedom of Information Act Fee Schedule and Guidelines, 52 FR 10,012, 10,018 (Mar. 27, 1987) ("OMB Guidance"), which instructs agencies to charge fees that recoup the full allowable direct costs that they incur. The OMB Guidance states that agencies may

charge the average basic pay rate of employees routinely performing these services plus 16% to cover associated benefits. Id. Also, "agencies may establish an average rate for the range of grades typically involved." Id.

The current regulation contains set rates for FOIA request search and review activities: \$16/hour for grade 11 and below; and \$28/hour for grade 12 and above. The Commission is proposing to revise the regulation to provide the formula contained in the OMB Guidance rather than a set price. Moreover, the proposed regulation provides that the Commission will establish an average rate for each of the three different groups of grades typically involved: personnel in grades SK 8 or below; personnel in grades SK 9 to 13; and personnel in grades SK 14 or above.¹ The Commission's website will contain current rates for search and review fees for each class. The rates will be updated when salaries change and will be determined by using the formula in the regulation and averaging the hourly rate of the different groups of grades of staff who routinely perform these duties. For the current calendar year, the fees would be assessed as follows: SK 8 or below: \$26/hour; SK 9 to 13: \$40/ hour; and SK 14 or above: \$70/hour. The cost of the average fee collection activity is \$20; therefore, no fee will be charged of \$20 or less. See 5 U.S.C. 552(a)(4)(A)(iv) (providing that no fee may be charged if fee exceeds costs of collecting and processing fee).

II. Statutory Basis

The Commission is proposing amendments to 17 CFR Part 200 pursuant to 5 U.S.C. 552 and 15 U.S.C. 78d-1.

¹ Fees for searches of computerized records will continue to be based on the actual cost to the Commission which includes machine and operator time. 17 C.F.R. 200.80(e)(9)(i).

List of Subjects in 17 CFR Part 200:

Administrative practice and procedure, Freedom of information, Organization and functions.

III. Text of Proposed Amendments

For the reasons set forth in the preamble, Title 17 Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 200 - ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

Subpart D - Information and Requests

1. The general authority citation for Part 200, subpart D, is revised to read as follows:

AUTHORITY: 5 U.S.C. 552, as amended, 15 U.S.C. 77f(d), 77s, 77ggg(a), 77sss, 78m(F)(3), 78w, 80a-37, 80a-44(a), 80a-44(b), 80b-10(a), 80b-11.

2. Section 200.80e, first paragraph, is revised to read as follows:

§ 200.80e Appendix E – Schedule of fees for records services.

Search and review services: The average salary rates (i.e., basic pay plus 16%) of employees performing these services. The hourly rates are listed on the Commission's Web site at <http://www.sec.gov/foia/feesche.htm>.

By the Commission

Florence E. Harmon

Florence E. Harmon
Acting Secretary

Date: December 23, 2008

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59164; File No. S7-34-08)

December 24, 2008

ORDER GRANTING TEMPORARY EXEMPTIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934 IN CONNECTION WITH REQUEST OF LIFFE ADMINISTRATION AND MANAGEMENT AND LCH.CLEARNET LTD. RELATED TO CENTRAL CLEARING OF CREDIT DEFAULT SWAPS, AND REQUEST FOR COMMENTS

I. Introduction

In response to the recent turmoil in the financial markets, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets.¹ Today the Commission is taking further action designed to address concerns related to the market in credit default swaps ("CDS"). The over-the-counter ("OTC") market for CDS has been a source of concerns to us and other financial regulators. These concerns include the systemic risk posed by CDS, highlighted by the possible

¹ A nonexclusive list of the Commission's actions to stabilize financial markets during this credit crisis include: adopting a package of measures to strengthen investor protections against naked short selling, including rules requiring a hard T+3 close-out, eliminating the options market maker exception of Regulation SHO, and expressly targeting fraud in short selling transactions (See Securities Exchange Act Release No. 58572 (September 17, 2008), 73 FR 54875 (September 23, 2008)); issuing an emergency order to enhance protections against naked short selling in the securities of primary dealers, Federal National Mortgage Association ("Fannie Mae"), and Federal Home Loan Mortgage Corporation ("Freddie Mac") (See Securities Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379 (July 21, 2008)); taking temporary emergency action to ban short selling in financial securities (See Securities Exchange Act Release No. 58592 (September 18, 2008), 73 FR 55169 (September 24, 2008)); approving emergency rulemaking to ensure disclosure of short positions by hedge funds and other institutional money managers (See Securities Exchange Act Release No. 58591A (September 21, 2008), 73 FR 55557 (September 25, 2008)); proposing rules to strengthen the regulation of credit rating agencies and making the limits and purposes of credit ratings clearer to investors (See Securities Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008)); entering into a Memorandum of Understanding with the Board of Governors of the Federal Reserve System ("FRB") to make sure key federal financial regulators share information and coordinate regulatory activities in important areas of common interest (See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), http://www.sec.gov/news/press/2008/2008-134_mou.pdf).

inability of parties to meet their obligations as counterparties and the potential resulting adverse effects on other markets and the financial system.² Recent credit market events have demonstrated the seriousness of these risks in a CDS market operating without meaningful regulation, transparency,³ or central counterparties ("CCPs").⁴ These events have emphasized the need for CCPs as mechanisms to help control such risks.⁵ A CCP for CDS could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts. In November 2008, the President's Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority⁶ and, in furtherance of this recommendation, the Commission, the FRB and the Commodity Futures Trading Commission ("CFTC") signed a Memorandum of Understanding⁷ that establishes a framework for consultation and information sharing on issues related to CCPs for CDS. Given the continued uncertainty in this market, taking action to help foster the prompt development of

² In addition to the potential systemic risks that CDS pose to financial stability, we are concerned about other potential risks in this market, including operational risks, risks relating to manipulation and fraud, and regulatory arbitrage risks.

³ See Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets, November 14, 2008, available at <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf> ("Public reporting of prices, trading volumes and aggregate open interest should be required to increase market transparency for participants and the public.").

⁴ See The Role of Credit Derivatives in the U.S. Economy Before the H. Agric. Comm., 110th Cong. (2008) (Statement of Erik Sirri, Director of the Division of Trading and Markets, Commission).

⁵ See *id.*

⁶ See Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf>. See also Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (March 13, 2008), http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf; Progress Update on March Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (October 2008), <http://www.treas.gov/press/releases/reports/q4progress%20update.pdf>.

⁷ See Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 14, 2008), <http://www.treas.gov/press/releases/reports/finalmou.pdf>.

CCPs, including granting conditional exemptions from certain provisions of the federal securities laws, is in the public interest.

A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations of a single entity or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in bonds or in segments of the debt market as represented by an index, or to capitalize on the volatility in credit spreads during times of economic uncertainty. In recent years, CDS market volumes have rapidly increased.⁸ This growth has coincided with a significant rise in the types and number of entities participating in the CDS market.⁹

The Commission's authority over this OTC market for CDS is limited. Specifically, Section 3A of the Securities Exchange Act of 1934 ("Exchange Act") limits the Commission's authority over swap agreements, as defined in Section 206A of the Gramm-Leach-Bliley Act.¹⁰ For those CDS that are swap agreements, the exclusion from the definition of security in Section 3A of the Exchange Act, and related provisions, will continue to apply. The Commission's

⁸ See Semiannual OTC derivatives statistics at end-December 2007, Bank for International Settlements ("BIS"), available at <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

⁹ CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant with their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

¹⁰ 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of "security" under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a "swap agreement" as "any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act. . .) . . . the material terms of which (other than price and quantity) are subject to individual negotiation." 15 U.S.C. 78c note.

action today does not affect these CDS, and this Order does not apply to them. For those CDS that are not swap agreements ("non-excluded CDS"), the Commission's action today provides conditional exemptions from certain requirements of the Exchange Act.

The Commission believes that using well-regulated CCPs to clear transactions in CDS would help promote efficiency and reduce risk in the CDS market and among its participants. These benefits could be particularly significant in times of market stress, as CCPs would mitigate the potential for a market participant's failure to destabilize other market participants, and reduce the effects of misinformation and rumors. CCP-maintained records of CDS transactions would also aid the Commission's efforts to prevent and detect fraud and other abusive market practices.

A well-regulated CCP also would address concerns about counterparty risk by substituting the creditworthiness and liquidity of the CCP for the creditworthiness and liquidity of the counterparties to a CDS. In the absence of a CCP, participants in the OTC CDS market must carefully manage their counterparty risks because the default by a counterparty can render worthless, and payment delay can reduce the usefulness of, the credit protection that has been bought by a CDS purchaser. CDS participants currently attempt to manage counterparty risk by carefully selecting and monitoring their counterparties, entering into legal agreements that permit them to net gains and losses across contracts with a defaulting counterparty, and often requiring counterparty exposures to be collateralized.¹¹ A CCP could allow participants to avoid these risks specific to individual counterparties because a CCP "novates" bilateral trades by entering

¹¹ See generally R. Bliss and C. Papathanassiou, "Derivatives clearing, central counterparties and novation: The economic implications" (March 8, 2006), at 6. See also "New Developments in Clearing and Settlement Arrangements for OTC Derivatives," Committee on Payment and Settlement Systems, BIS, at 25 (March 2007), available at <http://www.bis.org/pub/cpss77.pdf>; "Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market," Before the Sen. Subcomm. On Secs., Ins. and Investments, 110th Cong. (2008) (Statement of Patrick Parkinson, Deputy Director, Division of Research and Statistics, FRB).

from certain requirements under the Exchange Act with respect to their proposed activities in clearing and settling certain index-based CDS, as well as the proposed activities of certain other persons, as described below.¹⁴

Based on the facts that LIFFE A&M and LCH.Clearnet have presented and the representations they have made,¹⁵ and for the reasons discussed in this Order, the Commission temporarily is exempting, subject to certain conditions, LCH.Clearnet from the requirement to register as a clearing agency under Section 17A of the Exchange Act solely to perform the functions of a clearing agency for certain non-excluded CDS transactions. The Commission also temporarily is exempting eligible contract participants and others from certain Exchange Act requirements with respect to non-excluded CDS cleared by LCH.Clearnet. The Commission's exemptions are temporary and will expire on September 25, 2009. To facilitate the operation of one or more CCPs for the CDS market, the Commission has also approved interim final temporary rules providing exemptions under the Securities Act of 1933 and the Exchange Act for non-excluded CDS. Finally, the Commission is providing temporary exemptions in connection with Sections 5 and 6 of the Exchange Act for transactions in non-excluded CDS.¹⁶

¹⁴ See Letter from Arthur W. Hahn, KattenMuchinRosenman LLP, to Florence Harmon, Acting Secretary, Commission, December 24, 2008.

¹⁵ See *id.* The exemptions we are granting today are based on representations made by LIFFE A&M and LCH.Clearnet. We recognize, however, that there could be legal uncertainty in the event that one or more of the underlying representations were to become inaccurate. Accordingly, if any of these exemptions were to become unavailable by reason of an underlying representation no longer being materially accurate, the legal status of existing open positions in non-excluded CDS associated with persons subject to those unavailable exemptions would remain unchanged, but no new positions could be established pursuant to the exemptions until all of the underlying representations were again accurate.

¹⁶ See Securities Exchange Act Release No. 59165 (December 24, 2008).

II. Discussion

A. Description of LIFFE A&M and LCH.Clearnet's Proposal

The exemptive request by LIFFE A&M and LCH.Clearnet describes how their proposed arrangements for central clearing of CDS would operate, and makes representations about the safeguards associated with those arrangements, as described below:

1. LCH Central Counterparty Services for CDS

LIFFE A&M has developed and makes available to its members an OTC derivatives processing service, called Bclear, that will provide a mechanism for the processing and centralized clearing of CDS based on credit default swap indices. The Bclear service processes OTC transactions that are submitted to it by LIFFE A&M members or authorized customers of those members. The Bclear service submits these transactions for clearance to LCH.Clearnet, which stands as the central counterparty to all transactions processed through Bclear.¹⁷ LIFFE A&M will begin processing index CDS through Bclear and would like to make such services available to certain market participants in the U.S. LIFFE A&M represents that the following information regarding index CDS will be available on its Web site (www.nyx.com): (a) contract specifications for index CDS that may be processed and cleared through the Bclear Service, and (b) a description of the Bclear Service and rules applicable thereto.

¹⁷ Bclear provides a means by which counterparties to an index CDS may negotiate a transaction on a bilateral basis and then submit the transaction for processing and clearance by LCH.Clearnet. Bclear accepts only completed transactions and is not a matching system for counterparties.

LCH.Clearnet provides CCP services to the following markets and services: London Stock Exchange, SWX Europe Ltd., LIFFE, EDX London, London Metal Exchange, other European Multilateral Trading Facilities ("MTF"), and RepoClear and SwapClear.¹⁸

LIFFE A&M has been granted recognition as a Recognised Investment Exchange under the United Kingdom ("U.K.") Financial Services and Markets Act 2000 ("FSMA") by the Financial Services Authority ("FSA"). LCH.Clearnet has been granted recognition as a Recognized Clearing House ("RCH") under FSMA by the FSA.¹⁹ Regulation and oversight in the U.K. is carried out by the FSA and the Bank of England. The FSA is the main regulator of LCH.Clearnet as an RCH, while the Bank of England's oversight is confined to LCH.Clearnet's payment system.²⁰

The FSA has a regulatory supervision relationship with LIFFE A&M and with LCH.Clearnet. On an annual basis, the FSA undertakes a risk assessment of LIFFE A&M and LCH.Clearnet pursuant to which the FSA determines whether relevant regulatory obligations

¹⁸ LCH.Clearnet publishes its rules and procedures for the various markets cleared, together with information on risk management, application costs and procedures, minimum contributions towards and interest rates on the default fund, and transactions tariffs.

¹⁹ LCH.Clearnet has been approved as a Derivatives Clearing Organization ("DCO") by the CFTC. In addition, FSA and the Bank of England performed a risk assessment of LCH in June 2006 against the Recommendations for Central Counterparties ("RCCP"), which was drafted by a joint task force composed of representative members of the International Organization of Securities Commissions ("IOSCO") and Committee on Payment and Settlement Systems ("CPSS") and published in November 2004.

The Task Force consisted of securities regulators and central bankers from 19 countries and the European Union. The U.S. representatives on the Task Force included staff from the Commission, FRB, and the CFTC. The complete RCCP Report is available on the Web sites of the Bank for International Settlements and the International Organization of Securities Commission at, <http://www.bis.org/publ/cpss64.htm>, and at <http://www.iosco.org>, respectively. LCH.Clearnet has assured the Commission that it is in full compliance with the Recommendations for Central Counterparties. The assessment can be found at <http://www.fsa.gov.uk/pubs/other/lchclearnet.pdf>.

²⁰ LCH.Clearnet is owned 73.3 percent by users, 10.9 percent by exchanges, and 15.8 percent by Euroclear. Euroclear is a user-owned, user-governed Brussels, Belgium-based financial services company that specializes in the settlement of securities transactions.

continue to be met and whether the activities of either LIFFE A&M or LCH.Clearnet pose any risks to the FSA's statutory objectives, including maintaining market confidence and providing customer protection. The FSA approves the business continuity plans of LCH.Clearnet.

2. CCP Role of LCH.Clearnet in Connection with LIFFE A&M

LIFFE A&M has two categories of members, clearing members and non-clearing members. LIFFE A&M further has two types of clearing members: Individual Clearing Members that clear and settle business for their own account or, in the case of broker-dealers, on behalf of their customers; and General Clearing Members that, in addition, clear and settle business on behalf of other LIFFE A&M members. All transactions of non-clearing members must be cleared through a specific clearing member. All clearing members must also be members of LCH.Clearnet and all are subject to standards of capital adequacy (set by LCH.Clearnet as well as by their respective regulators). Clearing members must also satisfy LIFFE A&M and LCH.Clearnet that they have adequate systems and controls to clear and settle transactions.

The rules of LIFFE A&M provide for members to trade for their own account and/or for their customers, but all transactions must be in the name of the member effecting the trade and that member will be the counterparty for those transactions. Thus, a LIFFE A&M member will be considered to be "acting as principal." This means that a transaction on LIFFE A&M automatically generates a sequence of matching contracts. For example, a sequence could be between a customer and a LIFFE A&M member, between that member and a clearing member, and between the clearing member and LCH.Clearnet.

The purpose of the LIFFE A&M rules is to ensure that a party to a transaction need only look to its immediate counterparty for performance and need not concern itself with parties at

other points on the contractual chain. Thus, LCH.Clearnet need only look to its clearing members and would have no contractual relationship with, or knowledge of, the non-clearing members of LIFFE A&M or customers on whose behalf the transaction was executed.

Hence, LCH.Clearnet is the CCP to clearing firms each acting as principal in respect of index CDS. Non-clearing members and non-member customers are not party to any contracts registered by clearing members with LCH.Clearnet. Once an index CDS contract has been accepted by LIFFE A&M, a chain of linked contracts is created, all having the same terms. Specifically, the process by which the chain of linked contracts is created is as follows:

a. When a non-member customer enters into an index CDS with or through a non-clearing member, the non-clearing member submits the contract to Bclear. Once LIFFE A&M has accepted the contract, an exchange contract²¹ is created between the non-clearing member, as principal, and its customer. If another customer was originally a counterparty to the index CDS, an exchange contract is created between the non-clearing member, as principal, and the second customer. The contracts are referred to as "customer contracts." The customer contracts replace the initial index CDS, which ceases to exist at that point.

b. Simultaneously, a matching contract between the non-clearing member and its clearing member, called a "parallel contract," comes into existence for each of the customer contracts.

c. If the counterparty to the trade is a customer of another non-clearing member, a "related contract" is created between the respective clearing members. The related contract is presented to LCH.Clearnet for registration. If there is a single non-clearing member involved in the transaction, the parallel contracts are presented to LCH.Clearnet for registration.

²¹ An "exchange contract" refers to a contract that is subject to the rules of LIFFE A&M. The term does not indicate that a central order book exists for a product.

d. The related contract is replaced by contracts between LCH.Clearnet and the clearing member on each side of the transaction.

Through this process, the index CDS is discharged and a set of on-exchange contracts arise imposing equivalent obligations on and granting equivalent rights to the original parties to the index CDS, but with LCH.Clearnet as the CCP. Because the non-member customer will not be a party to a contract registered with LCH.Clearnet by the clearing member, the relationship between the non-member customer and the non-clearing member will remain intact, although such relationship will now be based upon the exchange contract, rather than the index CDS originally entered into by the respective parties.

3. LCH Risk Management

LCH.Clearnet requires the posting of initial margin and maintenance ("variation") margin for all clearing accounts. The initial margin and maintenance margin is determined utilizing the London SPAN (Standard Portfolio Analysis of Risk) methodology. London SPAN was adapted from the Chicago Mercantile Exchange's margining system.

The initial margin requirement for a member's CDS portfolio is the largest loss identified under these various market conditions that might reasonably occur taking into account risk offsets within the CDS portfolio. Initial margin is refunded when the margined index CDS position is closed. This risk management methodology is designed to protect LCH.Clearnet against the worst likely loss from one or two days' move in the market.

Net Liquidation Value ("NLV"), the value of a member's portfolio at closing market prices representing the income or expenditure which would be associated with closing out an index CDS position, is added to initial margin to give the total margin requirement.

LCH.Clearnet revalues the margin positions of its members on at least a daily basis to account for changes or volatility in the market price of the underlying index and in LCH.Clearnet's valuation of margin collateral provided in the form of securities. During the day, LCH.Clearnet monitors market prices and clearing members' positions and may call for additional margin payments from members. LCH.Clearnet then revalues each member's margin requirements each night.²²

LCH.Clearnet's margin requirements are only applicable to clearing members. All clearing members must provide LCH.Clearnet with enough margin to cover the risk on their total net positions for each account they clear. Clearing members and/or non-clearing members in turn set the margin requirements applicable to their customers.

4. Margin Collateral

LCH.Clearnet accepts a wide variety of collateral types from clearing members in meeting their initial and NLV margin payments. Members may meet their margin requirements by cash payments in the following currencies: sterling, U.S. dollars, yen, Swiss francs, and euros. In addition, LCH.Clearnet will accept an extensive range of collateral including approved bank

²² While LCH.Clearnet's margin requirements are central to its risk management, LCH.Clearnet also has other measures at its disposal, including:

1. additional financial resource requirements (buffers);
2. additional initial margin requirements;
3. imposition of position limits;
4. trading for liquidation only;
5. prior authorization of trades above a certain size; and
6. issuing instructions to reduce positions.

LCH.Clearnet also monitors large cumulative profits or losses. If large and unusual trading activity is detected (relative to previous exposures), LCH.Clearnet will contact compliance officers and seek assurances from the senior executives or boards of a member firm or parent company.

guarantees, certain U.K. treasury bills, U.K. gilts, sterling, U.S. dollar certificates of deposit, German, Italian, and Spanish government bonds and U.K. equities.

To avoid frequent margin payments, clearing members may deposit margin in excess of the LCH.Clearnet required minimum. In such cases, LCH.Clearnet pays interest to clearing members on excess cash margin on deposit currently at the overnight London Inter-Bank Bid Rate ("LIBID") minus twenty-five basis points.

5. Member Default

If a clearing member appears to LCH.Clearnet to be unable, or likely to become unable, to meet its obligations to LCH.Clearnet, it may be declared by LCH.Clearnet in default under LCH.Clearnet's default rules in relation to the contracts registered by it with LCH.Clearnet.

Where a clearing member has been declared in default by LCH.Clearnet, contracts between such clearing member and its non-clearing members and clients will be dealt with under LIFFE A&M's default rules. A default by a non-clearing member will also be dealt with under LIFFE A&M's default rules. Where the defaulting party is an LCH.Clearnet clearing member, LCH.Clearnet's default rules take primacy over LIFFE A&M's, although all actions in such circumstances are typically coordinated between LCH.Clearnet and LIFFE A&M to take advantage of statutory protections afforded to LCH.Clearnet as an RCH.

As the legal counterparty to each clearing member, LCH.Clearnet bears any loss arising from the default of a clearing member, beyond the margin deposits held as security in respect of the defaulting member's liabilities. LCH.Clearnet's supplementary resources for use in default cases, should a member's margin deposits prove insufficient, comprise a Default Fund, totaling approximately £600 million, which is provided by members and held in cash by LCH. Each member's Default Fund contribution is assessed every three months on the basis of that

member's initial margin and (in the case of exchange traded derivatives) trading volumes over the preceding three months.

The Default Fund is "mutualized" in that any loss faced by LCH.Clearnet as a result of a default which cannot be met from the defaulter's margin on deposit at LCH.Clearnet or from its contribution to the Default Fund will be met by the Default Fund generally. Customers of a defaulting clearing member have no contractual relationship with LCH.Clearnet, but are protected to the extent of their client agreement with the defaulting member and any segregation arrangements in place with the defaulting member.²³

LCH.Clearnet uses a stress testing model to ensure that its post-default financial backing is sufficient. The stress testing model assesses the adequacy of initial margin requirements and the Default Fund on the basis of extreme price movement scenarios in all contracts cleared by LCH.

The sequence of protections to be applied in the event of a default is as follows:²⁴

- a. Defaulting Member's Initial Margin (including excess collateral posted).
- b. Defaulting Member's Default Fund Contribution.
- c. Up to £20 million of LCH.Clearnet's capital and reserves.
- d. Remainder of the Default Fund.
- e. Remainder of LCH.Clearnet's capital and reserves.

As the counterparty to every clearing member, LCH.Clearnet reduces the scope of counterparty risk between clearing members. LCH.Clearnet is legally responsible for the financial performance of the contracts that it has registered and any resulting delivery

²³ LCH is not a counterparty to contracts that clearing members have with their customers.

²⁴ The sequence does not take into account the anticipated replenishment of the Default Fund by market members and/or national governments between steps d. and e.

obligations. LCH.Clearnet represents that its rules and procedures are available on its Web site and such rules and procedures generally set forth the sequence of protections to be applied in the event of a default by a clearing member.

6. Client Money Rules and Other Member Requirements

Clearing members that undertake business for clients are subject to UK client money and client asset rules or, if they are authorized outside the UK, similar rules of their relevant regulator. In the European Union, the client money rules are governed by the Markets in Financial Instruments Directive, although the UK client money rules prescribe some extended conditions in certain cases. Clearing members may have two accounts with LCH.Clearnet, one for segregated customer business and one for all house and non-segregated client business, and neither LCH.Clearnet nor the clearing member can offset liabilities on the house margin account with credits arising on the client margin account. Clearing members are required to segregate customer funds and securities except in instances where the investor, if permitted to do so, contracts out of the segregation requirement.

LIFFE A&M represents that it only considers for membership entities located in jurisdictions with regulatory arrangements it deems satisfactory regarding: (i) supervision of investment activity; (ii) information sharing and cooperation between the supervisory authority of the jurisdiction concerned and LIFFE A&M and/or the FSA; and (iii) capital adequacy, liquidity, and segregation of customers' funds and securities (and related books and records provisions). LIFFE A&M further represents that before offering Index CDS services to U.S. persons, LIFFE A&M will adopt a requirement that will prohibit a member from directly or indirectly submitting, or permitting an authorized customer to submit, an Index CDS to the Bclear service when the member receives or holds funds or securities of U.S. persons for the

purpose of purchasing, selling, clearing, settling, or holding that Index CDS position, unless the member, in connection with such Index CDS activities, is regulated by: (i) a signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, (ii) a signatory to a bilateral arrangement with the Commission for enforcement cooperation, or (iii) a financial regulatory authority in Ireland or Sweden. In that regard, LIFFE A&M states that it intends to launch the Index CDS service for non-U.S. persons on December 22, 2008. LIFFE A&M will notify members at that time that the service may not be offered to U.S. persons until LIFFE A&M issues an additional notice.

In addition, LCH.Clearnet represents that its rules require its clearing members to: (i) meet specific capital adequacy standards that vary depending on the type of activities undertaken by the member; (ii) provide copies of audited annual financial statements to LCH.Clearnet; and (iii) notify LCH.Clearnet upon the happening of certain material events, such as significant reductions in shareholders' funds or net capital.

B. Temporary Conditional Exemption from Clearing Agency Registration Requirement

Section 17A of the Exchange Act sets forth the framework for the regulation and operation of the U.S. clearance and settlement system, including CCPs. Specifically, Section 17A directs the Commission to use its authority to promote enumerated Congressional objectives and to facilitate the development of a national clearance and settlement system for securities transactions. Absent an exemption, a CCP that novates trades of non-excluded CDS that are securities and generates money and settlement obligations for participants is required to register with the Commission as a clearing agency.

Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons,

securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, by rule, regulation, or order, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.²⁵

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant an exemption until September 25, 2009 to LCH.Clearnet from Section 17A of the Exchange Act, solely to perform the functions of a clearing agency for Cleared Index CDS,²⁶ subject to the conditions discussed below.

Our action today balances the aim of facilitating the prompt establishment of LCH.Clearnet as a CCP for non-excluded CDS transactions – which should help reduce systemic risks during a period of extreme turmoil in the U.S. and global financial markets – with ensuring that important elements of Commission oversight are applied to the non-excluded CDS market. In doing so, we are mindful that applying the full scope of the Exchange Act to transactions involving non-excluded CDS could deter the prompt establishment of LCH.Clearnet as a CCP to settle those transactions.

²⁵ 15 U.S.C. 78mm.

²⁶ For purposes of this exemption, and the other exemptions addressed in this Order, “Cleared Index CDS” means a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to LCH.Clearnet, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which the reference index is an index in which 80 percent or more of the index’s weighting is comprised of the following entities or securities: (i) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available; (ii) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States; (iii) a foreign sovereign debt security; (iv) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or (v) an asset-backed security issued or guaranteed by the Fannie Mae, Freddie Mac, or the Government National Mortgage Association (“Ginnie Mae”). As discussed above, the Commission’s action today does not affect CDS that are swap agreements under Section 206A of the Gramm-Leach-Bliley Act. See text at note 10, *supra*.

While we are acting so that the prompt establishment of LCH.Clearnet as a CCP for non-excluded CDS will not be delayed by the need to apply the full scope of Exchange Act Section 17A's requirements that govern clearing agencies, the relief we are providing is temporary and conditional. The limited duration of the exemptions will permit the Commission to gain more direct experience with the non-excluded CDS market after LCH.Clearnet becomes operational, giving the Commission the ability to oversee the development of the centrally cleared non-excluded CDS market as it evolves. During the exemptive period, the Commission will closely monitor the impact of the CCPs on the CDS market. In particular, the Commission will seek to assure itself that the CCPs do not act in anticompetitive manner or indirectly facilitate anticompetitive behavior with respect to fees charged to members, the dissemination of market data and the access to clearing services by independent CDS exchanges or CDS trading platforms. The Commission will take that experience into account in future actions.

Moreover, this temporary exemption in part is based on LCH.Clearnet's representation that it meets the standards set forth in the RCCP.²⁷ The RCCP establishes a framework that requires a CCP to have: (i) the ability to facilitate the prompt and accurate clearance and settlement of CDS transactions and to safeguard its users' assets; and (ii) sound risk management, including the ability to appropriately determine and collect clearing fund and monitor its users' trading. This framework is generally consistent with the requirements of Section 17A of the Exchange Act.

In addition, this Order is designed to assure that – as LCH.Clearnet and LIFFE A&M have represented – information will be available to market participants about the terms of the CDS cleared by LCH.Clearnet, the creditworthiness of LCH.Clearnet or any guarantor, and the

²⁷ See note 19, *supra*.

clearing and settlement process for the CDS. Moreover, to be within the definition of Cleared Index CDS for purposes of this exemption (as well as the other exemptions granted through this Order), at least 80 percent of the weighting of the index must be comprised of reference entities or reference securities that satisfy certain conditions relating to the availability of information about such persons or securities. The definition does not prescribe the type of financial information that must be available nor the location of the particular information, recognizing that eligible contract participants have access to information about reference entities and reference securities through multiple sources. The Commission believes, however, that it is important in the CDS market, as in the market for securities generally, that parties to transactions should have access to financial information that would allow them to appropriately evaluate the risks relating to a particular investment and make more informed investment decisions.²⁸ Such information availability also will assist LCH.Clearnet and the buyers and sellers in valuing their Cleared Index CDS and their counterparty exposures. As a result of the Commission's actions today, the Commission believes that information should be available for market participants to be able to make informed investment decisions, and value and evaluate their Cleared Index CDS and their counterparty exposures.

This temporary exemption is subject to a number of conditions that are designed to enable Commission staff to monitor LCH.Clearnet's clearance and settlement of CDS transactions, coordinate and cooperate with the FSA, and help reduce risk in the CDS market. These conditions require that LCH.Clearnet: (i) make available on its Web site annual audited

²⁸ The Commission notes the recommendations of the President's Working Group on Financial Markets regarding the informational needs and due diligence responsibilities of investors. See Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets, March 13, 2008, available at: http://www.treas.gov/press/releases/reports/pwgpolicystatemkkturmoil_03122008.pdf.

financial statements; (ii) preserve records related to the conduct of its Cleared Index CDS clearance and settlement services for at least five years (in an easily accessible place for the first two years); (iii) supply information relating to its Cleared Index CDS clearance and settlement services to the Commission; (iv) provide access to the Commission to conduct on-site inspections of facilities, records and personnel related to its Cleared Index CDS clearance and settlement services, subject to coordination with FSA and upon terms and conditions agreed between the FSA and the Commission; (v) notify the Commission about material disciplinary actions taken against users of its Cleared Index CDS clearance and settlement services, and about the involuntary termination of the membership of an entity using those services; (vi) provide the Commission with prior notice of changes to its Default Rules and Default Fund Rules; (vii) provide the Commission with reports with respect to certain automated systems used in connection with its Cleared Index CDS clearance and settlement services, and with annual audited financial statements;²⁹ and (viii) provide notice to the Commission regarding the suspension of services or the inability to operate facilities in connection with its Cleared Index CDS clearance and settlement services.

In addition, this relief is conditioned on LCH.Clearnet, directly or indirectly, making available to the public on terms that are fair and reasonable and not unreasonably discriminatory:

(i) all end-of-day settlement prices and any other prices with respect to Cleared Index CDS that LCH.Clearnet may establish to calculate mark-to market margin requirements for LCH.Clearnet

²⁹ As a condition of LCH.Clearnet's exemption, LIFFE A&M has agreed to provide the Commission with reports with respect to certain automated systems used in connection with LCH.Clearnet's Cleared Index CDS clearance and settlement services. These reports will be generated in accordance with risk assessments of the areas set forth in the Commission's Automation Review Policy Statements ("ARPs"). See Automated Systems of Self-Regulatory Organization, Securities Exchange Act Release No. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989), and Automated Systems of Self-Regulatory Organization (II), Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

or LIFFE A&M participants; and (ii) any other pricing or valuation information with respect to Cleared Index CDS as is published or distributed by LCH.Clearnet or LIFFE A&M. The Commission believes this is an appropriate condition for LCH.Clearnet's exemption from registration as a clearing agency. In Section 11A of the Exchange Act, Congress included a finding that "[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities."³⁰ The President's Working Group on Financial Markets has stated that increased transparency is a policy objective for the over-the-counter derivatives market,³¹ which includes the market for CDS. This condition is designed to further this policy objective of both Congress and the President's Working Group by requiring LCH.Clearnet and LIFFE A&M to make available to the public on terms that are fair and reasonable all end-of-day settlement prices and any other prices with respect to Cleared Index CDS that LCH.Clearnet may establish to calculate mark-to-market margin requirements for LCH.Clearnet or LIFFE A&M Participants. In addition, LCH.Clearnet or LIFFE A&M must make available to the public on terms that are fair and reasonable and not unfairly discriminatory any other pricing or valuation information with respect to Cleared Index CDS as is published or distributed by LCH.Clearnet or LIFFE A&M.

As a CCP, LCH.Clearnet will collect and process information about CDS transactions and positions from all of its participants. With this information, a CCP will, among other things, calculate and disseminate current values for open positions for the purpose of setting appropriate

³⁰ 15 U.S.C. 78k-1(a)(1)(C)(iii). See also 15 U.S.C. 78k-1(a)(1)(D).

³¹ See President's Working Group on Financial Markets, Policy Objectives for the OTC Derivatives Market (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf> ("Public reporting of prices, trading volumes and aggregate open interest should be required to increase market transparency for participants and the public.").

margin levels, or have an agent perform these functions on its behalf. The availability of such information can improve fairness, efficiency, and competitiveness of the market – all of which enhance investor protection and facilitate capital formation. Moreover, with pricing and valuation information relating to Cleared Index CDS, market participants would be able to derive information about underlying securities and indexes. This may improve the efficiency and effectiveness of the securities markets by allowing investors to better understand credit conditions generally.

C. Temporary General Exemption for LCH.Clearnet, LIFFE A&M and Certain Eligible Contract Participants

Applying the full panoply of Exchange Act requirements to participants in transactions in non-excluded CDS likely would deter some participants from using CCPs to clear CDS transactions. At the same time, it is important that the antifraud provisions of the Exchange Act apply to transactions in non-excluded CDS; indeed, OTC transactions subject to individual negotiation that qualify as security-based swap agreements already are subject to these antifraud provisions.³²

³² While Section 3A of the Exchange Act excludes “swap agreements” from the definition of “security,” certain antifraud and insider trading provisions under the Exchange Act explicitly apply to security-based swap agreements. See (a) paragraphs (2) through (5) of Section 9(a), 15 U.S.C. 78i(a), prohibiting the manipulation of security prices; (b) Section 10(b), 15 U.S.C. 78j(b), and underlying rules prohibiting fraud, manipulation or insider trading (but not prophylactic reporting or recordkeeping requirements); (c) Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices; (d) Sections 16(a) and (b), 15 U.S.C. 78p(a) and (b), which address disclosure by directors, officers and principal stockholders, and short-swing trading by those persons, and rules with respect to reporting requirements under Section 16(a); (e) Section 20(d), 15 U.S.C. 78t(d), providing for antifraud liability in connection with certain derivative transactions; and (f) Section 21A(a)(1), 15 U.S.C. 78u-1(a)(1), related to the Commission’s authority to impose civil penalties for insider trading violations.

“Security-based swap agreement” is defined in Section 206B of the Gramm-Leach-Bliley Act as a swap agreement in which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

We thus believe that it is appropriate in the public interest and consistent with the protection of investors temporarily to apply substantially the same framework to transactions by market participants in non-excluded CDS that applies to transactions in security-based swap agreements. Applying substantially the same set of requirements to participants in transactions in non-excluded CDS as apply to participants in OTC CDS transactions will avoid deterring market participants from promptly using CCPs, which would detract from the potential benefits of central clearing.

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant an exemption until September 25, 2009 from certain requirements under the Exchange Act. This temporary exemption applies to LCH.Clearnet and LIFFE A&M, and also to certain eligible contract participants³³ other than: eligible contract participants that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling or holding Cleared Index CDS positions for other persons;³⁴ eligible contract participants that are

³³ This exemption in general applies to eligible contract participants, as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order, other than persons that are eligible contract participants under paragraph (C) of that section.

³⁴ For these purposes, and for the purpose of the definition of "Cleared Index CDS," the terms "purchasing" and "selling" mean the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing the rights or obligations under, a Cleared Index CDS, as the context may require. This is consistent with the meaning of the terms "purchase" or "sale" under the Exchange Act in the context of security-based swap agreements. See Exchange Act Section 3A(b)(4).

A separate temporary conditional exemption addresses members of LIFFE A&M that hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared Index CDS positions for other persons. See Part II.D, infra.

self-regulatory organizations; or eligible contract participants that are registered brokers or dealers.³⁵

Under this temporary exemption, and solely with respect to Cleared Index CDS, these persons generally are exempt from provisions of the Exchange Act and the rules and regulations thereunder that do not apply to security-based swap agreements. Those persons thus would still be subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements.³⁶ In addition, all provisions of the Exchange Act related to the Commission's enforcement authority in connection with violations or potential violations of such provisions would remain applicable.³⁷ In this way, the temporary exemption would apply the same Exchange Act requirements in connection with non-excluded CDS as apply in connection with OTC credit default swaps.

This temporary exemption, however, does not extend to Sections 5 and 6 of the Exchange Act. The Commission separately is issuing a conditional exemption from these provisions to all broker-dealers and exchanges.³⁸ This temporary exemption also does not extend to Section 17A of the Exchange Act; instead, LCH.Clearnet is exempt from registration as a clearing agency under the conditions discussed above. In addition, this exemption does not apply to Exchange

³⁵ A separate temporary exemption addresses the Cleared Index CDS activities of registered broker-dealers. See Part II.E, *infra*.

³⁶ See note 32, *supra*.

³⁷ Thus, for example, the Commission retains the ability to investigate potential violations and bring enforcement actions in the federal courts and administrative proceedings, and to seek the full panoply of remedies available in such cases.

³⁸ See note 16, *supra*. A national securities exchange that effects transactions in Cleared Index CDS would continue to be required to comply with all requirements under the Exchange Act applicable to such transactions. A national securities exchange could form subsidiaries or affiliates that operate exchanges exempt under that order. Any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link, the exempt CDS exchange with the registered exchange including the premises or property of such exchange for effecting or reporting a transaction without being considered a "facility of the exchange." See Section 3(a)(2), 15 U.S.C. 78c(a)(2).

Act Sections 12, 13, 14, 15(d) and 16;³⁹ eligible contract participants and other persons instead should refer to the interim final temporary rules issued today by the Commission. Finally, this temporary exemption does not extend to the Commission's administrative proceeding authority under Sections 15(b)(4) and (b)(6),⁴⁰ or to certain provisions related to government securities.⁴¹

D. Conditional Temporary General Exemption for Certain Clearing Members of LIFFE

A&M and LCH.Clearnet

Absent an exception, persons that effect transactions in non-excluded CDS that are securities may be required to register as broker-dealers pursuant to Section 15(a)(1) of the Exchange Act.⁴² Moreover, certain reporting and other requirements of the Exchange Act could

³⁹ 15 U.S.C. 78l, 78m, 78n, 78o(d), 78p.

⁴⁰ Exchange Act Sections 15(b)(4) and 15(b)(6), 15 U.S.C. 78o(b)(4) and (b)(6), grant the Commission authority to take action against broker-dealers and associated persons in certain situations. Accordingly, while this exemption generally extends to persons that act as inter-dealer brokers in the market for Cleared Index CDS and do not hold funds or securities for others, such inter-dealer brokers may be subject to actions under Sections 15(b)(4) and (b)(6) of the Exchange Act.

In addition, such inter-dealer brokers may be subject to actions under Exchange Act Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices. As noted above, Section 15(c)(1) explicitly applies to security-based swap agreements. Sections 15(b)(4), 15(b)(6) and 15(c)(1), of course, would not apply to persons subject to this exemption who do not act as broker-dealers or associated persons of broker-dealers.

⁴¹ This exemption specifically does not extend to the Exchange Act provisions applicable to government securities, as set forth in Section 15C, 15 U.S.C. 78o-5, and its underlying rules and regulations; nor does the exemption extend to related definitions found at paragraphs (42) through (45) of Section 3(a), 15 U.S.C. 78c(a). The Commission does not have authority under Section 36 to issue exemptions in connection with those provisions. See Exchange Act Section 36(b), 15 U.S.C. 78mm(b).

⁴² 15 U.S.C. 78o(a)(1). This section generally provides that, absent an exception or exemption, a broker or dealer that uses the mails or any means of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security must register with the Commission.

Section 3(a)(4) of the Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," but provides 11 exceptions for certain bank securities activities. 15 U.S.C. 78c(a)(4). Section 3(a)(5) of the Exchange Act generally defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account," but includes exceptions for certain bank activities. 15 U.S.C. 78c(a)(5). Exchange Act Section 3(a)(6) defines a "bank" as a bank or savings association that is directly supervised and examined by state or federal banking authorities (with certain additional requirements for banks and savings associations

apply to such persons, as broker-dealers, regardless of whether they are registered with the Commission.

It is consistent with our investor protection mandate to require that intermediaries in securities transactions that receive or hold funds and securities on behalf of others comply with standards that safeguard the interests of their customers. For example, registered broker-dealers are required to segregate assets held on behalf of customers from proprietary assets, because segregation will assist customers in recovering assets in the event the intermediary fails. To the extent that funds and securities are not segregated, they could be used by a participant to fund its own business and could be attached to satisfy debts of the participant were the participant to fail. Moreover, the maintenance of adequate capital and liquidity protects customers, CCPs and other market participants. Adequate books and records (including both transactional and position records) are necessary to facilitate day to day operations as well as to help resolve situations in which a participant fails and either a regulatory authority or receiver is forced to liquidate the firm. Appropriate records also are necessary to allow examiners to review for improper activities, such as insider trading or fraud.

At the same time, requiring intermediaries that receive or hold funds and securities on behalf of customers in connection with transactions in non-excluded CDS to register as broker-dealers may deter the use of CCPs in CDS transactions, to the detriment of the markets and market participants generally. Also, as noted above with regard to other eligible contract participants to non-excluded CDS transactions, immediately applying the panoply of Exchange Act requirements to centrally cleared transactions may deter the use of CCPs for CDS transactions.

that are not chartered by a federal authority or a member of the Federal Reserve System). 15 U.S.C. 78c(a)(6).

Those factors argue in favor of flexibility in applying the requirements of the Exchange Act to these intermediaries. Along with those factors, in granting an exemption here we are particularly relying on the representation of LIFFE A&M that it only considers for membership entities located in jurisdictions with regulatory arrangements it deems satisfactory regarding: (i) supervision of investment activity; (ii) information sharing and cooperation between the supervisory authority of the jurisdiction concerned and LIFFE A&M and/or the FSA; and (iii) capital adequacy, liquidity, and segregation of customers' funds and securities (and related books and records provisions). We also are particularly relying on the representation of LCH.Clearnet that its rules require its clearing members to: (i) meet specific capital adequacy standards that vary depending on the type of activities undertaken by the member; (ii) provide copies of audited annual financial statements to LCH.Clearnet; and (iii) notify LCH.Clearnet upon the happening of certain material events, such as significant reductions in shareholders' funds or net capital.

We further are relying on LIFFE A&M's representation that before offering Index CDS services to U.S. persons,⁴³ LIFFE A&M will adopt a requirement that will prohibit a member from directly or indirectly submitting, or permitting an authorized customer to submit, an Index CDS to the Bclear service when the member receives or holds funds or securities of U.S. persons for the purpose of purchasing, selling, clearing, settling, or holding that Index CDS position, unless the member, in connection with such Index CDS activities, is regulated by: (i) a signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, (ii) a signatory to a bilateral arrangement with the Commission for enforcement cooperation, or (iii) a financial regulatory authority in Ireland or

⁴³ As noted above, LIFFE A&M states that it intends to launch the Index CDS service for non-U.S. persons on December 22, 2008. LIFFE A&M will notify members at that time that that the service may not be offered to U.S. persons until LIFFE A&M issues an additional notice.

Sweden.⁴⁴ This will help ensure that the Commission can access trading records and other information of LIFFE A&M members as needed to enforce the federal securities laws.

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant a conditional exemption until September 25, 2009 from certain Exchange Act requirements. In general, we are providing a temporary exemption, subject to the conditions discussed below, to any member of LIFFE A&M that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling or holding Cleared Index CDS positions for other persons. Solely with respect to Cleared Index CDS, those members generally will be exempt from those provisions of the Exchange Act and the underlying rules and regulations that do not apply to security-based swap agreements.⁴⁵

As with the exemption discussed above that is applicable to LCH.Clearnet, LIFFE A&M and certain eligible contract participants, and for the same reasons, this exemption for LIFFE A&M members that receive or hold funds and securities does not extend to Exchange Act provisions that explicitly apply in connection with security-based swap agreements,⁴⁶ or to related enforcement authority provisions.⁴⁷ As with the exemption discussed above, we also are

⁴⁴ The Commission has established informal relationships with securities authorities in Ireland and Sweden and cooperates with them on an ad hoc basis. The Commission will explore entering into arrangements for cooperation with these authorities and, in the near term, will seek letters of intent to cooperate.

⁴⁵ This exemption will be available both to clearing members and to non-clearing members of LIFFE A&M that hold funds and securities on behalf of others in connection with transactions in Cleared Index CDS.

⁴⁶ See note 32, supra.

⁴⁷ See note 37, supra.

not exempting those members from Sections 5, 6, 12(a) and (g), 13, 14, 15(b)(4), 15(b)(6), 15(d), 16 and 17A of the Exchange Act.⁴⁸

This temporary exemption is subject to the member complying with conditions that are important for protecting customer funds and securities. Particularly, the member must be in material compliance with the rules of LIFFE A&M and, if it is a clearing member, with the rules of LCH.Clearnet, and applicable laws and regulations, relating to capital, liquidity, and segregation of customers' funds and securities (and related books and records provisions) with respect to non-excluded CDS.⁴⁹ Also, to the extent that the member receives or holds funds or securities of U.S. eligible contract participants for the purpose of purchasing, selling, clearing, settling or holding non-excluded CDS positions for those persons, this exemption is predicated on the member satisfying the following three conditions: (i) the U.S. persons cannot be natural persons; (ii) the member must segregate such funds and securities of such U.S. persons from the member's own assets (i.e., the member may not permit U.S. persons to "opt out" of applicable segregation requirements for such funds and securities even if regulations or laws would permit the person to "opt out"); and (iii) the member shall disclose to such U.S. persons that the member is not regulated by the Commission and that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the member.

⁴⁸ Nor are we exempting those members from provisions related to government securities, as discussed above.

⁴⁹ A member would not be "in material compliance" if it failed in any way to segregate customer funds and securities consistent with these rules, laws and regulations. In that circumstance, the member could not rely on this exemption.

E. Temporary General Exemption for Certain Registered Broker-Dealers

The temporary exemptions addressed above – with regard (i) to LCH.Clearnet, LIFFE A&M and certain eligible contract participants and (ii) to LIFFE A&M members that receive or hold funds and securities of others – are not available to persons that are registered as broker-dealers with the Commission (other than those that are notice registered pursuant to Section 15(b)(11)).⁵⁰ The Exchange Act and its underlying rules and regulations require broker-dealers to comply with a number of obligations that are important to protecting investors and promoting market integrity. We are mindful of the need to avoid creating disincentives to the prompt use of CCPs, and we recognize that the factors discussed above suggest that the full panoply of Exchange Act requirements should not immediately be applied to registered broker-dealers that engage in transactions involving Cleared Index CDS. At the same time, we also are sensitive to the critical importance of certain broker-dealer requirements to promoting market integrity and protecting customers (including those broker-dealer customers that are not involved with CDS transactions).

This calls for balancing the facilitation of the development and prompt implementation of CCPs with the preservation of certain key investor protections. Pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant an exemption until September 25, 2009 from certain Exchange Act requirements. Consistent with the temporary exemptions discussed above, and solely with respect to Cleared Index CDS, we are exempting registered broker-dealers in general from provisions of the Exchange Act and its underlying rules and regulations that do not apply to security-based swap agreements. As

⁵⁰ Exchange Act Section 15(b)(11) provides for notice registration of certain persons that effect transactions in security futures products. 15 U.S.C. 78o(b)(11).

above, we are not excluding registered broker-dealers from Exchange Act provisions that explicitly apply in connection with security-based swap agreements or from related enforcement authority provisions.⁵¹ As above, and for similar reasons, we are not exempting registered broker-dealers from: Sections 5, 6, 12(a) and (g), 13, 14, 15(b)(4), 15(b)(6), 15(d), 16 and 17A of the Exchange Act.⁵²

Further we are not exempting registered broker-dealers from the following additional provisions under the Exchange Act: (1) Section 7(c),⁵³ which addresses the unlawful extension of credit by broker-dealers; (2) Section 15(c)(3),⁵⁴ which addresses the use of unlawful or manipulative devices by broker-dealers; (3) Section 17(a),⁵⁵ regarding broker-dealer obligations to make, keep and furnish information; (4) Section 17(b),⁵⁶ regarding broker-dealer records subject to examination; (5) Regulation T⁵⁷, a Federal Reserve Board regulation regarding extension of credit by broker-dealers; (6) Exchange Act Rule 15c3-1, regarding broker-dealer net capital; (7) Exchange Act Rule 15c3-3, regarding broker-dealer reserves and custody of securities; (8) Exchange Act Rules 17a-3 through 17a-5, regarding records to be made and preserved by broker-dealers and reports to be made by broker-dealers; and (9) Exchange Act Rule 17a-13, regarding quarterly security counts to be made by certain exchange members and broker-dealers. Registered broker-dealers should comply with these provisions in connection

⁵¹ See notes 32 and 37, *supra*. As noted above, broker-dealers also would be subject to Section 15(c)(1) of the Exchange Act, which prohibits brokers and dealers from using manipulative or deceptive devices, because that provision explicitly applies in connection with security-based swap agreements.

⁵² We also are not exempting those members from provisions related to government securities, as discussed above.

⁵³ 15 U.S.C. 78g(c).

⁵⁴ 15 U.S.C. 78o(c)(3).

⁵⁵ 15 U.S.C. 78q(a).

⁵⁶ 15 U.S.C. 78q(b).

⁵⁷ 12 CFR 220.1 *et seq.*

with their activities involving non-excluded CDS because these provisions are especially important to helping protect customer funds and securities, ensure proper credit practices and safeguard against fraud and abuse.⁵⁸

F. Solicitation of Comments

The Commission intends to monitor closely the development of the CDS market and intends to determine to what extent, if any, additional regulatory action may be necessary. For example, as circumstances warrant, certain conditions could be added, altered, or eliminated. Moreover, because these exemptions are temporary, the Commission will in the future consider whether they should be extended or allowed to expire. The Commission believes it would be prudent to solicit public comment on its action today, and on what action it should take with respect to the CDS market in the future. The Commission is soliciting public comment on all aspects of these exemptions, including:

1. Whether the length of this temporary exemption (until September 25, 2009) is appropriate. If not, what should the appropriate duration be?
2. Whether the conditions to these exemptions are appropriate. Why or why not? Should other conditions apply? Are any of the present conditions to the exemptions provided in this Order unnecessary? If so, please specify and explain why such conditions are not needed.
3. Whether LCH.Clearnet ultimately should be required to register as a clearing agency under the Exchange Act. Why or why not?

⁵⁸ Indeed, Congress directed the Commission to promulgate broker-dealer financial responsibility rules, including rules regarding custody, the use of customer securities and the use of customers' deposits or credit balances, and regarding establishment of minimum financial requirements.

4. Whether LIFFE A&M members that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling or holding non-excluded CDS positions for other persons ultimately should be required to register as broker-dealers? Why or why not?

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-34-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov/>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-34-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. We will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/other.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

III. Conclusion

IT IS HEREBY ORDERED, pursuant to Section 36(a) of the Exchange Act, that, until September 25, 2009:

(a) Exemption from Section 17A of the Exchange Act.

LCH.Clearnet Ltd. ("LCH.Clearnet") shall be exempt from Section 17A of the Exchange Act solely to perform the functions of a clearing agency for Cleared Index CDS (as defined in paragraph (e) of this Order), subject to the following conditions:

(1) LCH.Clearnet shall make available on its Web site annual audited financial statements.

(2) LCH.Clearnet shall keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it relating to its Cleared Index CDS clearance and settlement services. These records shall be kept for at least five years and for the first two years shall be held in an easily accessible place.

(3) LCH.Clearnet shall supply such information and periodic reports relating to its Cleared Index CDS clearance and settlement services as may be reasonably requested by the Commission.

(4) Subject to coordination with the FSA and upon such terms and conditions as may be agreed between the FSA and the Commission, LCH.Clearnet shall provide access to the Commission to conduct on-site inspections of all facilities (including automated systems and systems environment), records, and personnel related to LCH.Clearnet's Cleared Index CDS clearance and settlement services.

(5) LCH.Clearnet shall notify the Commission, on a monthly basis, of any material disciplinary actions taken against any of its members utilizing its Cleared Index CDS clearance and settlement services, including the denial of services, fines, or penalties. LCH.Clearnet shall notify the Commission promptly when it involuntarily terminates the membership of an entity that is utilizing LCH.Clearnet's Cleared Index CDS clearance and settlement services. Both notifications shall describe the facts and circumstances that led to LCH.Clearnet's disciplinary action.

(6) LCH.Clearnet shall provide the Commission with notice of all changes to its Default Rules and Default Fund Rules, not less than one day prior to effectiveness or implementation of such rule changes or, in exigent circumstances, as promptly as reasonably practicable under the circumstances. If LCH.Clearnet gives notice to, or seeks approval from, the FSA regarding any other changes to its rules regarding its Index CDS clearance and settlement services, LCH.Clearnet will also provide notice to the Commission. All such rule changes will be posted on LCH.Clearnet's Web site. Such notifications will not be deemed rule filings that require Commission approval.

(7) LCH.Clearnet shall provide the Commission with reports with respect to automated systems used in connection with Cleared Index CDS clearance and settlement services, other than the TRS/CPS system, prepared by independent audit personnel that are generated in accordance with risk assessment of the areas set forth in the Commission's Automation Review Policy Statements ("ARPs"). LIFFE A&M shall provide the Commission with reports with respect to its TRS/CPS system prepared by audit personnel from Risk and Audit Services, an independent department of NYSE Euronext, that are generated in accordance with risk assessment of the areas set forth in

the ARPs. LCH.Clearnet shall provide the Commission with annual audited financial statements prepared by independent audit personnel.

(8) LCH.Clearnet shall provide notice to the Commission at the same time it provides notice to the FSA in accordance with FSA REC 3.15 and FSA REC 3.16 regarding the suspension of services or inability to operate its facilities in connection with the clearance and settlement of Cleared Index CDS.

(9) LCH.Clearnet, directly or indirectly, shall make available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (a) all end-of-day settlement prices and any other prices with respect to Cleared Index CDS that LCH.Clearnet or LIFFE A&M may establish to calculate mark-to-market margin requirements for LCH.Clearnet or LIFFE A&M Participants; and (b) any other pricing or valuation information with respect to Cleared Index CDS as is published or distributed by LCH.Clearnet or LIFFE A&M.

(b) Exemption for LCH.Clearnet, LIFFE A&M, and certain eligible contract participants.

(1) Persons eligible. The exemption in paragraph (b)(2) is available to:

(i) LCH.Clearnet;

(ii) LIFFE A&M; and

(iii) Any eligible contract participant (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), other than: (A) an eligible contract participant that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared Index CDS positions for other persons; (B) an eligible contract

participant that is a self-regulatory organization, as that term is defined in Section 3(a)(26) of the Exchange Act; or (C) a broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof).

(2) Scope of exemption.

(i) In general. Such persons generally shall, solely with respect to Cleared Index CDS, be exempt from the provisions of the Exchange Act and the rules and regulations thereunder that do not apply in connection with security-based swap agreements. Accordingly, under this exemption, those persons would remain subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements (i.e., paragraphs (2) through (5) of Section 9(a), Section 10(b), Section 15(c)(1), paragraphs (a) and (b) of Section 16, Section 20(d) and Section 21A(a)(1) and the rules thereunder that explicitly are applicable to security-based swap agreements). All provisions of the Exchange Act related to the Commission's enforcement authority in connection with violations or potential violations of such provisions also remain applicable.

(ii) Exclusions from exemption. The exemption in paragraph (b)(2)(i), however, does not extend to the following provisions under the Exchange Act:

- (A) Paragraphs (42), (43), (44), and (45) of Section 3(a);
- (B) Section 5;
- (C) Section 6;
- (D) Section 12 and the rules and regulations thereunder;
- (E) Section 13 and the rules and regulations thereunder;
- (F) Section 14 and the rules and regulations thereunder;

- (G) Paragraphs (4) and (6) of Section 15(b);
- (H) Section 15(d) and the rules and regulations thereunder;
- (I) Section 15C and the rules and regulations thereunder;
- (J) Section 16 and the rules and regulations thereunder; and
- (K) Section 17A (other than as provided in paragraph (a)).

(c) Exemption for certain LIFFE A&M members.

Any member of LIFFE A&M that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling or holding Cleared Index CDS positions for other persons shall be exempt from the provisions of the Exchange Act and the rules and regulations thereunder specified in paragraph (b)(2), solely with respect to Cleared Index CDS, subject to the following conditions:

(1) The member shall be in material compliance with the rules of LIFFE A&M and, if a clearing member, with the rules of LCH.Clearnet, and applicable laws and regulations, relating to capital, liquidity, and segregation of customers' funds and securities (and related books and records provisions) with respect to Cleared Index CDS; and

(2) To the extent that the member receives or holds funds or securities of U.S. persons for the purpose of purchasing, selling, clearing, settling, or holding Cleared Index CDS positions:

- (i) The U.S. persons shall not be natural persons;
- (ii) The member shall segregate such funds and securities of such U.S. persons from the member's own assets (i.e., the member may not permit U.S.

persons to "opt out" of applicable segregation requirements for such funds and securities even if regulations or laws would permit the person to "opt out"); and

(iii) The member shall disclose to such U.S. persons that the member is not regulated by the Commission and that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the member.

(d) Exemption for certain registered broker-dealers.

A broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof) shall be exempt from the provisions of the Exchange Act and the rules and regulations thereunder specified in paragraph (b)(2), solely with respect to Cleared Index CDS, except:

- (1) Section 7(c);
- (2) Section 15(c)(3);
- (3) Section 17(a);
- (4) Section 17(b);
- (5) Regulation T, 12 CFR 200.1 et seq.;
- (6) Rule 15c3-1;
- (7) Rule 15c3-3;
- (8) Rule 17a-3;
- (9) Rule 17a-4;
- (10) Rule 17a-5; and
- (11) Rule 17a-13.

(e) For purposes of this Order, "Cleared Index CDS" shall mean a credit default swap that is submitted (or offered, purchased or sold on terms providing for submission) to LCH.Clearnet, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described below:

(1) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available;

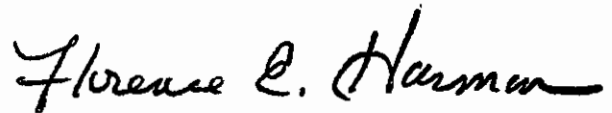
(2) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States;

(3) a foreign sovereign debt security;

(4) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or

(5) an asset-backed security issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.

By the Commission.



Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59165; File No. S7-35-08)

December 24, 2008

Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting
Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers
and Exchanges Effecting Transactions in Credit Default Swaps

I. Background

In response to the recent turmoil in the financial markets, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets.¹ Today, we are taking further action designed to address concerns related to the market in credit default swaps ("CDS"). The over-the-counter ("OTC") market for CDS has been a source of concerns to us and other financial regulators. These concerns include the systemic risk posed by CDS, highlighted by the possible inability of parties to meet their obligations as counterparties and the potential resulting adverse effects on other markets and the

¹ A nonexclusive list of the Commission's actions to stabilize financial markets during this credit crisis include: adopting a package of measures to strengthen investor protections against naked short selling, including rules requiring a hard T+3 close-out, eliminating the options market maker exception of Regulation SHO, and expressly targeting fraud in short selling transactions (See Securities Exchange Act Release No. 58572 (September 17, 2008), 73 FR 54875 (September 23, 2008)); issuing an emergency order to enhance protections against naked short selling in the securities of primary dealers, Fannie Mae, and Freddie Mac (See Securities Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379 (July 21, 2008)); taking temporary emergency action to ban short selling in financial securities (See Securities Exchange Act Release No. 58592 (September 18, 2008), 73 FR 55169 (September 24, 2008)); approving emergency rulemaking to ensure disclosure of short positions by hedge funds and other institutional money managers (See Securities Exchange Act Release No. 58591A (September 21, 2008), 73 FR 55557 (September 25, 2008)); proposing rules to strengthen the regulation of credit rating agencies and making the limits and purposes of credit ratings clearer to investors (See Securities Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008)); entering into a Memorandum of Understanding with the Board of Governors of the Federal Reserve System ("FRB") to make sure key federal financial regulators share information and coordinate regulatory activities in important areas of common interest (See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), http://www.sec.gov/news/press/2008/2008-134_mou.pdf).

financial system.² Recent credit market events have demonstrated the seriousness of these risks in a CDS market operating without meaningful regulation, transparency,³ or central counterparties ("CCPs").⁴ These events have emphasized the need for CCPs as mechanisms to help control such risks.⁵ A CCP for CDS could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts. In November 2008, the President's Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority⁶ and, in furtherance of this recommendation, the Commission, the FRB and the Commodity Futures Trading Commission ("CFTC") signed a Memorandum of Understanding⁷ that establishes a framework for consultation and information sharing on issues related to CCPs for CDS. Given the continued uncertainty in this market, taking

² In addition to the potential systemic risks that CDS pose to financial stability, we are concerned about other potential risks in this market, including operational risks, risks relating to manipulation and fraud, and regulatory arbitrage risks.

³ See Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf> ("Public reporting of prices, trading volumes and aggregate open interest should be required to increase market transparency for participants and the public.").

⁴ See The Role of Credit Derivatives in the U.S. Economy Before the H. Agric. Comm., 110th Cong. (2008) (Statement of Erik Sirri, Director of the Division of Trading and Markets, Commission).

⁵ See *id.*

⁶ See Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf>. See also Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (March 13, 2008), http://www.treas.gov/press/releases/reports/pwgpolicystatementkturmoil_03122008.pdf; Progress Update on March Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (October 2008), <http://www.treas.gov/press/releases/reports/q4progress%20update.pdf>.

⁷ See Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 14, 2008), <http://www.treas.gov/press/releases/reports/finalmou.pdf>.

action to help foster the prompt development of CCPs, including granting conditional exemptions from certain provisions of the federal securities laws, is in the public interest.

A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations ("reference obligations") of a single entity (a "reference entity") or on a particular security or other debt obligation ("reference security"), or an index of several such entities, securities, or obligations. The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in bonds or in segments of the debt market as represented by an index, or to capitalize on the volatility in credit spreads during times of economic uncertainty. In recent years, CDS market volumes have rapidly increased.⁸ This growth has coincided with a significant rise in the types and number of entities participating in the CDS market.⁹

The Commission's authority over this OTC market for CDS is limited. Specifically, Section 3A of the Securities Exchange Act of 1934 ("Exchange Act") limits the Commission's authority over swap agreements, as defined in Section 206A of the Gramm-Leach-Bliley Act.¹⁰ For those CDS that are swap agreements, the exclusion from

⁸ See Semiannual OTC derivatives statistics at end-December 2007, Bank for International Settlements ("BIS"), <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

⁹ CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant with their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

¹⁰ 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of "security" under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a "swap agreement" as "any agreement, contract, or transaction between eligible contract participants (as defined in section

the definition of security in Section 3A of the Exchange Act, and related provisions, will continue to apply. The Commission's action today does not affect these CDS, and this order does not apply to them. For those CDS that are not swap agreements ("non-excluded CDS"), the Commission's action today provides certain exemptions to exchanges that effect transactions in such non-excluded CDS and to brokers and dealers that effect transactions in non-excluded CDS on exchanges, and is designed to facilitate the development of one or more CDS exchanges.¹¹

In companion actions today, the Commission is temporarily exempting, subject to conditions, LCH.Clearnet Ltd. from the requirement to register as a clearing agency under Section 17A of the Exchange Act solely to perform the functions of a clearing agency for non-excluded CDS transactions.¹² To facilitate the operation of one or more CCPs for the CDS market, the Commission has also approved interim final temporary rules providing exemptions under the Securities Act of 1933 and Exchange Act for non-excluded CDS.

1a(12) of the Commodity Exchange Act. . . . the material terms of which (other than price and quantity) are subject to individual negotiation." 15 U.S.C. 78c note.

¹¹ The Commission found that credit default options and credit default basket options, which are essentially exchange-traded equivalents of OTC CDS, proposed by the Chicago Board Options Exchange, were securities because they are options based on the value of a security or securities, options on an interest in a security or securities, or options based on the value of an interest in a security or securities. See Securities Exchange Act Release No. 55871 (June 6, 2007), 72 FR 32372, 32375-77 (June 12, 2007) (File No. SR-CBOE-2006-84) ("CBOE CDO Order"); Securities Exchange Act Release No. 56275 (August 17, 2007), 72 FR 47297 (August 22, 2008) (File No. SR-CBOE-2007-26) (together with the CBOE CDO Order, the "CBOE Orders"). The Commission made special note that, "because credit default options will be exchange-traded and not individually negotiated, . . . they are not qualifying swap agreements under Section 206A of the Gramm-Leach-Bliley Act, . . . and, therefore, not excluded from the definition of security by Section 3A of the Exchange Act." 72 FR at 32376 n. 39. Unlike the options at issue in the CBOE Orders, which had fixed payouts in the event of a default or other credit event, the CDS that are the subject of the Commission's actions today may provide for the delivery of a debt security or securities against a specified amount, or a cash payment based on the value of a debt security or securities. For those CDS that are not qualifying swap agreements, that have payouts tied to the delivery of debt securities, or that are based on the value of debt securities, there may be arguments in addition to those in the CBOE Orders that such CDS are security options.

¹² See Securities Exchange Act Release No. 59164 (December 24, 2008) (File No. S7-34-08).

In conjunction with these exemptions, the Commission in this order is providing a temporary exemption to any exchange that effects or reports transactions in non-excluded CDS and is not otherwise subject to the requirements under Sections 5 and 6 of the Exchange Act¹³ from the requirement to register as a national securities exchange, and to any broker or dealer that effects or reports transactions in non-excluded CDS on such an exempt exchange.¹⁴ The exemptions in this order are subject to the conditions discussed below.

The Commission believes that the CDS market would benefit from the development of exchanges for non-excluded CDS. As the Commission has previously noted when approving a proposed rule change by the Chicago Board Options Exchange to list and trade certain CDS contracts, there are several benefits to trading such products on exchanges rather than over-the-counter.¹⁵ These benefits include a centralized market, standardized contract specifications, transparent quotations, and transaction reporting.¹⁶ Exchange trading would permit real-time matching of orders, and enhance transparency of the CDS market by promoting dissemination of pre-trade quotations as well as post-trade transaction information. Additional pre-trade and post-trade transparency would enable exchange subscribers to better assess market depth and liquidity and allow regulators to better surveil for violations of the securities laws.

¹³ 15 U.S.C. 78e and 78f.

¹⁴ A national securities exchange that effects transactions in CDS would continue to be required to comply with all requirements under the Exchange Act applicable to such transactions. A national securities exchange could form subsidiaries or affiliates that operate exchanges exempt under this order. Any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link, the exempt CDS exchange with the registered exchange, including the premises or property of such exchange for effecting or reporting a transaction, without being considered a "facility of the exchange." See Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c(a)(2).

¹⁵ See CBOE Orders, *supra* note 11.

¹⁶ *Id.*

Accordingly, the Commission is using its authority under Section 36 of the Exchange Act¹⁷ to exempt temporarily any exchange that effects transactions in non-excluded CDS and is not otherwise subject to the requirements under Sections 5 and 6 of the Exchange Act,¹⁸ and the rules and regulations thereunder, from the requirement to register as a national securities exchange under Section 6 of the Exchange Act,¹⁹ and from the prohibition in Section 5 of the Exchange Act²⁰ against effecting transactions as an exchange unless it is registered as a national securities exchange or exempt from registration due to the limited volume of its transactions. The Commission finds that such action is necessary and appropriate in the public interest and consistent with the protection of investors to facilitate the operation of one or more CDS exchanges in connection with the establishment of one or more CCP that clear and settle non-excluded CDS.²¹ The Commission is also temporarily exempting brokers and dealers from the Section 5 prohibition against effecting or reporting transactions in securities otherwise than on a national securities exchange or an exchange that is exempt from registration due to its limited volume.

The conditions to these exemptions will enable to the Commission to oversee the development of CDS exchanges, and to take such additional action as we may deem necessary to promote the public interest and the protection of investors. Moreover, the limited duration of the exemptions provided today will enable one or more CDS exchanges to become operational while we gain experience with the CDS market and

¹⁷ 15 U.S.C. 78mm.

¹⁸ 15 U.S.C. 78e and 78f.

¹⁹ 15 U.S.C. 78f.

²⁰ 15 U.S.C. 78e.

²¹ See supra note 12.

evaluate public input, including comments we receive on the temporary exemptions granted in today's order.

II. Discussion

Section 5 of the Exchange Act states that "[i]t shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transactions, unless such exchange (1) is registered as a national securities exchange under section 6 of [the Exchange Act], or (2) is exempted from such registration . . . by reason of the limited volume of transactions effected on such exchange...."²² Section 6 of the Exchange Act sets forth a procedure whereby an exchange²³ may register as a national securities exchange.²⁴

Section 36 of the Exchange Act provides that the Commission, "by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." To facilitate the establishment of one or more exchanges for non-excluded CDS, the Commission is exercising its authority under

²² 15 U.S.C. 78e.

²³ Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1), defines "exchange." Rule 3b-16 under the Exchange Act, 17 CFR 240.3b-16, defines certain terms used in the statutory definition of exchange. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Adopting Release") (adopting Rule 3b-16 in addition to Regulation ATS).

²⁴ 15 U.S.C. 78f. Section 6 of the Exchange Act also sets forth various requirements to which a national securities exchange is subject.

Section 36 of the Exchange Act to temporarily exempt any exchange, broker or dealer that effects transactions in non-excluded CDS from the prohibition in Section 5 of the Exchange Act and (in the case of exchanges) the requirements in Section 6 of the Exchange Act and the rules and regulations thereunder. These temporary exemptions are subject to certain conditions, discussed further below. These conditions on exchanges generally mirror those applicable to alternative trading systems, which are securities trading systems that the Commission previously exempted from exchange registration.²⁵

This temporary exemption is designed to allow brokers, dealers, and exchanges to effect transactions in non-excluded CDS on exchanges, subject to certain conditions. The Commission believes the exemption, together with the conditions, is necessary in the public interest and consistent with the protection of investors. In addition, the Commission believes that these conditions will not impede the ability of brokers, dealers, and exchanges to compete in the market for CDS. The limited term of this exemption will provide the Commission with adequate time to evaluate the application of this exemption to non-excluded CDS exchanges, and whether such conditions should be modified. In particular, the Commission will be considering whether Regulation ATS, with or without modifications, could apply to systems that match orders in non-excluded CDS of multiple buyers and sellers.

²⁵ See Regulation ATS, 17 CFR 242.300 *et seq.* In 1998, the Commission exercised its exemptive authority under Section 36 of the Exchange Act and its general authority under Section 11A of the Exchange Act, 15 U.S.C. 78k-1, to establish a regulatory framework for "alternative trading systems," which perform many of the same functions as exchanges. Under this framework, an entity that, like an exchange, matches the orders in securities of multiple buyers and sellers according to established, non-discretionary methods is exempt from the definition of "exchange" if it instead registers as a broker-dealer and complies with Regulation ATS. Regulation ATS is designed, among other things, "to adopt a regulatory framework that addresses [the Commission's] concerns without jeopardizing the commercial viability of these markets." Regulation ATS Adopting Release, *supra* note 23, 63 FR at 70846.

This temporary exemption is available only to exchanges that effect transactions in non-excluded CDS. To the extent that an exchange is otherwise subject to the requirements of Section 5 of the Exchange Act, it must register with the Commission as a national securities exchange under Section 6 of the Exchange Act and the rules and regulations thereunder or comply with the terms of another exemption. Similarly, a broker or dealer is temporarily exempt from the prohibition in Section 5 only to the extent that it effects transactions in non-excluded CDS on an exchange or reports such transactions on an exchange.

The Commission believes that this order will facilitate the establishment of one or more exchanges that effect transactions in non-excluded CDS. For this reason and the reasons discussed above,²⁶ the Commission believes that these exemptions are necessary or appropriate in the public interest and consistent with the protection of investors.

As noted, the conditions under which CDS exchanges must operate to qualify for the exemption from exchange registration being granted today are modeled on requirements applicable to alternative trading systems. Like an alternative trading system, a CDS exchange must keep records about its operations, its subscribers, and their orders.²⁷ A CDS exchange also must provide the Commission with trading information on a quarterly basis²⁸ and establish procedures to ensure the confidential treatment of trading information.²⁹ Likewise, a CDS exchange must permit the Commission to examine its premises, systems, and records and must cooperate with the examination of

²⁶ See *supra* notes 15-16 and accompanying text.

²⁷ Compare 17 CFR 242.301(b)(8), 242.302, and 242.303.

²⁸ Compare 17 CFR 242.301(b)(9).

²⁹ Compare 17 CFR 242.301(b)(10).

its subscribers.³⁰ These requirements are designed to allow the Commission to monitor market developments, to ascertain how new entrants are affecting the national market system, and to promote compliance with the federal securities laws generally. The Commission believes that temporarily exempting exchanges that effect transactions in non-excluded CDS from exchange registration, subject to these conditions, is necessary or appropriate in the public interest and is consistent with the protection of investors.

A. Exemption from Sections 5 and 6 of the Exchange Act for Exchanges

1. No Self-Regulatory Authority

To be exempt under this order, the exchange must not: (a) set rules governing the conduct of subscribers other than the conduct of such subscribers trading on such exchange; or (b) discipline subscribers under the Exchange Act other than by exclusion from trading. That is, an exempted exchange may not exercise self-regulatory authority over its subscribers. The Commission intends this condition to be the same requirement as applies to alternative trading systems under Regulation ATS. As described in the Regulation ATS Adopting Release, self-regulatory authority would include, for example, any restrictions on subscribers' activities outside of the exchange or imposing as a condition of participation any requirement for which the exchange would examine subscribers for compliance. The requirement in Regulation ATS and this condition are based on the Commission's belief that an organization, association, or group of persons that could exercise self-regulatory authority over its subscribers should be registered as an self-regulatory organization ("SRO") and subject to the full responsibilities and supervision that registration entails. The Commission continues to believe that rules

³⁰ Compare 17 CFR 242.301(b)(7).

governing exchange subscriber conduct may be imposed and enforced only by SROs because of the potential that they may be applied for anti-competitive purposes.

However, as we noted in connection with adopting Regulation ATS, the Commission does not intend this condition to preclude a trading system from applying credit standards to its subscribers or requiring subscribers to provide financial information relevant to their activity on the system.³¹

2. Recordkeeping

In addition, to be exempt under this order, an exchange must maintain an audit trail of orders that it receives and transactions that it effects. These records are critical to the Commission's ability to oversee the CDS market, detect and deter illicit market activity, and take action as necessary to address manipulation and fraud, including insider trading. These recordkeeping and record preservation requirements are comparable to those required under Regulation ATS and tailored to apply to non-excluded CDS.³² Specifically, an exchange must make and keep the following records for a period of not less than three years, the first two years in an easily accessible place:

- A record of subscribers in the exchange (identifying any affiliations between the exchange and subscribers in the exchange, including common directors, officers, or owners);
- Daily summaries of trading, including: (a) information identifying CDS in which transactions are effected; and (b) transaction volume, expressed in terms of number of trades and total U.S. dollar notional value;

³¹ See Regulation ATS Adopting Release, *supra* note 23, 63 FR at 70859.

³² See 17 CFR 242.301(b)(8), 242.302, and 242.303.

- Time-sequenced records of order information, including: (a) identity of the party entering an order; (b) identification of non-excluded CDS contract (including the reference entity, security, or index, and notional value); (c) date and time that order was received; (d) price (whether expressed as credit spread, rate, strike, or coupon); (e) whether the order is to buy or sell and any order conditions; (f) any subsequent modification or cancellation of the order; (g) date and time the order was executed, the size (e.g., notional value amount) executed, and the price; and (h) identity of the parties to the transaction.³³

In addition, as a condition of this exemption, an exchange must preserve the following records:

- For a period of not less than three years, the first two years in an easily accessible place, all notices provided by such exchange to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions

³³

These information items, with one exception, must be recorded and kept current by alternative trading systems pursuant to Regulation ATS. See 17 CFR 242.301(b)(8) and 242.302(c). Alternative trading systems are not required by Regulation ATS to keep records of the identity of the party entering an order. The Commission believes, however, that such information could be important to its ability to enforce the securities laws and is, therefore, to be kept as a condition to this exemption. Alternative trading systems must be registered with the Commission as a broker-dealer, and are therefore subject to additional Commission recordkeeping rules. See 17 CFR 242.301(b)(1). An exchange that avails itself of this exemption, however, may not otherwise be subject to requirements under the Exchange Act.

pertaining to access to the market and denials of, or limitations on, access to the exchange; and

- During the life of the enterprise and of any successor enterprise, the exchange's organizational documents and copies of reports filed with the Commission pursuant to this exemption.

An exchange exempt pursuant to this order may comply with these recordkeeping and record preservation requirements through use of a service bureau, depository, or other recordkeeping service that maintains and preserves these records on behalf of the exchange. An agreement with a service bureau, depository, or other recordkeeping service will not relieve the exchange from the responsibility to prepare and maintain the specified records.

The Commission believes that the types of records an exchange would be required to make and keep pursuant to this condition are records an exchange would keep in the normal course of its business and, therefore, that this condition is not unduly burdensome.

3. Regulatory Reporting

An exchange that relies on this order must, within five days of commencing operation, submit a notice to the Commission³⁴ that includes the following information:

1. Full legal name of the exchange;
2. A description of the exchange's ownership structure;
3. Contact person and contact information;
4. A general description of the CDS contracts that trade on the exchange; and

³⁴ Any such notice should be sent to: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549, and be noted as regarding "CDS Exchange Exemption from Registration."

5. A description of how the exchange operates.

This information is essential for the Commission to understand developments in the CDS market. Any subsequent action regarding this exemption – for example, whether it should be modified, extended, or allowed to expire – is predicated on understanding which market participants are relying on it. In the future, different regulatory frameworks may be appropriate for different market participants. These notices will enable the Commission to commence a dialog with the relevant market participants.

In addition, an exchange that relies on this exemption must report the following information to the Commission within 30 days of the end of each quarter:

1. The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index;
2. The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index; and
3. A list of all subscribers that effected transactions on the exchange during the quarter.

Reporting of this information will assist the Commission in carrying out its responsibility to supervise and regulate the securities markets. This information is similar to that which an alternative trading system must provide quarterly.³⁵

³⁵ See 17-CFR 242.301(b)(9)(i); Form ATS-R, 17 CFR 249.638. The Commission notes that an alternative trading system is not required to report to the Commission its transaction volume by security; only aggregate volumes must be reported to the Commission. Reports in most equity securities and many debt securities traded on an ATS are required to be reported to an SRO on a transaction-by-transaction basis. This is not the case for CDS. For this reason, the Commission is conditioning this exemption on an exchange providing quarterly information to the Commission on trading volume broken down by reference entity, security, or index. The Commission believes it is appropriate to require this more specific information from CDS exchanges to better understand the development of the exchange-traded market in non-excluded CDS.

4. Confidentiality of Trading Information

An exchange relying on this order also must establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include: (a) limiting access to the confidential trading information of subscribers to those employees of the exchange who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (b) implementing standards controlling employees of the exchange trading for their own accounts. The exchange must adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed. This condition, which closely tracks a requirement applicable to alternative trading systems,³⁶ is designed to prevent the misuse of subscriber trading information that is available to the exchange. This should strengthen confidence in the exchange, promoting participation.

5. Commission Jurisdiction

Finally, an exchange that relies on this order must provide access to the Commission to conduct on-site inspections of its facilities (including automated systems and systems environment), records, and personnel related to exchange activities. The exchange must cooperate with the Commission in connection with the investigation of any exchange subscribers. This requirement is similar to one in Regulation ATS that applies to alternative trading systems.³⁷

Recent market events have clearly demonstrated the importance of the CDS market and its potential to impact other markets, including the equity securities markets.

³⁶ See 17 CFR 242.301(b)(10).

³⁷ See 17 CFR 242.301(b)(7).

It is therefore imperative that the Commission have examination authority over any exchange that effects transactions in non-excluded CDS, with regard to its compliance with the conditions of the exemption provided under this order as well as enforcement of the antifraud provisions of the securities laws, including the prohibitions on insider trading. Particularly because the CDS market is so large and involves many market participants that are not directly subject to the Commission's authority, cooperation by the CDS exchange with the Commission in any investigation or enforcement action is crucial.

B. Exemption from Section 5 of the Exchange Act for Brokers and Dealers

Absent an exemption, Section 5 of the Exchange Act³⁸ would prohibit brokers and dealers from effecting transactions in non-excluded CDS on an exchange that is not a national securities exchange because of that exchange's reliance on this order. The Commission finds that temporarily exempting brokers and dealers that effect transactions in non-excluded CDS on such an exchange from this restriction in Section 5 is necessary and appropriate in the public interest and is consistent with the protection of investors because it will facilitate brokers' and dealers' use of CDS exchanges, which for the reasons noted above the Commission believes would be beneficial. Without also exempting brokers and dealers from this Section 5 requirement, the Commission's temporary exemption of CDS exchanges would be ineffective, because brokers and dealers would not be permitted to effect transactions on those exchanges.

Section 5 of the Exchange Act recognizes that there are situations where brokers and dealers should be permitted to trade on an exchange that is not registered as a

³⁸

15 U.S.C. 78e.

national securities exchange. Section 5 provides in relevant part that brokers and dealers may effect transactions on an exchange that the Commission, by reason of the limited volume of transactions effected on such exchange, has exempted from registration under Section 6. Brokers and dealers are also permitted to effect transactions on alternative trading systems, which are exempted from the definition of "exchange" and thus do not fall within the restriction of Section 5. For the reasons noted above, the Commission finds that it is consistent with the public interest and the protection of investors to grant a temporary exemption from Section 5 of the Exchange Act to any broker or dealer that effects transactions in non-excluded CDS, or reports such transactions, on an exchange that is exempted pursuant to this order.

C. Solicitation of Comments

The Commission intends to monitor closely the development of the CDS market and intends to determine to what extent, if any, additional regulatory action may be necessary. For example, as circumstances warrant, certain conditions could be added, altered, or eliminated. Moreover, because this exemption is temporary, the Commission will in the future consider whether it should be extended or allowed to expire. The Commission believes it would be prudent to solicit public comment on its action today, and what action it should take with respect to the CDS market in the future. The Commission is soliciting public comment on all aspects of this exemption, including:

1. Whether the length of this temporary exemption (until September 25, 2009) is appropriate. If not, what should the appropriate duration be?
2. Whether the conditions to the exemption are appropriate. Why or why not? Should other conditions apply? Are any of the present conditions to

the exemption provided in this order unnecessary? If so, please specify and explain why such conditions are not needed.

3. Whether exchanges relying on this exemption should ultimately be required to register under the Exchange Act. Why or why not?
4. Whether exchanges for non-excluded CDS can reasonably comply with Regulation ATS. Why or why not? If not, what aspects or conditions of Regulation ATS are problematic?

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-35-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov/>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-35-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/other.shtml>). Comments are also available for public

inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

III. Conclusion

IT IS HEREBY ORDERED pursuant to Section 36 of the Exchange Act that until September 25, 2009, an exchange is exempt from the requirements of Sections 5 and 6 of the Exchange Act³⁹ and the rules and regulations thereunder to the extent that such exchange effects or reports transactions in non-excluded CDS and is not otherwise required to register as a national securities exchange, subject to the following conditions:

(1) The exchange must not: (a) set rules governing the conduct of subscribers other than the conduct of such subscribers trading on such exchange; or (b) discipline subscribers other than by exclusion from trading;

(2) The exchange must make and keep for a period of not less than three years, the first two years in an easily accessible place, the following records:

- A record of subscribers in the exchange (identifying any affiliations between the exchange and subscribers in the exchange, including common directors, officers, or owners);
- Daily summaries of trading, including (a) information identifying CDS in which transactions are effected; and (b) transaction volume, expressed in terms of number of trades and total U.S. dollar notional value;

³⁹ 15 U.S.C. 78e and 78f.

- Time-sequenced records of order information, including: (a) identity of the party entering an order; (b) identification of non-excluded CDS contract (including the reference entity, security, or index, and notional value); (c) date and time that order was received; (d) price (whether expressed as credit spread, rate, strike, or coupon); (e) whether the order is to buy or sell and any order conditions; (f) any subsequent modification or cancellation of the order; (g) date and time the order was executed, the size (e.g., notional value amount) executed, and the price; and (h) identity of the parties to the transaction;

(3) The exchange must preserve the following records:

- For a period of not less than three years, the first two years in an easily accessible place, all notices provided by such exchange to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the market and denials of, or limitations on, access to the exchange; and
- During the life of the enterprise and of any successor enterprise, the exchange's organizational documents and copies of reports filed with the Commission pursuant to this exemption;

(4) An exchange must, within five days of commencing operation, submit a notice to the Commission that includes the following information:

- Full legal name of the exchange;

- A description of the exchange's ownership structure;
- Contact person and contact information;
- A general description of what CDS contracts trade on the exchange; and
- A description of how the exchange operates;

(5) An exchange must report the following information to the Commission within 30 days of the end of each quarter:

- The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index;
- The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index; and
- A list of all subscribers that effected transactions on the exchange during the quarter;

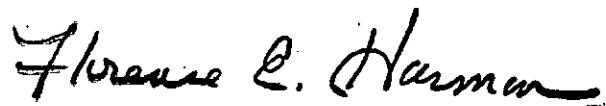
(6) The exchange must establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include: (a) limiting access to the confidential trading information of subscribers to those employees of the exchange who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (b) implementing standards controlling employees of the exchange trading for their own accounts. The exchange must adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed; and

(7) The exchange must provide access to the Commission to conduct on-site inspections of its facilities (including automated systems and systems environment),

records, and personnel related to exchange activities. The exchange must cooperate with the Commission in connection with the investigation of any exchange subscribers.

IT IS FURTHER ORDERED pursuant to Section 36 of the Exchange Act that until September 25, 2009, a broker or dealer that effects transactions in non-excluded CDS, or reports such transactions, on an exchange that is exempted pursuant to this order is exempt from Section 5 of the Exchange Act.

By the Commission.

A handwritten signature in cursive script, reading "Florence E. Harmon".

Florence E. Harmon
Acting Secretary

*Commissioners Watter
and Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59172 / December 29, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2913 / December 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13320

In the Matter of

STEWART ENTERPRISES,
INC., KENNETH C. BUDDE,
CPA, AND MICHAEL G.
HYMEL, CPA,

Respondents.

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Stewart Enterprises, Inc. ("Stewart"), Kenneth C. Budde ("Budde"), and Michael G. Hymel ("Hymel") (collectively, the "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.

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III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

RESPONDENTS

1. Stewart Enterprises, Inc. is a Louisiana corporation headquartered in Jefferson, Louisiana. At all relevant times, Stewart's common stock was registered with the Commission under Section 12(g) of the Exchange Act and was traded publicly on the NASDAQ under the symbol "STEL." Over its last five fiscal years, Stewart's total revenues have averaged approximately \$498 million per year.

2. Kenneth C. Budde, age 60, of Metairie, Louisiana, is Stewart's former chief executive officer ("CEO") and chief financial officer ("CFO"). Budde joined Stewart as a divisional CFO in 1984, was promoted to CFO in 1998, and further promoted to CEO in June 2004. In June 2006, Budde retired. Budde was a CPA, licensed in Louisiana and employed at a major public accounting firm in the late 1970s. Budde allowed his CPA license to lapse in the early 1990s and is currently retired.

3. Michael G. Hymel, age 52, of Harahan, Louisiana, is currently Stewart's vice-president of taxation, budgeting and planning. In 1989, Stewart hired Hymel as a tax manager, and in 1990, Hymel became a divisional controller. In 1998 Budde promoted Hymel to the position of chief accounting officer ("CAO"). In 2006, Hymel assumed his current position at Stewart. Hymel was a CPA licensed in Louisiana and employed by a major public accounting firm from 1978 through 1989. He has remained a licensed CPA current throughout his career at Stewart.

SUMMARY

4. From 2001 through 2005, Stewart's public filings with the Commission repeatedly represented that it utilized a delivery method to recognize cemetery merchandise sold prior to the need for a funeral ("pre-need cemetery merchandise"), pursuant to which, upon delivery, Stewart would recognize as revenue the full contract amount paid by the customer. However, Stewart could not readily identify the actual pre-need contract amount and instead developed an estimate of the amount of revenue to be recognized. Stewart's failure to disclose this methodology of estimating revenues in its public filings with the Commission rendered its financial statements not in conformity with Generally Accepted Accounting Principles ("GAAP"). Errors arising from the assumptions underlying Stewart's methodology for estimating revenues resulted in an overstatement of net revenue from 2001 through 2005 by more than \$72 million, overstated annual net earnings before taxes during this period by amounts ranging from 10.76% to 38.76%, and were the primary basis for a subsequent material restatement of earnings. As a result, Stewart violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13, Budde and Hymel caused such violations, and Budde directly violated Exchange Act Rule 13a-14.

FACTS

Background

5. Stewart is the second largest publicly traded death care services provider in the country. Stewart provides a complete range of death care services, including both funeral operations (memorial services, caskets, cremations) and cemetery operations (cemetery lots, burial vaults, headstones, markers). Stewart's business is further divided between time of death services, called "at need," and advance purchase pre-need services. Pre-need cemetery merchandise revenue represented approximately 10% to 12% of Stewart's total delivered revenue during the relevant time period.

6. Stewart grew rapidly during the 1990s, primarily by acquiring smaller funeral homes and cemeteries. In 1991, Stewart had 43 funeral homes and 29 cemeteries in six states. By 1999, Stewart owned 633 funeral homes and 161 cemeteries, located in 30 states, Puerto Rico and several other countries.

Stewart Changes its Revenue Recognition Policy

7. In December 1999, in an effort to clarify the Commission staff's positions with respect to selected issues of revenue recognition, the Commission's Division of Corporation Finance and Office of the Chief Accountant ("OCA") released Staff Accounting Bulletin 101 ("SAB 101"). SAB 101 reminded issuers that, under GAAP, revenue for the sale of merchandise should typically be recognized upon delivery to the customer. Prior to the issuance of SAB 101, Stewart, along with other public issuers in the death care services industry, recognized revenue from the sale of pre-need cemetery merchandise at the time of sale.

8. In early 2000, Stewart, along with other major industry participants, entered into discussions with OCA regarding whether, with respect to the sale of pre-need cemetery merchandise, revenue could be recognized upon time of sale rather than delivery. OCA clarified that GAAP required Stewart, and other industry participants, to recognize revenue from the sale of pre-need cemetery merchandise at the time of delivery. Stewart reflected the change beginning in its first quarter of fiscal 2001 as a cumulative effect of change in accounting principles.

9. On March 6, 2001, Hymel, on behalf of Stewart, issued a letter to OCA indicating that for pre-need cemetery merchandise revenue, Stewart would defer the recognition of that revenue until the point in time "when the customer takes possession/delivery of the specific item purchased" or when Stewart "has no further obligation or involvement related to the merchandise."

Stewart Delays Implementing an Actual Delivery Method, Instead Developing the "A/P Method"

10. Shortly after announcing its shift to a delivery method to recognize revenue for the sale of pre-need cemetery merchandise, Stewart realized that, because its prior revenue recognition methodology was based on time of sale, it had no effective system in place to fully identify either:

(a) the physical delivery of cemetery merchandise to particular customers; or (b) the specific pre-need contract for which delivery of certain cemetery merchandise was actually being made. These difficulties were heightened by virtue of Stewart's having grown through the acquisition of hundreds of funeral homes and cemeteries throughout the country and abroad. These funeral homes and cemeteries had sold hundreds of thousands of pre-need contracts, and, because prior to SAB 101 Stewart recognized revenue at the time of sale, it was not necessary to input the specific pricing details and original customers amounts paid into Stewart's accounting systems.

11. Stewart quickly realized, though, that the undertaking to create and fully implement an automated delivery system would take a significant amount of time, likely several years, and be highly resource intensive. Stewart notified its outside auditors of these difficulties in implementing such an automated delivery system. Although Stewart undertook efforts to develop an automated delivery system, it did not dedicate, upfront, the full resources necessary to address all of these difficulties. Stewart's accounting department, operating under Budde and Hymel, instead developed a unique methodology for estimating both the physical delivery and amount of revenue to be recorded in its accounting records. This process was intended to be used until the automated delivery system was fully developed and implemented.

12. With respect to identifying the point in time at which the physical delivery of pre-need cemetery merchandise occurred, Stewart determined that it could use the receipt of its own vendor invoices as a proxy for actual physical delivery, as Stewart did not produce any of the pre-need cemetery merchandise itself, and stored very little cemetery merchandise. Stewart assumed that because vendors typically invoiced Stewart for cemetery merchandise after it had been delivered, any vendor invoice for cemetery merchandise that was sold pre-need would likely correspond to the delivery of that merchandise to Stewart's customer. As this system relied on accounts payable invoices as proxies for physical delivery, Stewart referred to this method of revenue recognition internally as the "A/P Method."

13. To quantify the amount of revenue to be recognized, Stewart developed an accounting estimate, called the "mark-up" factor, because it could not readily identify the actual pre-need contract for the delivery of specific cemetery merchandise to specific contracts. In determining the mark-up factor, Stewart calculated the ratio between what it believed to be its vendor costs to acquire cemetery merchandise and the historical prices as sold to customers for this merchandise. Upon receiving a vendor invoice for pre-need cemetery merchandise, Stewart calculated the amount of revenue that should be recognized for that product by multiplying its own vendor invoice cost by the appropriate mark-up factor.

14. Budde and Hymel reviewed the A/P Method and approved the decision to begin utilizing the A/P Method and its underlying estimates to formally book revenue for the first quarter of Stewart's fiscal year ended October 31, 2001. From the outset, Stewart's outside auditor questioned Stewart's use of estimates to record revenue. While conceding in its annual management letter that Stewart's inability to "properly account and track the status and delivery of pre-need cemetery merchandise contracts" required Stewart to estimate revenues, the outside auditor cautioned Stewart that "[c]ontinued use of [the A/P Method] heightens the possibility of misstatements on the amount of revenue recognized in a period." Starting in 2001, the outside

auditor also recommended that Stewart move to a revenue recognition system based on “actual deliveries of cemetery merchandise and its associated cost without having to be as dependant on estimates.” Despite these comments, the outside auditor issued unqualified audit opinions for each year that Stewart used the A/P Method.

**Stewart’s Deferred Revenue Project Identifies Material Problems
with its Reported Revenue under the A/P Method and Weaknesses in Internal Controls**

15. Over time, Stewart identified and corrected what it determined to be immaterial errors in the A/P Method. Stewart continually reviewed the mark-up factor utilized in the A/P Method and made adjustments to the mark-up accordingly. In 2002, Stewart assigned a former division CFO to review the A/P Method and to accelerate efforts to develop and implement an automated delivery system for recognizing cemetery merchandise revenue.

16. In October 2004, Stewart launched a review of its internal accounting controls and financial reporting in anticipation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”). Earlier in 2004, Stewart had begun to roll out and test its automated delivery system for revenue recognition, and had noted revenue recognition discrepancies that it initially attributed to the automated system’s design. The Section 404 undertaking quickly focused on Stewart’s revenue recognition policies and the amounts of deferred revenue on Stewart’s financial statements. As the project progressed, Stewart concluded that it was necessary to devote substantial resources to finding, reviewing, and inputting the pricing details from all pre-need contracts. This was a significant undertaking, ultimately requiring the review of nearly 700,000 pre-need contracts. Stewart referred to this review as the “Deferred Revenue Project.”

17. By October 2005, as a result of the progress of the Deferred Revenue Project, Stewart believed that a restatement of its prior period financial statements could be warranted. On October 21, 2005, Stewart filed a Form 8-K disclosing the existence and purpose of the Deferred Revenue Project and announcing that a restatement was likely to occur, with an estimated impact of \$60 million or less to shareholder equity. No portion of this Form 8-K made any reference or description to Stewart’s use of an estimated methodology to book revenue for pre-need cemetery merchandise.

18. In January 2006, Stewart realized that errors in the A/P Method had likely caused a material overstatement of revenue for fiscal years 2001 through the first three quarters of fiscal year 2005. These errors primarily occurred because Stewart had used incorrect internal vendor costs for its cemetery merchandise in calculating the mark-up factor.

19. On February 17, 2006, Stewart filed its 2005 Form 10-K, which announced the results of both the completion of the Deferred Revenue Project and its Sarbanes-Oxley Section 404 internal controls assessment. The Deferred Revenue Project ultimately resulted in a \$93 million charge against shareholder equity (of which \$72 million was directly attributable to errors in the A/P Method mark-up factor) for fiscal years 2001 through the third quarter of 2005. The chart below illustrates the impact on Stewart’s net earnings before taxes for fiscal years 2001 through 2005 attributable to the errors in the A/P Method.

Fiscal Year	Net Earnings (loss), Before Taxes ("EBT") (prior to 2005 restatement) (000's omitted)	Amount of Reported EBT Attributable to Errors within A/P Method (000's omitted)	Percentage of EBT Improperly Reported due to A/P Method Errors
2001	(\$197,427)	\$21,253	10.76%
2002	\$47,882	\$18,561	38.76%
2003	(\$44,757)	\$12,019	26.85%
2004	\$68,428	\$10,963	16.02%
2005*	\$26,404	\$9,516	36.04%

* These figures only represent the first nine months of Fiscal Year 2005.

20. In addition to disclosing these restatements, Stewart also identified in its 2005 Form 10-K that it "did not maintain effective internal control over financial reporting" and had "material weaknesses relating to ... revenue recognition of pre-need cemetery merchandise and services contracts...." As with the language related to the restatement, however, no portion of the internal controls assessment identified Stewart's prior use of the A/P Method and its underlying use of estimates.

21. After learning of the problems in the A/P Method uncovered during the Deferred Revenue Project and identifying the corresponding weaknesses in internal controls, Stewart's outside auditor advised that it would no longer approve the use of the A/P Method. Only at this point in time, when Stewart was completing its compliance obligations under Sarbanes-Oxley Section 404 and its outside auditor indicated it would no longer approve of the use of the A/P Method did Stewart finalize the implementation of and begin booking revenue through an actual delivery system.

**Stewart Did Not Disclose its Use of the A/P Method
and Misleadingly Described its Revenue Recognition Policies**

22. In general, beginning with Stewart's March 15, 2001 Form 8-K that attached Stewart's letter to OCA, and continuing through its filing of its Form 10-K for its fiscal year ended October 31, 2004, Stewart's filings with the Commission contained misleading statements that "for preneed sales of cemetery merchandise, primarily vaults and markers ... the associated revenue and certain costs to acquire the sale are deferred until the merchandise is delivered."

23. Stewart's Forms 10-K for fiscal years 2001 through 2003, filed with the Commission between 2002 and 2004, contained additional misleading statements and omissions suggesting that Stewart could identify the actual amount of revenue to be recognized from the sale of its pre-need cemetery merchandise. Specifically, these filings misleadingly stated that, "[w]hen the ... merchandise is delivered, the Company recognizes as revenue the full contract amount." As Stewart had no systems in place to allow it to identify the underlying contracts on which revenue was being recognized, Stewart was in actuality utilizing the A/P Method to estimate the "full contract amount." Stewart's Forms 10-Q for the first quarter of fiscal year 2002, filed March 18, 2002, and for the second quarter of fiscal year 2003, filed June 13, 2003, also referenced this misleading language within the Forms 10-K regarding the "full contract amount" of revenue being recognized upon delivery.

24. Budde and Hymel signed each of the Forms 10-K and Forms 10-Q that contained these misleading descriptions and omissions, while Hymel signed and Budde reviewed the March 2001 Form 8-K. Pursuant to Sarbanes-Oxley Section 302 and Exchange Act Rule 13a-14, Budde also certified Stewart's 2003 Form 10-K and second quarter 2003 Form 10-Q as CFO. In each respective certification, Budde attested that, based on his knowledge, the respective Forms 10-K and 10-Q did not "contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made . . . not misleading."

ACCOUNTING ANALYSIS

25. Under GAAP, revenue from the sale of merchandise should generally be recognized upon delivery of the merchandise to the buyer, even if the sale precedes delivery. FASB Statement of Concepts ("SFAC") No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, ¶ 84(a), (b). Upon delivery, the seller should typically recognize as revenue the amount received from the buyer. See SFAC No. 5 at ¶ 83 ("Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets . . ."); SFAC No. 6, Elements of Financial Statements, ¶ 78 ("Revenues are inflows or other enhancements of assets of an entity . . . from delivering or producing goods . . ."). GAAP further requires that the amount of revenue recorded must be "measurable with sufficient reliability." SFAC No. 5 at ¶ 63; see also SFAC No. 2, Qualitative Characteristics of Accounting Information, ¶ 72 ("Reporting accounting numbers as certain and precise if they are not is a negation of reliable reporting."). GAAP further requires issuers to disclose any significant deviation from these basic revenue recognition policies. Accounting Principles Board Opinion No. 22, specifically requires issuers to disclose, among other things: (1) "important judgments as to the appropriateness of principles relating to recognition of revenue;" and (2) "[u]nusual or innovative applications of [GAAP] (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates)." Stewart's failure to disclose its use of the A/P Method and its underlying layers of estimates therefore rendered its financial statements not in conformity with GAAP.

LEGAL ANALYSIS

Stewart Violated the Reporting, Books and Records and Internal Controls Provisions of the Exchange Act, and Budde and Hymel Caused Such Violations

26. Section 13(a) of the Exchange Act requires issuers to file such periodic and other reports as the Commission may prescribe and in conformity with such rules as the Commission may promulgate. Rules 13a-1, 13a-11 and 13a-13 require the filing of annual, current and quarterly reports, respectively. "The reporting provisions of the Exchange Act are clear and unequivocal, and they are satisfied only by the filing of complete, accurate, and timely reports." SEC v. Savoy Industries, 587 F.2d 1149, 1165 (D.C. Cir. 1978) (citing SEC v. IMC Int'l, Inc., 384 F. Supp. 889, 893 (N.D. Tex. 1974)). A violation of Section 13(a) is established if a report is shown to contain materially false or misleading information. SEC v. Kalvex, Inc., 425 F. Supp. 310, 316 (S.D.N.Y. 1975). Rule 12b-20 of the Exchange Act requires an issuer to include any

additional material information necessary to make the required statements in the filing not misleading. No showing of scienter is necessary to establish an issuer's violation of Section 13(a) of the Exchange Act. SEC v. Wills, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

27. Stewart violated Exchange Act Section 13(a) and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder because its filings with the Commission between 2001 and 2005 contained materially misleading statements and omitted material information concerning Stewart's revenue recognition policies and materially misstated Stewart's revenues in reports filed with the Commission as a result of errors directly attributable to the estimates underlying the A/P Method. Budde and Hymel caused these violations by Stewart because they reviewed and approved of these filings and knew or should have known that they did not disclose the use of the A/P Method and inaccurately described Stewart's revenue recognition policies as being based on recognition of the "full contract amount," when Stewart was instead utilizing the A/P Method to estimate the actual contract amount.

28. Section 13(b)(2)(A) of the Exchange Act requires issuers with securities registered under the Exchange Act to make and keep books, records, and accounts that in reasonable detail accurately and fairly reflect the issuer's transactions and dispositions of assets. Section 13(b)(2)(B) of the Exchange Act requires the same issuers to devise and maintain a system of internal accounting controls which provide reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. The Commission need not show scienter to prove violations of Section 13(b)(2). SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 749 (N.D. Ga. 1983).

29. Stewart violated Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because its internal books, records, and accounts improperly and inaccurately reflected numerous transactions for which revenue should not have been recognized. Stewart's February 2006 restatement acknowledged the multiple errors in revenue recognition that had occurred and led to a \$93 million charge against shareholder equity, of which \$72 million was directly attributable to errors in the A/P Method. Stewart further lacked sufficient accounting procedures and controls by which it could identify the specific pre-need contract and corresponding amount of revenue for which cemetery merchandise had been delivered. Budde and Hymel caused these internal controls and books and records violations by Stewart. Budde and Hymel had ultimate responsibility for the adequacy of Stewart's internal controls and the accuracy of Stewart's accounting records. They knew or should have known that Stewart lacked adequate internal controls to identify the appropriate amount of revenue to recognize from the sale of pre-need cemetery merchandise and, thus, that Stewart's internal accounting records were inaccurate.

Budde Violated Exchange Act Rule 13a-14

30. Sarbanes-Oxley Section 302 provides that the Commission shall, by rule, require the principal executive officer and the principal financial officer of companies filing periodic reports under Section 13(a) of the Exchange Act to make certain certifications in each annual or quarterly report. To implement Section 302, the Commission promulgated Exchange Act Rule 13a-14, which provides that an issuer's annual and quarterly reports shall include certifications

signed by the principal executive and principal financial officer of the issuer that the report, to the best of their knowledge, does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made not misleading with respect to the period covered by the report.

31. Budde certified Stewart's 2003 Form 10-K and second-quarter 2003 Form 10-Q as CFO, in each certification attesting that, based on his knowledge, the respective Forms 10-K and 10-Q did not "contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made . . . not misleading." As set forth above, these filings contained materially misleading statements and omissions regarding Stewart's revenue recognition policies and methodologies. Accordingly, Budde violated Exchange Act Rule 13a-14.

REMEDIAL EFFORTS

In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Stewart and cooperation afforded the Commission staff.

IV.

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

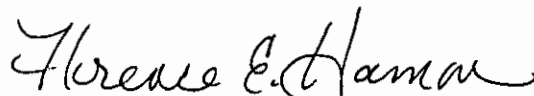
Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Stewart cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

B. Pursuant to Section 21C of the Exchange Act, Respondent Budde cease and desist from committing or causing any violations and any future violations of Exchange Act Rule 13a-14 and cease and desist from causing any violations and any future violations of Section 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

C. Pursuant to Section 21C of the Exchange Act, Respondent Hymel cease and desist from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

By the Commission.



Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59181 / December 30, 2008

Admin. Proc. File No. 3-12684

In the Matter of

NATURE'S SUNSHINE PRODUCTS, INC.

ORDER GRANTING REQUEST FOR
PROTECTIVE ORDER

On December 4, 2008, Nature's Sunshine Products, Inc. ("Nature's Sunshine" or the "Company") filed a motion for a protective order seeking to limit from public disclosure and maintain under seal the Division of Enforcement's ("Division") Supplemental Brief, also filed on December 4, 2008 pursuant to the Commission's November 14, 2008 Order Directing the Filing of Additional Briefs. Nature's Sunshine contends that the Division's Supplemental Brief contains confidential information related to a continuing, non-public investigation of the Company pursuant to a formal order of investigation concerning possible violations of the federal securities laws (other than the failure to file periodic reports that is the subject of this proceeding). The Division does not oppose Nature's Sunshine's request for a protective order.

Under our Rule of Practice 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information." 1/ "A motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure." 2/

The Commission recognizes that the Division's Supplemental Brief contains sensitive information concerning a law enforcement investigation. At this stage of the proceeding, we

1/ 17 C.F.R. § 201.322(a).

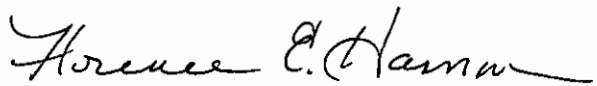
2/ 17 C.F.R. § 201.322(b).

believe that the harm resulting from complete disclosure outweighs the benefits. However, we have determined that disclosure of certain information included in the Supplemental Brief might be necessary to the resolution of the issues before us.

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the Division of Enforcement's Supplemental Brief shall be disclosed only to the parties to this action, their counsel, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.
2. All persons who receive access to the Supplemental Brief or the information contained in the Supplemental Brief shall keep it confidential and, except as provided in this Order, shall not divulge the document or information to any person.
3. No person to whom the Supplemental Brief covered by the Order is disclosed shall make any copies or otherwise use such document or information, except in connection with this proceeding or any appeal thereof.
4. The Office of the Secretary shall place the Supplemental Brief in a sealed envelope or other sealed container marked with the title of this action, identifying the document, and marked "CONFIDENTIAL."
5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the Supplemental Brief or to citation of particular information contained therein in oral arguments, opinions, or in any other similar use directly connected with this action or any appeal thereof.
6. The Commission expressly reserves the authority to reach a different conclusion regarding the confidentiality of the Supplemental Brief or information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.


Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59174 / December 30, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13321

In the matter of	:	ORDER INSTITUTING PROCEEDINGS,
	:	MAKING FINDINGS, AND REVOKING
RICA FOODS, INC.,	:	REGISTRATION OF SECURITIES
	:	PURSUANT TO SECTION 12(j) OF THE
Respondent.	:	SECURITIES EXCHANGE ACT OF 1934
	:	

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against Rica Foods, Inc. ("Rica" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

A. Rica, a Nevada corporation based in Costa Rica, is a poultry company. The common stock in Rica has been registered under Section 12(g) of the Exchange Act since 1996. Until October 24, 2006, Rica's common stock was listed and traded on the American Stock Exchange.

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B. Rica has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an Annual Report on Form 10-K since January 3, 2005 (for the fiscal year ended September 30, 2004), or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending June 30, 2005.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with the provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale, of any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.



Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2824 / December 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13319

In the Matter of

WILLIAM J. DEL BIAGGIO III,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF
THE INVESTMENT ADVISERS ACT
OF 1940, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against William J. Del Biaggio III ("Respondent" or "Del Biaggio").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that

1. Del Biaggio is the managing member and majority owner of Sand Hill Capital Partners III, LLC; BDB Management, LLC; and BDB Management III, LLC. Neither Del Biaggio nor his entities have ever registered with the Commission as investment advisers, but, through these entities, Del Biaggio has provided investment advice to clients for compensation from at least 2003 to the present. Del Biaggio, 41 years old, is a resident of San Jose, California.

2. On December 12, 2008, a final judgment was entered by consent against Del Biaggio, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. William J. Del Biaggio III, Civil Action Number CV-08-5450 CRB, in the United States District Court for the Northern District of California.

3. The Commission's complaint alleges that, in connection with the sale of unsecured promissory notes and other investments, Del Biaggio made false and misleading statements to, or omitted material information from, his advisory clients and other investors. Among other things, the complaint alleges that Del Biaggio told his clients and other investors that their funds would be invested in various business ventures when, in fact, Del Biaggio misappropriated their money for personal use; omitted to tell his advisory clients and other investors material information that he intended to use their money for personal expenses; and otherwise engaged in a variety of conduct which operated as a fraud and deceit on his advisory clients and other investors.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Del Biaggio's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Del Biaggio be, and hereby is barred from association with any investment adviser.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson
By **Jill M. Peterson**
Assistant Secretary

*Commissioner Haredes
not participating*

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 211, 229, and 249

[Release Nos. 33-8995; 34-59192; FR-78; File No. S7-15-08]

RIN 3235-AK00

MODERNIZATION OF OIL AND GAS REPORTING

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; interpretation; request for comment on Paperwork Reduction Act burden estimates.

SUMMARY: The Commission is adopting revisions to its oil and gas reporting disclosures which exist in their current form in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2. The revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves, which should help investors evaluate the relative value of oil and gas companies. In the three decades that have passed since adoption of these disclosure items, there have been significant changes in the oil and gas industry. The amendments are designed to modernize and update the oil and gas disclosure requirements to align them with current practices and changes in technology. The amendments concurrently align the full cost accounting rules with the revised disclosures. The amendments also codify and revise Industry Guide 2 in Regulation S-K. In addition, they harmonize oil and gas disclosures by foreign private issuers with the disclosures for domestic issuers.

DATES: Effective Date: January 1, 2010.

Comment Date: Comments on the Paperwork Reduction Act Analysis should be received on or before [insert 30 days after date of publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-08 on the subject line; or
- Use the Federal e-Rulemaking Portal <http://www.regulations.gov>. Follow the instructions for submitting comments.

Paper comments:

- Send paper submissions in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-15-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/concept.shtml>). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Ray Be, Special Counsel, Office of Chief Counsel at (202) 551-3500; Dr. W. John Lee, Academic Petroleum Engineering Fellow, or Brad Skinner, Senior Assistant Chief Accountant, Office of Natural Resources and Food at (202) 551-3740; Leslie Overton, Associate Chief Accountant, Office of Chief Accountant for the Division of Corporation Finance at (202) 551-3400, Division of Corporation Finance; or Mark Mahar, Associate Chief Accountant, Jonathan Duersch, Assistant Chief Accountant, or Doug Parker, Professional Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTAL INFORMATION: We are adopting amendments to Rule 4-10¹ of Regulation S-X² and Items 102, 801 and 802³ of Regulation S-K.⁴ We also are adding new Subpart 1200, including Items 1201 through 1208, to Regulation S-K.

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¹ 17 CFR 210.4-10.

² 17 CFR 210.

³ 17 CFR 229.102, 17 CFR 229.801, and 17 CFR 229.802.

⁴ 17 CFR 229.

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I. Introduction

A. Background

On June 26, 2008, the Commission issued a proposing release (Proposing Release) seeking public comment on proposed amendments to the disclosure requirements regarding oil and gas companies.⁵ These proposals encompassed issues that were previously addressed more generally in a concept release that the Commission issued on December 12, 2007 (Concept Release),⁶ which solicited comment on possible revisions to the oil and gas reserves disclosure requirements specified in Rule 4-10 of Regulation S-X⁷ and Item 102 of Regulation S-K.⁸ The Proposing Release also contained proposals not addressed by the Concept Release related to the updating and codification of Industry Guide 2.

⁵ Release No. 33-8935 (June 27, 2008) [73 FR 39181].

⁶ Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

⁷ 17 CFR 210.4-10. See Release No. 33-6233 (Sept. 25, 1980) [45 FR 63660] (adopting amendments to Regulation S-X, including Rule 4-10). The precursor to Rule 4-10 was Rule 3-18 of Regulation S-X, which was adopted in 1978. See Accounting Series Release No. 253 (Aug. 31, 1978) [43 FR 40688]. See also Accounting Series Release No. 257 (Dec. 19, 1978) [43 FR 60404] (further amending Rule 3-18 of Regulation S-X and revising the definition of proved reserves).

⁸ Item 102 of Regulation S-K [17 CFR 229.102]. In 1982, the Commission adopted Item 102 of Regulation S-K. Item 102 contains the disclosure requirements previously located in Item 2 of Regulation S-K. See Release No. 33-6383 (March 16, 1982) [47 FR 11380]. The Commission also "recast . . . the disclosure requirements for oil and gas operations, formerly contained in Item 2(b) of Regulation S-K, as an industry guide." See Release No. 33-6384 (Mar. 16, 1982) [47 FR 11476].

We initially adopted our oil and gas disclosure requirements in 1978 and 1982.⁹ Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital.¹⁰ Prior to our issuance of the Concept Release and the Proposing Release, many industry participants had expressed concern that our disclosure rules are no longer in alignment with current industry practices and therefore limit their usefulness to the market and investors.¹¹

B. Issuance of the Concept Release

The Concept Release addressed the potential implications for the quality, accuracy and reliability of oil and gas disclosure if the Commission were to:

- Revise the definition of “proved reserves” in our rules, in particular, the criteria used to assess and quantify resources that can be classified as proved reserves; and
- Expand the categories of resources that may be disclosed in Commission filings to include resources other than proved reserves.

⁹ The disclosure requirements were introduced pursuant to a directive in the Energy Policy and Conservation Act of 1975 (the “EPCA”). The EPCA directed the Commission to “take such steps as may be necessary to assure the development and observance of accounting practices to be followed in the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas in the United States.” See 42 U.S.C. 6201-6422.

¹⁰ See, for example, Daniel Yergin and David Hobbs: “The Search for Reasonable Certainty in Reserves Disclosure,” *Oil and Gas Journal* (July 18, 2005).

¹¹ See, for example, Greg Courturier, “Standard & Poor’s Urges SEC to Change Disclosure Rules,” *International Oil Daily* (Dec. 3, 2007); Steve Levine, “Tracking the Numbers: Oil Firms Want SEC to Loosen Reserves Rules,” *Wall Street Journal Online* (Feb. 7, 2006); Christopher Hope, “Oil Majors Back Attack on SEC Rules,” *The Daily Telegraph* (London) (Feb. 24, 2005); Barrie McKenna, “Rules undervalue reserves report says: Volumes buried in Canada’s oil sands not counted by SEC’s measure,” *The Globe & Mail* (Canada) (Feb. 24, 2005); and “Deloitte Calls on Regulators to Update Rules for Oil and Gas Reserves Reporting,” *Business Wire Inc.* (Feb. 9, 2005).

In addition, the Concept Release questioned whether our revised disclosure rules should be modeled on any particular resource classification framework currently being used within the oil and gas industry. We also asked how any revised disclosure rules could be made flexible enough to address future technological innovation and changes within the oil and gas industry. The Concept Release sought further comment on whether the Commission should require independent third-party assessments of reserves estimates that a company includes in its filings.

In response to the Concept Release, commenters submitted 80 comment letters.¹² We received comment letters from a variety of industry participants such as accounting firms, engineering consulting firms, domestic and foreign oil and gas companies, federal government agencies, individuals, law firms, professional associations, public interest groups, and rating agencies. We considered these comments and addressed many of them in issuing the Proposing Release.

C. Overview of the Comment Letters Received on the Proposing Release

The Proposing Release sought significantly more detailed comment on issues raised in the Concept Release, as well as proposed amendments to the disclosure items in our rules and Industry Guide 2. In response to the Proposing Release, we received 65 comment letters, again from a variety of constituents with interests in oil and gas industry disclosure.

Almost all commenters supported some form of revision to the current oil and gas disclosure requirements, particularly given the length of time that has elapsed since the

¹² The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F St. NE, Washington, DC 20549 in File No. S7-29-07. They are also available on-line at <http://www.sec.gov/comments/s7-29-07/s72907.shtml>.

requirements were initially adopted.¹³ Commenters provided significantly more detailed comments on the Proposing Release than on the Concept Release, which did not include specific proposed regulatory text. We discuss those comments in detail in the relevant sections of this release. However, in general, commenters focused on several key issues raised by the Proposing Release. These issues included the following:

- The proposal to permit disclosure of probable and possible reserves;
- The proposed use of average historical prices to represent existing economic conditions to determine the economic producibility of oil and gas reserves for disclosure purposes while continuing to use a single day

¹³ See letters from American Association of Petroleum Geologists ("AAPG"), American Clean Skies Foundation ("American Clean Skies"), American Petroleum Institute ("API"), AngloGold Ashanti Ltd. ("AngloGold"), Apache Corporation ("Apache"), BHP Billiton Petroleum ("BHP"), BP Plc. ("BP"), Brookwood Petroleum Advisors, Ltd. ("Brookwood"), Canadian Association of Petroleum Producers ("CAPP"), Canadian Natural Resources Ltd. ("Canadian Natural"), Center for Audit Quality ("CAQ"), Center for Corporate Policy ("CCP"), CFA Institute Centre for Financial Market Integrity ("CFA"), Chesapeake Energy Corporation ("Chesapeake"), Chevron Corporation ("Chevron"), Coeur d'Alene Mines Corporation ("Coeur"), Cunningham, Peter ("Cunningham"), Davis, Polk & Wardwell ("Davis Polk"), Deloitte & Touche ("Deloitte"), Devon Energy Corporation ("Devon"), EnCana Corporation ("EnCana"), Energen Corporation ("Energen"), Energy Information Administration (of DOE) ("EIA"), Eni S.p.A. ("Eni"), Equitable Resources, Inc. ("Equitable"), Ernst & Young ("E&Y"), Evolution Petroleum Corporation ("Evolution"), ExxonMobil Corporation ("ExxonMobil"), Federal Energy Regulatory Commission ("FERC"), Graff Consulting Group LLC ("Graff Consulting"), Grant Thornton ("Grant Thornton"), Imperial Oil Ltd. ("Imperial"), Independent Petroleum Association of America ("IPAA"), KPMG ("KPMG"), Luscher, Brian ("Luscher"), Magoto, Joseph ("Magoto"), McMoRan Exploration Co. ("McMoRan"), Newfield Exploration Company ("Newfield"), Nexen, Inc. ("Nexen"), Peabody Energy Corporation ("Peabody"), Petro-Canada ("Petro-Canada"), Petroleo Brasileiro S.A. ("Petrobras"), Petroleos Mexicanos ("PEMEX"), PRA International Ltd. ("PRA"), PriceWaterhouseCoopers ("PWC"), Questar Market Resources ("Questar"), Repsol YPF, S.A. ("Repsol"), Ross Petroleum Ltd. ("Ross"), Ryder Scott Company, L.P. ("Ryder Scott"), Sasol Ltd. ("Sasol"), Senator Robert Menendez, Senator Russell D. Feingold, and Senator Bernard Sanders, U.S. Senate ("Three Senators"), Shearman & Sterling ("Shearman & Sterling"), Shell International B.V. ("Shell"), Society of Exploration Geophysicists ("SEG"), Society of Petroleum Engineers ("SPE"), Society of Petroleum Evaluation Engineers ("SPEE"), Southwestern Energy Production Company ("Southwestern"), Standard Advantage ("Standard Advantage"), StatoilHydro ("StatoilHydro"), Swift Energy Company ("Swift"), Talisman Energy Inc. ("Talisman"), Total, S.A. ("Total"), van Wyk, Mike ("van Wyk"), Wagner, Robert ("Wagner"), Zakaib, Geoff ("Zakaib").

year-end price to determine the economic producibility of reserves for accounting purposes;

- The proposed inclusion of bitumen, oil shales, and other resources in the definition of “oil and gas producing activities”;
- The proposed provision to broaden the types of technology that a company may use to establish reserves estimates and categories;
- The proposed change in the definition of proved undeveloped reserves to eliminate the “certainty” requirement; and
- The increased detail of disclosure that would be required as a result of our proposed definition of “geographic location.”

II. Revisions and Additions to the Definition Section in Rule 4-10 of Regulation S-X

A. Introduction

The revisions and additions to the definition section in Rule 4-10(a) of Regulation S-X¹⁴ update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted. Many of the definitions are designed to be consistent with the Petroleum Resource Management System (PRMS).¹⁵ Among other things, the revisions to these definitions address four issues that have been of particular interest to companies, investors, and securities analysts:

¹⁴ 17 CFR 210.4-10(a).

¹⁵ The Petroleum Resources Management System is a widely accepted standard for the management of petroleum resources developed by several industry organizations. See Society of Petroleum Engineers, the World Petroleum Council, American Association of Petroleum Geologists, and the Society of Petroleum Evaluation Engineers, Petroleum Resources Management System, SPE/WPC/AAPG/SPEE (2007).

- The use of single-day year-end pricing to determine the economic producibility of reserves;
- The exclusion of activities related to the extraction of bitumen and other “non-traditional” resources from the definition of oil and gas producing activities;
- The limitations regarding the types of technologies that an oil and gas company may rely upon to establish the levels of certainty required to classify reserves; and
- The limitation in the current rules that permits oil and gas companies to disclose only their proved reserves.

The revisions of, and additions to, the Rule 4-10 definitions attempt to address these issues without sacrificing clarity and comparability, which provide protection and transparency to investors. In addition, to the extent appropriate, we have revised our proposals so that the final definitions are more consistent with terms and definitions in the PRMS to improve compliance and understanding of our new rules.

B. Pricing Mechanism for Oil and Gas Reserves Estimation

1. 12-month average price

The final rules define the term “proved oil and gas reserves” in part as “those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain,

regardless of whether deterministic or probabilistic methods are used for the estimation.”

The definition states that the economic producibility of a reservoir must be based on existing economic conditions. It specifies that, in calculating economic producibility, a company must use a 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.¹⁶

Most commenters supported the use of a 12-month average price to serve as a proxy for existing economic conditions to determine the economic producibility of reserves.¹⁷ Some noted that a 12-month average price is considered to reflect “current economic conditions” by PRMS.¹⁸ They noted that the use of an average price would reduce the effects of short term volatility¹⁹ and seasonality,²⁰ while maintaining comparability of disclosures among companies.²¹

Seven commenters recommended the use of first-of-the-month prices²² instead of the proposed use of end-of-the-month prices because the use of first-of-the-month prices

¹⁶ See Rule 4-10(a)(22)(v) [17 CFR 210.4-10(a)(22)(v)].

¹⁷ See letters from AngloGold, Apache, API, BHP, BP, Canadian Natural, CAPP, Chesapeake, Chevron, Devon, EIA, EnCana, Equitable, Evolution, ExxonMobil, Newfield, Nexen, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ryder Scott, Sasol, Shell, Southwestern, SPE, Total, and Wagner.

¹⁸ See letters from AngloGold, BHP, Equitable, Ryder Scott, and SPE.

¹⁹ See letters from Apache, API, BHP, BP, Canadian Natural, CAPP, Chesapeake, EIA, EnCana, Equitable, Evolution, ExxonMobil, Imperial, IPAA, Newfield, Petrobras, Petro-Canada, Repsol, Ryder Scott, SPE, Total, and Wagner.

²⁰ See letters from Apache, Canadian Natural, Devon, EnCana, Evolution, IPAA, Petro-Canada, Repsol, and Ryder Scott.

²¹ See letters from BHP, Canadian Natural, CAPP, Deloitte, Devon, IPAA, Newfield, Petro-Canada, Total, and Wagner.

²² See letters from Apache, BP, Chesapeake, Chevron, Devon, Repsol, and Shell.

would provide companies with more time to estimate their reserves²³ and they thought that these prices better reflect the actual price received under typical natural gas contracts.²⁴ Conversely, six commenters recommended the use of a 12-month daily average price²⁵ because they thought that a daily average price would be more appropriate than a monthly average price. These commenters noted that oil sales contracts often are based on daily averages.²⁶ Two commenters expressed concern that end-of-the-month prices are not representative of actual prices because commodity traders often "clear their books" at the end of the month.²⁷

One commenter opposed the use of average prices stating that, conceptually, the use of average prices is poor regulatory policy and may encourage the market to pressure standard setters to use historical average prices for financial instruments and other assets and liabilities associated with volatile markets.²⁸ It noted that volatility reflects the underlying economics of the oil and gas industry.²⁹

The objective of reserves estimation is to provide the public with comparable information about volumes, not fair value, of a company's reserves available to enable investors to compare the business prospects of different companies. The use of a 12-month average historical price to determine the economic producibility of reserves quantities increases comparability between companies' oil and gas reserve disclosures,

²³ See letters from Chesapeake, Devon, and Shell.

²⁴ See letters from Apache, Newfield, and Repsol.

²⁵ See letters from Canadian Natural, CAPP, EnCana, Nexen, Petro-Canada, and Repsol.

²⁶ See letter from Newfield.

²⁷ See letters from Apache and Shell.

²⁸ See letter from CFA.

²⁹ See letter from CFA.

while mitigating any additional variability that a single-day price may have on reserve estimates. Although oil and gas prices themselves are subject to market-based volatility, the estimation of reserves quantities based on any historical price assumption determines those reserves quantities as if the oil or gas already has been produced, even though they have not, and these measures do not attempt to portray a reflection of their fair value. If the objective of reserve disclosures were to provide fair value information, we believe a pricing system that incorporates assumptions about estimated future market prices and costs related to extraction could be a more appropriate basis for estimation.

In order to provide disclosures which are more consistent with the objective of comparability, the amendments state that the existing economic conditions for determining the economic producibility of oil and gas reserves include the 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period.³⁰ For example, a company with a reporting year end of December 31 would determine its reserves estimates for its annual report based on the average of the prices for oil or gas on the first day of every month from January through December. Therefore, the use of a 12-month average price provides companies with the ability to efficiently prepare useful reserve information without sacrificing the objective of comparability. We believe that the revised definition of the term “proved oil and gas reserves” will provide investors with improved reserves information thereby enhancing their ability to analyze the disclosures.

³⁰ See new Rule 4-10(a)(22)(v) of Regulation S-X [17 CFR 210.4-10(a)(22)(v)].

2. Prices used for disclosure and accounting purposes

A proposal that resulted in significant comment was the use of a 12-month average price to estimate reserves for disclosure purposes, but a single-day, year-end price for accounting purposes.³¹ All commenters addressing the issue of using different prices to determine reserves for disclosure and accounting opposed the proposal.³² We are not adopting this aspect of the proposal. Instead, we are revising both our disclosure rules and our full-cost accounting rules related to oil and gas reserves to use a single price based on a 12-month average.³³ We also will continue to communicate with the FASB staff to align their accounting standards with these rules.

Commenters pointed out that the use of two different prices for disclosure and accounting purposes could:

- Confuse investors and other users of financial statements.³⁴
- Create misleading information;³⁵

³¹ Currently, companies use a single-day, year-end price to determine the quantity of its proved reserves. From an accounting perspective, the quantity of those reserves, while not included on the balance sheet, is used to determine the depreciation, depletion and amortization of certain capitalized costs included on the balance sheet. If the final rule retained a single-day, year-end price for determining reserves for accounting purposes (i.e., for determining depreciation, depletion and amortization), then companies would effectively be required to calculate reserves twice, using two different pricing assumptions—once for disclosure purposes and once for accounting purposes. Similarly, under the full cost rules, the full cost ceiling test, as described in Section III of this release, would have similar implications.

³² See letters from Apache, API, Audit Quality, BHP, BP, Canadian Natural, CAPP, CFA, Chesapeake, Chevron, Deloitte, Devon, E&Y, EnCana, Energen, Eni, Equitable, Evolution, ExxonMobil, Grant Thornton, Imperial, KPMG, McMoRan, Newfield, Nexen, PEMEX, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ross, Ryder Scott, Sasol, Shell, Southwestern, SPEE, StatoilHydro, Swift, Talisman, Total, and Wagner.

³³ See proposed Rule 4-10.

³⁴ See letters from Audit Quality, BHP, Canadian Natural, CAPP, Chesapeake, Deloitte, Devon, Evolution, ExxonMobil, Imperial, Newfield, Nexen, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ryder Scott, Shell, Swift, Talisman, Total, and Wagner.

³⁵ See letters from BP, CFA, Devon, Eni, Nexen, Repsol, and Wagner.

- Harm comparability;³⁶
- Decrease transparency;³⁷
- Increase costs and burden significantly;³⁸
- Increase the complexity of disclosures;³⁹
- Double record-keeping burden;⁴⁰
- Require more disclosure to explain the differences in reserves estimates; and⁴¹
- Break the connection between disclosures and accounting.⁴²

Some commenters noted that the disclosure and accounting rules and guidance do not use a different pricing method in other situations.⁴³ In addition, several commenters believed that changing to the use of an average price to estimate proved reserves would have a minimal impact on depreciation and net income.⁴⁴ We believe that changing the rules to use a 12-month average price in reserves estimations is not inconsistent with the principles and objectives of financial reporting in authoritative accounting guidance.

³⁶ See letters from Apache, Canadian Natural, CAPP, Questar, StatoilHydro, and Wagner.

³⁷ See letters from Canadian Natural, CAPP, ExxonMobil, Shell, Swift, and Wagner.

³⁸ See letters from Apache, Audit Quality, BHP, Canadian Natural, CAPP, Chevron, Deloitte, Devon, Eni, Equitable, Evolution, ExxonMobil, Imperial, McMoRan, Newfield, Nexen, Petrobras, Questar, Petro-Canada, PWC, Ryder Scott, Shell, Swift, Total, and Wagner.

³⁹ See letters from CAPP, CFA, and Devon.

⁴⁰ See letters from Apache, Chesapeake, Eni, Equitable, and Imperial.

⁴¹ See letters from CAPP, Devon, Eni, ExxonMobil, Imperial, and Wagner.

⁴² See letters from Apache, Audit Quality, CAPP, CFA, Deloitte, E&Y, Energen, Eni, ExxonMobil, Imperial, KPMG, Newfield, PWC, Repsol, and Total.

⁴³ See letters from API, CAPP, and Shell.

⁴⁴ See letters from API, Canadian Natural, EnCana, ExxonMobil, and Total.

With respect to accounting pronouncements that currently make reference to a single-day pricing regime with respect to oil and gas reserves, we are communicating with the FASB staff to align the standards used in its pronouncements with the 12-month average price used in our new rules, as several commenters recommended.⁴⁵ As discussed in more detail below, we are adopting a compliance date that will provide sufficient time to coordinate such activities with the FASB. However, as we discuss our revisions with the FASB, we will consider whether to delay the compliance date further.

3. Alternate pricing schemes

Some commenters on the Proposing Release believed that oil and gas futures prices, or management's forecast of future prices, would better represent the value of the reserves⁴⁶ and be better aligned with fair value of the reserves.⁴⁷ They indicated that management uses futures prices, not historical prices, in its planning and day-to-day decision making.⁴⁸ They suggested that the use of futures prices, combined with disclosure of how management made the estimates, would provide greater transparency⁴⁹ and comparability of disclosure.⁵⁰ One noted that historical prices have little to do with a company's future investments and values.⁵¹ Another commenter noted that differentials can be calculated through established accounting procedures under SFAS 157.⁵²

⁴⁵ See letters from Apache, BHP, Canadian Natural, CAPP, CFA, Deloitte, McMoRan, Newfield, Nexen, Questar, Southwestern, Talisman, and Total.

⁴⁶ See letters from CFA, Deloitte, Grant Thornton, and McMoRan.

⁴⁷ See letters from CFA and Deloitte.

⁴⁸ See letters from CFA, Grant Thornton, and McMoRan.

⁴⁹ See letter from Deloitte.

⁵⁰ See letters from Deloitte and McMoRan.

⁵¹ See letter from McMoRan.

⁵² See letter from CFA.

However, other commenters argued that futures prices are not available for all reserves locations⁵³ and that applying differentials to prices would require subjective estimates and reduce comparability among companies.⁵⁴ Two commenters noted that standard prices are not consistently available in some geographic regions.⁵⁵ Similarly, two commenters were concerned that futures price estimates would have to be accompanied by estimates of future costs, which they thought would be very subjective and not comparable for determining future economic conditions.⁵⁶ One commenter asserted that the use of future prices would require companies to document assumptions about future costs, or else the disclosure would be very inconsistent among reporting companies.⁵⁷ Three commenters believed that futures prices are more subject to market perceptions than market realities and are seldom used in actual physical trading of oil and gas.⁵⁸

We share the concerns of many of these commenters that determinations of expected future prices could require significant estimations which could fall into a wide, albeit reasonable, range. For example, in many situations and parts of the world, natural gas is sold through longer term contracts where observable market inputs are not widely available. As a result, there could be less comparability among different companies depending on their assumptions, which are inherent in determining futures prices.

⁵³ See letters from ExxonMobil and Wagner.

⁵⁴ See letters from EnCana, Evolution, ExxonMobil, Newfield, Ryder Scott, and Total.

⁵⁵ See letters from Ryder Scott and Total.

⁵⁶ See letters from SPE and Total.

⁵⁷ See letter from SPE.

⁵⁸ See letters from Evolution, Ryder Scott, and Wagner.

Difference in assumptions between companies could reduce the comparability of reserves information between those companies.

We believe that the purpose of disclosing reserves estimates is to provide investors with information that is both meaningful and comparable. The reserves estimates in our disclosure rules, however, are not designed to be, nor are they intended to represent, an estimation of the fair market value of the reserves. Rather, the reserves disclosures are intended to provide investors with an indication of the relative quantity of reserves that is likely to be extracted in the future using a methodology that minimizes the use of non-reserves-specific variables. By eliminating assumptions underlying the pricing variable, as any historical pricing method would do, investors are able to compare reserves estimates where the differences are driven primarily by reserves-specific information, such as the location of the reserves and the grade of the underlying resource. We recognize that energy markets are continuing to develop. Therefore, we are not adopting a rule that requires companies to use futures prices to estimate reserves at this time.

4. Time period over which the average price is to be calculated

Numerous commenters on the Proposing Release recommended that the 12-month period used to calculate the average price for estimating reserves should not coincide with the fiscal year, as we proposed.⁵⁹ Most of these commenters recommended a 12-month period running from the beginning of the fourth quarter of the prior fiscal year through the end of the third quarter of the present fiscal year. For example, for a

⁵⁹ See letters from Apache, API, BP, Canadian Natural, CAPP, EnCana, Eni, ExxonMobil, PEMEX, Petro-Canada, Repsol, Ryder Scott, Sasol, Shell, Total, van Wyk, and Wagner.

company with a fiscal year end of December 31, the relevant 12-month period would span from October 1 of the prior year to September 30 of the fiscal year covered by the annual report.⁶⁰ Several commenters suggested that we provide a two-month buffer between the end of the measurement period and the end of the company's fiscal year so that reserves estimates would be based on prices from November 1 through October 31 by a company with a fiscal year ending on December 31.⁶¹ Commenters attributed the need for a buffer period to the accelerated filing dates for annual reports⁶² and stated that they expected that the additional time would result in better, more accurate disclosure.⁶³ Others noted that some agreements, like production sharing contracts and other complex concession agreements, can make calculations difficult.⁶⁴ One commenter also noted that shifting the relevant measurement period so that it ends three-months prior to the fiscal-year end would align economic calculations with technical calculations, which typically occur at the end of the third quarter.⁶⁵

As noted above, we have considered all of these recommendations. We are adopting a pricing formula based on the average of prices at the beginning of each month in the 12-month period prior to the end of the reporting period. A number of commenters believed that the use of first-of-the-month prices essentially would provide companies

⁶⁰ See letters from Apache, API, BP, Canadian Natural, CAPP, Devon, Eni, ExxonMobil, PEMEX, Petro-Canada, Repsol, Ryder Scott, Sasol, Shell, Total, van Wyk, and Wagner.

⁶¹ See letters from Canadian Natural, CAPP, Eni, Nexen, and Petro-Canada.

⁶² See letters from API, Canadian Natural, CAPP, Devon, Evolution, PEMEX, Petrobras, Ryder Scott, Sasol, Shell, Total, and Wagner.

⁶³ See letters from Canadian Natural, CAPP, Nexen, Petrobras, Petro-Canada, Ryder Scott, Sasol, and Wagner.

⁶⁴ See letters from API and Shell.

⁶⁵ See letter from Shell.

with one month more to prepare the reserves disclosures,⁶⁶ while still aligning the time period with the fiscal year.⁶⁷ We agree with the commenters that such an average will provide companies more time to prepare more accurate disclosure, while still tying the pricing formula to the period covered by the annual report.

C. Extraction of Bitumen and Other Non-Traditional Resources

1. Definition of “oil and gas producing activities”

Our current definition of “oil and gas producing activities” explicitly excludes sources of oil and gas from “non-traditional” or “unconventional” sources, that is, sources that involve extraction by means other than “traditional” oil and gas wells.⁶⁸ These other sources include bitumen extracted from oil sands, as well as oil and gas extracted from coal and shales, even though some of these resources are sometimes extracted through wells, as opposed to mining and surface processing. However, such sources are increasingly providing energy resources to the world due in part to advancements in extraction and processing technology.⁶⁹ Therefore, the rules we adopt today revise the definition of “oil and gas producing activities” to include such activities.⁷⁰

All commenters on this issue supported including the extraction of unconventional resources as oil and gas producing activities.⁷¹ They believed that such

⁶⁶ See letters from API, Devon, Eni, Evolution, ExxonMobil, PEMEX, Petrobras, PWC, Repsol, and Total.

⁶⁷ See letters from Devon and ExxonMobil.

⁶⁸ See Rule 4-10(a)(1)(ii)(D) [17 CFR 210.4-10(a)(1)(ii)(D)].

⁶⁹ Commenters noted that unconventional resources currently represent 45% of natural gas production in the U.S. See letters from American Clean Skies and IPAA.

⁷⁰ See Rule 4-10(a)(16) [17 CFR 210.4-10(a)(16)].

⁷¹ See letters from American Clean Skies, Apache, API, Canadian Natural, CAPP, CAQ, CFA, Davis Polk, Devon, E&Y, EnCana, ExxonMobil, FERC, Imperial, IPAA, KPMG, Nexen,

inclusion would greatly improve the quality and completeness of the disclosures.⁷² Eight commenters noted that inclusion would better align disclosure with the way that companies view their operations.⁷³ Some noted that, although the distinction was reasonable decades ago when traditional resources dominated oil and gas production, the reality of today is that such unconventional resources are mainstream and companies invest significant amounts of capital to develop these resources.⁷⁴

The revised definition of “oil and gas producing activities” that we adopt today includes the extraction of the non-traditional resources described above.⁷⁵ This amendment is intended to shift the focus of the definition of “oil and gas producing activities” to the final product of such activities, regardless of the extraction technology used. The amended definition states specifically that oil and gas producing activities include the extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.⁷⁶

Petrobras, Petro-Canada, PRA, PWC, Repsol, Ryder Scott, Sasol, Shell, SPE, StatoilHydro, Talisman, Total, and Wagner.

⁷² See letters from API, CAPP, CAQ, ExxonMobil, Imperial, PWC, Repsol, Ryder Scott, Total, and Wagner.

⁷³ See letters from API, CAQ, E&Y, ExxonMobil, Imperial, Petro-Canada, PWC, and Total.

⁷⁴ See letters from Imperial, IPAA, Repsol, and Total.

⁷⁵ See Rule 4-10(a)(16) [17 CFR 210.4-10(a)(16)].

⁷⁶ A hydrocarbon product is saleable if it is in a state in which it can be sold even if there is no ready market for that hydrocarbon product in the geographic location of the project. The absence of a market does not preclude the activity from being considered an oil and gas producing activity. However, in order to claim reserves for that hydrocarbon product from a particular location, there must be a market, or a reasonable expectation of a market, for that product.

Currently, two types of natural resources pose a unique problem to establishing oil and gas reserves. Coal and, to a lesser degree, oil shale are used both as direct fuel and as feedstock to be converted into oil and gas. In response to our request for comment on how best to treat these resources, several commenters recommended that the extraction of coal⁷⁷ and oil shale⁷⁸ be categorized based on the final product. One commenter noted that investment decisions are based on the value and disposition of the final product.⁷⁹ We agree with these commenters and have revised the proposal to require a company to include coal and oil shale that is intended to be converted into oil and gas as oil and gas reserves. The adopted rules also, however, prohibit a company from including coal and oil shale that is not intended to be converted into oil and gas as oil and gas reserves.

2. Disclosure by final products

We proposed that disclosure of reserves would be organized based on the pre-processed resource extracted from the ground. For example, under the proposal, a company that extracted bitumen and processed that bitumen into synthetic crude oil in its own processing plant would have had to base its reserves disclosure on the amount of bitumen that was economically producible, not taking into account the economics of the processing plant. This proposal was consistent with our traditional separation of “upstream” activities such as drilling and producing oil and gas from “downstream” activities such as refining. Distinguishing between traditional resources and

⁷⁷ See letters from CAPP, ExxonMobil, Ryder Scott, Sasol, Shell, StatoilHydro, and Wagner.

⁷⁸ See letters from CAPP, ExxonMobil, Shell, StatoilHydro, and Wagner.

⁷⁹ See letter from ExxonMobil.

unconventional resources can be significant to investors because unconventional resources often involve significantly different economics and company resources than oil and gas from traditional wells.

Several commenters disagreed with our proposal, recommending that the determining factor should be the final product.⁸⁰ They believed that a company should be able to consider the prices of self-processed resources when estimating oil and gas reserves because the economics of the processing plant are critical to the registrant's evaluation of the economic producibility of the resources.⁸¹ One commenter was concerned that distinguishing bitumen or other intermediate product from traditional oil and gas creates a false and misleading sense of comparability because producers that upgrade bitumen and sell synthetic crude do not face the same risks and rewards as do producers who sell the bitumen itself.⁸²

We are persuaded by these commenters. However, we believe that the distinction between a company's traditional and unconventional activities is an important one from an investor's perspective because many of the unconventional activities are costlier and, therefore, have a much higher threshold of economic producibility. Therefore, we are revising the proposed table in Item 1202 to require separation of reserves based on final product, but distinguishing between final products that are traditional oil or gas from final products of synthetic oil or gas. We believe that with this separate disclosure, investors

⁸⁰ See letters from Apache, Nexen, Petrobras, and Ryder Scott.

⁸¹ See letters from Apache, CAQ, and Nexen.

⁸² See letter from Nexen.

will be able to identify resources in projects that produce synthetic oil or gas that may be more sensitive to economic conditions from other resources.

In addition, as proposed, we are amending the definition of “oil and gas producing activities” to include activities relating to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted. However, the definition would continue to exclude:

- Transporting, refining, processing (other than field processing of gas to extract liquid hydrocarbons by the company and the upgrading of natural resources extracted by the company other than oil or gas into synthetic oil or gas) or marketing oil and gas;
- The production of natural resources other than oil, gas, or natural resources from which synthetic oil and gas can be extracted; and
- The production of geothermal steam.

D. Proved Oil and Gas Reserves

We proposed to significantly revise the definition of “proved oil and gas reserves.” We are adopting that definition, substantially as proposed.⁸³ However, as noted above, we have decided to base the price used to establish economic producibility on the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period.

⁸³ See Rule 4-10(a)(22) [17 CFR 210.4-10(a)(22)].

One commenter recommended against using an average price to calculate existing economic conditions if the price is set by contractual arrangements.⁸⁴ We agree that under such circumstances, the appropriate price to use for establishing economic producibility is the price set by those contractual arrangements. Therefore, we have revised the definition to reflect that situation.⁸⁵

The existing definition of the term “proved oil and gas reserves” incorporates certain specific concepts such as “lowest known hydrocarbons” which limit a company’s ability to claim proved reserves in the absence of information on fluid contacts in a well penetration,⁸⁶ notwithstanding the existence of other engineering and geoscientific evidence.⁸⁷ We proposed revisions to the definition that would permit the use of new reliable technologies to establish the reasonable certainty of proved reserves. The proposed revisions to the definition of “proved oil and gas reserves” also included provisions for establishing levels of lowest known hydrocarbons and highest known oil through reliable technology other than well penetrations. We are adopting those revisions as proposed.

We also are adopting, as proposed, revisions that permit a company to claim proved reserves beyond those development spacing areas that are immediately adjacent to developed spacing areas if the company can establish with reasonable certainty that these

⁸⁴ See letter from SPE.

⁸⁵ See Rule 4-10(a)(22)(v) [17 CFR 210.4-10(a)(22)(v)].

⁸⁶ In certain circumstances, a well may not penetrate the area at which the oil makes contact with water. In these cases, the company would not have information on the fluid contact and must use other means to estimate the lower boundary depths for the reservoir in which oil is located.

⁸⁷ See Rule 4-10(a)(2)(i) [17 CFR 210.4-10(a)(2)(i)].

reserves are economically producible.⁸⁸ These revisions are designed to permit the use of alternative technologies to establish proved reserves in lieu of requiring companies to use specific tests. In addition, they establish a uniform standard of reasonable certainty that applies to all proved reserves, regardless of location or distance from producing wells.

E. Reasonable Certainty

Both the existing definition of the term “proved oil and gas reserves,” and the definition of that term that we are adopting in this release, rely on the term “reasonable certainty,” which previously was not defined in Rule 4-10. In the Proposing Release, we proposed to define the term “reasonable certainty” as “much more likely to be achieved than not” to avoid ambiguity in that term’s meaning. However, several commenters recommended that the rules mirror the PRMS definition more closely.⁸⁹ Four commenters were concerned that a different definition from the PRMS would cause confusion. They recommended using the PRMS standard of “high degree of confidence that the quantities will be recovered.”⁹⁰ One commenter recommended that, because the proposed definition is new, the Commission should adopt a safe harbor, to avoid potential uncertainty until a court interprets the phrase.⁹¹ But others believed that the proposed definition is consistent with the PRMS definition.⁹² One commenter opined that the

⁸⁸ See Rule 4-10(a)(24)(ii) [17 CFR 210.4-10(a)(24)(ii)]. See Section II.G for a more detailed discussion regarding this provision.

⁸⁹ See letters from EIA, ExxonMobil, and Zakaib.

⁹⁰ See letters from Apache, EIA, Energen, and SPE.

⁹¹ See letter from Evolution.

⁹² See letters from EnCana, ExxonMobil, Petrobras, and Ryder Scott.

concept of estimated ultimate recovery (EUR) is appropriate to establish proved oil and gas reserves.⁹³

We believe that the terms “high degree of confidence” from the PRMS and “much more likely to be achieved than not” in our proposal have the same meaning. Our proposed language was not intended to change the level of certainty required to establish reasonable certainty. However, we agree that the use of terminology that is consistent with the PRMS will assist in the understanding of those terms. Therefore, we are adopting the “high degree of confidence” standard that exists in the PRMS. We also are clarifying that having a “high degree of confidence” means that a quantity is “much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease” to provide elaboration to the definition of reasonable certainty.

We are adopting a definition of “reasonable certainty” that addresses, and permits the use of, both deterministic methods and probabilistic methods for estimating reserves, as proposed. Nine commenters supported permitting the use of either deterministic methods or probabilistic methods.⁹⁴ One commenter believed that each method may be more appropriate for different situations.⁹⁵ Other commenters also supported the proposed alignment of the definitions of those terms with the definitions in the PRMS

⁹³ Total.

⁹⁴ See letters from Apache, Devon, Evolution, Petro-Canada, Ryder Scott, Shell, SPE, Total, and Wagner.

⁹⁵ See letter from Wagner.

definitions.⁹⁶ The definition that we are adopting states that, if deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered.⁹⁷ Consistent with the PRMS definition, if probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.

F. Developed and Undeveloped Oil and Gas Reserves

We proposed to revise the definitions of the terms “proved developed oil and gas reserves” and “proved undeveloped oil and gas reserves.” One commenter noted that the terms “developed” and “undeveloped” are not restricted to proved oil and gas reserves, but could apply to all classifications of reserves, including probable and possible reserves.⁹⁸ We agree with that commenter. Although the development of a prospect may provide the company with more information and data to determine reserves amounts more accurately, companies may estimate proved, probable, and possible volumes regardless of the development stage. In the past, these terms were linked to the concept of proved reserves because our disclosure rules permitted the disclosure only of proved reserves. In light of our revision to allow disclosure of probable and possible reserves, the final rules define the terms “developed oil and gas reserves” and “undeveloped oil

⁹⁶ See letters from AAPG, SPE, and Southwestern.

⁹⁷ See Rule 4-10(a)(24) [17 CFR 210.4-10(a)(24)].

⁹⁸ See letter from SPE. We note that with respect to oil and gas reserves, the term “classification” is used to indicate the level of certainty that estimated amounts will be recovered. Thus, although the terms “developed” and “undeveloped” may be considered means in which to generically “classify” reserves, for clarity, we use that term to be consistent with industry usage.

and gas reserves” to indicate that the development status of the reserves is relevant to all classifications of oil and gas reserves.⁹⁹

1. Developed oil and gas reserves

Other than the change discussed above to eliminate “proved” from the term being defined, we are adopting a definition of “developed oil and gas reserves” substantially as proposed. We proposed to define the term “proved developed oil and gas reserves” as proved reserves that:

- In projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and
- In projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.

Two commenters suggested that, consistent with the PRMS, reserves should be considered developed if the cost of any required equipment is relatively minor compared to the cost of a new well or the installed equipment.¹⁰⁰ Again, we agree that consistency with PRMS would improve compliance with our rules. In addition, such a revision is consistent with our existing definition of the term “proved undeveloped reserves” which includes reserves on which a well exists, but a relatively “major” expenditure is required for recompletion.¹⁰¹ Therefore, the final rules provide that reserves also are developed if

⁹⁹ See Rules 4-10(a)(6) and (31) [17 CFR 210.4-10(a)(6) and (31)].

¹⁰⁰ See letters from SPE and Total.

¹⁰¹ See previous Rule 4-10(a)(4) [17 CFR 210.4-10(a)(4)].

the cost of any required equipment is relatively minor compared to the cost of a new well.¹⁰²

2. Undeveloped oil and gas reserves

In the Proposing Release, we proposed a significantly revised definition of the term “proved undeveloped oil and gas reserves.” The most significant aspect of the proposed revision was the replacement of the existing “certainty” test for areas beyond one offsetting drilling unit¹⁰³ from a productive well with a “reasonable certainty” test.

Currently, the definition of the term “proved undeveloped reserves” imposes a “reasonable certainty” standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well and a “certainty” standard for reserves in drilling units beyond the immediately adjacent drilling units.¹⁰⁴ All commenters on this issue supported the proposal.¹⁰⁵ Three commenters noted that a single standard—reasonable certainty—should apply to all proved reserves.¹⁰⁶ We are adopting this aspect of the definition as proposed.

Many commenters opposed the proposed language that would have imposed a five-year limit on maintaining undeveloped reserves unless “unusual” circumstances

¹⁰² See Rule 4-10(a)(6) [17 CFR 210.4-10(a)(6)].

¹⁰³ As noted later in this section of the release, we are replacing the term “drilling unit” with the term “development spacing area” in the final rules. However, for purposes of discussing the proposal and the existing rules, we continue to use the term “drilling unit” because that is the term used in the proposal and the existing rules.

¹⁰⁴ See 17 CFR 210.4-10(a)(4). A drilling unit refers to the spacing between wells required by some local jurisdictions to prevent wasting resources and optimize recovery.

¹⁰⁵ See letters from American Clean Skies, Apache, API, Canadian Natural, CAPP, Chesapeake, Devon, Evolution, ExxonMobil, McMoRan, Petro-Canada, Questar, Repsol, Southwestern, Shell, SPE, Total, and Wagner.

¹⁰⁶ See letters from Devon, EnCana, and Equitable.

existed.¹⁰⁷ They asserted that large projects, projects in remote areas, and projects in continuous accumulations, such as oil sands, typically take more than five years to develop, but they do not view such projects as “unusual.”¹⁰⁸ One commenter noted that the proposed rule is not consistent with the PRMS, which uses the term “specific circumstances,” rather than “unusual circumstances.”¹⁰⁹ Other commenters suggested that we require the company to explain why it has not developed any undeveloped reserves for more than five years.¹¹⁰ The intent of the proposal was not to exclude projects that typically take more than five years to develop from being considered reserves. We agree that the rule should allow the recognition of reserves in projects that are expected to run more than five years, regardless of whether “unusual” circumstances exist. Therefore, we have revised the rule to replace the term “unusual” with the term “specific.”¹¹¹ We note that, as proposed, Item 1203 of Regulation S-K would require disclosure regarding why such undeveloped reserves have not been developed.¹¹²

We also proposed to broaden the definition of the term “proved undeveloped reserves” to permit a company to include, in its undeveloped reserves estimates, quantities of oil that can be recovered through improved recovery projects and to expand the technologies that a company can use to establish reserves. Under the existing definition, a company can include such quantities only if techniques have been proved

¹⁰⁷ See letters from American Clean Skies, Apache, CAPP, Chesapeake, EnCana, ExxonMobil, Luscher, Newfield, Nexen, Petrobras, Petro-Canada, Ryder Scott, Shell, SPE, and Total.

¹⁰⁸ See letters from American Clean Skies, CAPP, Chesapeake, EnCana, ExxonMobil, Newfield, Nexen, Petrobras, Petro-Canada, Ryder Scott, Shell, and Total.

¹⁰⁹ See letter from SPE.

¹¹⁰ See letters from Devon, Ryder Scott, and Wagner.

¹¹¹ See Rule 4-10(a)(31) [17 CFR 210.4-10(a)(31)].

¹¹² See Item 1203(d) [17 CFR 229.1203(d)].

effective by actual production from projects in the area and in the same reservoir. As proposed, we are expanding this definition of the term “undeveloped oil and gas reserves” to permit the use of techniques that have been proved effective by actual production from projects in the same reservoir or an analogous reservoir or “by other evidence using reliable technology that establishes reasonable certainty.”¹¹³

We also are making other, less substantive revisions to the definition of “undeveloped oil and gas reserves.” First, commenters suggested that we use the term “development spacing”¹¹⁴ or “drainage areas”¹¹⁵ instead of “drilling units” because the term “drilling units” is only relevant in jurisdictions that establish such units. They noted that many foreign jurisdictions do not establish such units. We concur with those commenters and have replaced the term “drilling units” with the term “development spacing areas.”

One commenter also noted that the PRMS guidance on the use of analogs for improved recovery projects does not limit such use to “within the immediate area” and recommended that we delete this phrase from the definition.¹¹⁶ Again, we agree that consistency with PRMS would be beneficial in this instance and have deleted that phrase from the definition. We also have eliminated two paragraphs of the proposed definition because they were largely repetitive of other aspects of the definition and were unnecessary.¹¹⁷

¹¹³ See Rule 4-10(a)(25)(iii) [17 CFR 210.4-10(a)(25)(iii)].

¹¹⁴ See letter from Total.

¹¹⁵ See letter from SPE.

¹¹⁶ See letter from SPE.

¹¹⁷ These paragraphs would have clarified (1) in a conventional accumulation, offsetting productive units must lie within an area in which economic producibility has been established by reliable

G. Reliable Technology

1. Definition of the term "reliable technology"

We are adopting, substantially as proposed, a new definition of "reliable technology" that would broaden the types of technologies that a company may use to establish reserves estimates and categories. All commenters on this topic supported the proposed principles-based definition for reliable technology.¹¹⁸

The current rules limit the use of alternative technologies as the basis for determining a company's reserves disclosures. For example, under the current rules, a company must use actual production or flow tests to meet the "reasonable certainty" standard necessary to establish the proved status of its reserves.¹¹⁹ Similarly, the current rules provide bright line tests for determining fluid contacts, such as lowest known hydrocarbons and highest known oil, which establish the volume of the hydrocarbons in place.

We recognize that technologies have developed, and will continue to develop, improving the quality of information that can be obtained from existing tests and creating entirely new tests that we cannot yet envision. Thus, the new definition of the term

technology to be reasonably certain and (2) proved reserves can be claimed in a conventional or continuous accumulation in a given area in which engineering, geoscience, and economic data, including actual drilling statistics in the area, and reliable technology show that, with reasonable certainty, economic producibility exists beyond immediately offsetting drilling units. We do not believe that these statements, based on the terms "conventional accumulation" and "continuous accumulation" which are no longer being defined continue to serve a helpful purpose. See Section II.J.5 of this release.

¹¹⁸ See letters from AAPG, American Clean Skies, Apache, CFA, Davis Polk, Devon, EnCana, ExxonMobil, Petrobras, Ryder Scott, Sasol, Shell, SPE, Southwestern, and Wagner.

¹¹⁹ However, in the past, the Commission's staff has recognized that flow tests can be impractical in certain areas, such as the Gulf of Mexico, where environmental restrictions effectively prohibit these types of tests. The staff has not objected to disclosure of reserves estimates for these restricted areas using alternative technologies.

“reliable technology” permits the use of technology (including computational methods) that has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. This new standard will permit the use of a new technology or a combination of technologies once a company can establish and document the reliability of that technology or combination of technologies.

We are adopting certain revisions to our proposed definition of the term “reliable technology.” The proposal also would have required reliable technology to be “widely accepted.” However, some commenters were concerned that this requirement would exclude proprietary technologies that companies develop internally that have proven to be reliable.¹²⁰ We concur with these commenters and have removed the “widely accepted” requirement from the final rule.

We also proposed to define the term “reliable technology,” expressed in probabilistic terms, as technology that has been proven empirically to lead to correct conclusions in 90% or more of its applications. Several commenters expressed concern that this proposed 90% threshold would be difficult to verify and support on an ongoing basis.¹²¹ We agree that a bright line test would be difficult to apply to a particular technology or mix of technologies to determine their reliability. Therefore, we are not adopting the 90% threshold as part of the definition.

2. Disclosure of technologies used

The proposal would have required a company to disclose the technology used to establish reserves estimates and categories for material properties in a company’s first

¹²⁰ See letters from Chesapeake, ExxonMobil, Shell, and Total.

¹²¹ See letters from AAPG, Apache, EIA, Evolution, Ryder Scott, Shell, SPE, and Wagner.

filing with the Commission and for material additions to reserves estimates in subsequent filings because, under the proposal, a company would be able to select the technology or mix of technologies that it uses to establish reserves. Two commenters supported the proposal because they believed that disclosure of the technologies used is reasonable if the definition of "reliable technology" is principles-based.¹²² However, many other commenters were concerned that the proposed requirement to disclose the technologies used to establish levels of certainty for reserves estimates would lead to very complex, technical disclosures that would have little meaning to investors.¹²³ Others were concerned that disclosure of the technology, or the mix of technologies, might cause competitive harm.¹²⁴

As an alternative, some commenters recommended that the rule require a more general overview of the technologies used.¹²⁵ We are clarifying that the required disclosure would be limited to a concise summary of the technology or technologies used to create the estimate.¹²⁶ A company would not be required to disclose proprietary technologies, or a proprietary mix of technologies, at a level of specificity that would cause competitive harm. Rather, the disclosure may be more general. For example, a company may disclose that it used a combination of seismic data and interpretation, wireline formation tests, geophysical logs, and core data to calculate the reserves estimate. As noted, however, the Commission's staff, as part of the review and comment

¹²² See letters from Davis Polk and Sasol.

¹²³ See letters from API, Devon, Eni, ExxonMobil, PEMEX, Petro-Canada, Questar, Repsol, Ryder Scott, Shell, Southwestern, StatoilHydro, and Total.

¹²⁴ See letters from API, Devon, Evolution, ExxonMobil, Ryder Scott, StatoilHydro, and Total.

¹²⁵ See letters from EnCana, Eni, Evolution, Ryder Scott, and Shell.

¹²⁶ See Item 1202(a)(6) [17 CFR 229.1202(a)(6)].

process, may continue to request companies to provide supplemental data, consistent with current practice,¹²⁷ which, under the new rules, may include information sufficient to support a company's conclusion that a technology or mix of technologies used to establish reserves meets the definition of "reliable technology."

Two commenters supported the proposal to limit the disclosures to technologies used to establish reserves in a company's first filing with the Commission and material additions to reserves.¹²⁸ We are adopting this limitation as proposed.¹²⁹ If the company has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to its reserves estimates, the company must disclose the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed and the particular properties do not need to be identified. We believe that requiring such disclosure when reserves, or material additions to reserves, are reported for the first time will discourage the use of questionable technologies to establish reserves. However, we do not believe it is necessary to require a company to disclose the technology or technologies relied upon to establish reserves previously disclosed under our rules because the permitted technologies have been limited to those permitted by our existing rule. In addition, we believe that ongoing disclosure of the technologies used to establish all of a company's reserves would become unnecessarily cumbersome.

¹²⁷ Currently, the Commission's staff requests supplemental data pursuant to Instruction 4 to Item 102 of Regulation S-K [17 CFR 229.102], Rule 418 [17 CFR 230.418], and Rule 12b-4 [17 CFR 240.12b-4]

¹²⁸ See letters from Southwestern and Wagner.

¹²⁹ See Item 1202(a)(6) [17 CFR 229.1202(a)(6)].

H. Unproved Reserves—"Probable Reserves" and "Possible Reserves"

As discussed more fully in Section IV.B.3 of this release addressing the disclosure requirements of new Subpart 1200, we are adopting the proposal to permit disclosure of probable and possible reserves. Therefore, we are adopting the proposed definitions of the terms "probable reserves" and "possible reserves" as proposed.

When producing an estimate of the amount of oil and gas that is recoverable from a particular reservoir, a company can make three types of estimates:

- An estimate that is reasonably certain;
- An estimate that is as likely as not to be achieved; and
- An estimate that might be achieved, but only under more favorable circumstances than are likely.

These three types of estimates are known in the industry as (1) proved, (2) proved plus probable, and (3) proved plus probable plus possible reserves estimates.

1. Probable reserves

We are adopting the definition of the term "probable reserves" as proposed. It states that "probable reserves" are those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered.¹³⁰ This definition provides guidance for the use of both deterministic and probabilistic methods. The definition clarifies that, when deterministic methods are used, it is as likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves. Similarly, when probabilistic

¹³⁰ See Rule 4-10(a)(18) [17 CFR 210.4-10(a)(18)].

methods are used, there must be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates. This definition was derived from the PRMS definition of the term "probable reserves." Several commenters agreed with the proposed definition of this term, noting that it is roughly consistent with PRMS.¹³¹

2. Possible reserves

We also are adopting the definition of the term "possible reserves" as proposed. The new definition states that possible reserves include those additional reserves that are less certain to be recovered than probable reserves.¹³² It clarifies that, when deterministic methods are used, the total quantities ultimately recovered from a project have a low probability to exceed the sum of proved, probable, and possible reserves. When probabilistic methods are used, there must be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable, and possible estimates. Several commenters noted that our proposed definition of the term "possible reserves" was consistent with PRMS, which also uses a 10% threshold.¹³³ One commenter recommended that the threshold for "possible reserves" should be a 25% likelihood of recovery because that percentage would be more meaningful than 10%.¹³⁴ We believe that a definition consistent with the PRMS will provide the most certainty and clarity for companies and investors.

¹³¹ See letters from Devon, EnCana, SPE, and StatoilHydro.

¹³² See Rule 4-10(a)(17) [17 CFR 210.4-10(a)(17)].

¹³³ See letters from Devon, EnCana, SPE, and StatoilHydro.

¹³⁴ See letter from Evolution.

I. Reserves

We proposed to add a definition of the term “reserves” to our rules. The proposed definition would have described the criteria that an accumulation of oil, gas, or related substances must satisfy to be considered reserves (of any classification), including non-technical criteria such as legal rights. Specifically, we proposed to define reserves as the estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on:

- Analysis of geoscience and engineering data;
- The use of reliable technology;
- The legal right to produce;
- Installed means of delivering the oil, gas, or related substances to markets, or the permits, financing, and the appropriate level of certainty (reasonable certainty, as likely as not, or possible but unlikely) to do so; and
- Economic producibility at current prices and costs.

The proposed definition also would have clarified that reserves are classified as proved, probable, and possible according to the degree of uncertainty associated with the estimates. We are not adopting the definition as proposed. Four commenters recommended clarification that the term “legal right to produce” extends beyond the initial term of an oil and gas concession if there is a reasonable expectation that the concession will be renewed, consistent with the PRMS and current staff position.¹³⁵ We

¹³⁵

See letters from API, CAQ, Grant Thornton, and KPMG.

are adopting a definition of the term “reserves” that more closely parallels the PRMS definition of that term.

Our final rules define the term “reserves” as the estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations.¹³⁶ In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production of oil and gas, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.

A note to the definition clarifies that reserves should not be assigned to adjacent reservoirs isolated by major, potentially sealing, faults until those reservoirs are penetrated and evaluated as economically producible and that reserves should not be assigned to areas that are clearly separated from a known accumulation by a non-productive reservoir (i.e., absence of reservoir, structurally low reservoir, or negative test results). Such areas may contain prospective resources (i.e., potentially recoverable resources from undiscovered accumulations).¹³⁷

One notable difference between our final definition of “reserves” and the PRMS definition is that our definition is based on “economic producibility” rather than “commerciality.” One commenter believed that reserves must be “commercial,” as stated in the PRMS definition.¹³⁸ However, commerciality introduces a subjective aspect to the

¹³⁶ See Rule 4-10(a)(26) [17 CFR 210.4-10(a)(26)].

¹³⁷ See Note to Rule 4-10(a)(26) [17 CFR 210.4-10(a)(26)].

¹³⁸ See letter from StatoilHydro.

price used to establish existing economic conditions by factoring in the rate of return required by a particular company before it will commit resources to the project. This rate of return will vary among companies, reducing the comparability among disclosures. Therefore, the adopted definition of the term "reserves" relies on economic producibility, as proposed.

J. Other Supporting Terms and Definitions

We also proposed to define several other terms primarily to support and clarify the definitions of the key terms. We are adopting most of those supporting definitions as discussed in further detail below.

1. Deterministic estimate

A company can derive two different types of reserves estimates depending on the method used to calculate the estimates. These two types of estimates are known as "deterministic estimates" and "probabilistic estimates."¹³⁹ In the Proposing Release, we proposed to define the term "deterministic estimate" as an estimate based on a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation that is used in the reserves estimation procedure. We are adopting that definition as proposed.

2. Probabilistic estimate

We are adopting a new definition of the term "probabilistic estimate" substantially as proposed. The new rule defines the term "probabilistic estimate" as an

¹³⁹ See Rules 4-10(a)(5) and (a)(19) [17 CFR 210.4-10(a)(5) and (a)(19)]. These definitions are based on the Canadian Oil and Gas Evaluation Handbook (COGEH). This handbook was developed by the Calgary Chapter of the Society of Petroleum Evaluation Engineers and the Petroleum Society of CIM to establish standards to be used within the Canadian oil and gas industry in evaluating oil and gas reserves and resources.

estimate that is obtained when the full range of values that could reasonably occur from each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.¹⁴⁰ In response to a comment received, however, we revised the definition so that it does not include the application of a range of values with respect to economic conditions because those conditions, such as prices and costs, are based on historical data, and therefore are an established value, rather than a range of estimated values.¹⁴¹

3. Analogous reservoir

We proposed a definition of the term “analogous formation in the immediate area.” As noted above, we received comment indicating that the use of appropriate analogs should not be limited to the immediate area in which the reserves are being estimated.¹⁴² Therefore, we have changed the defined term to “analogous reservoir.”¹⁴³ In addition, based on commenters’ remarks, we are defining the term “analogous reservoir” in a manner that is more consistent with the PRMS, which addresses more specifically the types of reservoirs that may be used as analogues. The new definition of the term “analogous reservoir” states that analogous reservoirs, as used in resources assessments, have similar rock and fluid properties, reservoir conditions (depth, temperature, and pressure) and drive mechanisms, but are typically at a more advanced stage of development than the reservoir of interest and thus may provide concepts to

¹⁴⁰ See Rule 4-10(a)(19) [17 CFR 210.4-10(a)(19)].

¹⁴¹ See letter from Shell.

¹⁴² See letter from SPE.

¹⁴³ See Rule 4-10(a)(2) [17 CFR 210.4-10(a)(2)].

assist in the interpretation of more limited data and estimation of recovery.¹⁴⁴ When used to support proved reserves, an “analogous reservoir” refers to a reservoir that shares the following characteristics with the reservoir of interest:

- Same geological formation (but not necessarily in pressure communication with the reservoir of interest);
- Same environment of deposition;
- Similar geological structure; and
- Same drive mechanism.

As proposed, the new definition includes an instruction that clarifies that reservoir properties must, in the aggregate, be no more favorable in the analog than in the reservoir of interest. The new definition also clarifies that, although an analogous reservoir must be in the same geological formation as the reservoir of interest, it need not be in pressure communication with the reservoir of interest.

4. Definitions of other terms

We received no comment with regard to several of the proposed supporting definitions. We are adopting those definitions substantially as proposed without material changes. They include the following terms:

- “Condensate”;¹⁴⁵
- “Development project”;¹⁴⁶

¹⁴⁴ See Rule 4-10(a)(2) [17 CFR 210.4-10(a)(2)].

¹⁴⁵ See Rule 4-10(a)(3) [17 CFR 210.4-10(a)(4)].

¹⁴⁶ See Rule 4-10(a)(8) [17 CFR 210.4-10(a)(8)].

- “Economically producible”;¹⁴⁷
- “Estimated ultimate recovery,”¹⁴⁸
- “Exploratory well”;¹⁴⁹
- “Extension well”;¹⁵⁰ and
- “Resources.”¹⁵¹

Most of these supporting terms and their definitions are based on similar terms in the PRMS. The definition of “resources” is based on the Canadian Oil and Gas Evaluation Handbook (COGEH).

In the Proposing Release, we solicited comment on whether we should adopt any other supporting definitions. One commenter submitted an appendix to its letter containing numerous other terms that it thought we should adopt.¹⁵² We have decided not to adopt those additional definitions because we feel that they are unnecessary at this time. However, we have decided to adopt a definition for the term “bitumen.” We believe that providing a definition for this term will lead to more consistency among disclosures because there currently are several competing definitions of that term used in the industry.

We are defining the term “bitumen” as “petroleum in a solid or semi-solid state in natural deposits. In its natural state, it usually contains sulfur, metals, and other non-

¹⁴⁷ See Rule 4-10(a)(10) [17 CFR 210.4-10(a)(10)].

¹⁴⁸ See Rule 4-10(a)(11) [17 CFR 210.4-10(a)(11)].

¹⁴⁹ See Rule 4-10(a)(13) [17 CFR 210.4-10(a)(13)].

¹⁵⁰ See Rule 4-10(a)(14) [17 CFR 210.4-10(a)(14)].

¹⁵¹ See Rule 4-10(a)(28) [17 CFR 210.4-10(a)(28)].

¹⁵² See letter from SPE.

hydrocarbons. Bitumen has a viscosity greater than 10,000 centipoise measured at original temperature in the deposit and atmospheric pressure, on a gas free basis.”¹⁵³ This definition is similar to the PRMS definition of “natural bitumen.”

5. Proposed terms and definitions not adopted

We proposed definitions for the terms “continuous accumulations” and “conventional accumulations” to assist companies in disclosing segregated reserves based on these two types of accumulations. As noted elsewhere in this release, the final rules do not require disclosure based on the type of accumulation in which the reserves are found.¹⁵⁴ Therefore, there is no need to define these terms and we are not adopting the proposed definitions.

Similarly, we proposed a definition for the term “sedimentary basin” because it would have been part of our definition of the term “by geographic area.” As noted elsewhere in this release, we have substantially revised the definition of the term “by geographic area”¹⁵⁵ and the term “sedimentary basin” is no longer needed, so we are not adopting this proposed term and definition.

As noted above, one commenter recommended that we adopt a large glossary of terms and definitions that correspond with the PRMS definitions.¹⁵⁶ Rather than defining an extensive glossary of terms in our rules and attempting to constantly update those definitions, we advise companies to look to definitions that are commonly accepted

¹⁵³ See Rule 4-10(a)(3) [17 CFR 210.4-10(a)(3)].

¹⁵⁴ See Section III.B.3.c.

¹⁵⁵ See Section III. B.2.a.

¹⁵⁶ See letter from SPE.

within the oil and gas industry to the extent such definitions are not in, or inconsistent with, our rules.

K. Alphabetization of the Definitions Section of Rule 4-10

We are alphabetizing the definitional terms in Rule 4-10(a) because we are adding a significant number of defined terms to this section.

III. Revisions to Full Cost Accounting and Staff Accounting Bulletin

As we noted in Section II.B.2 of this release, commenters unanimously opposed our proposal to use different prices for disclosure and accounting purposes. We agree with those commenters and are revising our proposal to use a 12-month average price for accounting purposes. These revisions primarily will appear under the full cost accounting method described in Rule 4-10(c)¹⁵⁷ of Regulation S-X. The full cost accounting method permits certain oil and gas extraction costs to accumulate on a company's balance sheet subject to a limitation test or a "ceiling" as described in Rule 4-10(c)(3)(4). Like reserve disclosures, these capitalized costs and the related limitation test are not fair value based measurements. Rather the capitalized costs represent the accumulated historical acquisition, exploration and development costs (net of any previously recorded depletion, amortization or ceiling test write downs) incurred for oil and gas producing activities, limited to a standardized mathematical calculation (the full cost ceiling) adopted over 25 years ago. Costs that do not exceed the limitation are deferred and amortized over time. The limitation test calculation on capitalized costs is not designed or intended to represent a fair valuation of the related oil and gas assets.¹⁵⁸

¹⁵⁷ 17 CFR 210.4-10(c).

¹⁵⁸ While not intended to represent fair value, costs that are written down because they exceed the ceiling limitation are accounted for in the same manner as impairments recognized under

Similar to the single-day, year-end pricing used under the successful efforts method,¹⁵⁹ the application of the full cost method of accounting in Rule 4-10(c) has used “current prices,” interpreted as single-day, year-end prices, as the basis for calculating the limitation on costs that may be capitalized under the full cost method. In order to further the objective of providing comparable oil and gas reserve quantities, our final rule clarifies that the term “current prices” as used in Rule 4-10(c) is consistent with the 12-month average price as calculated in Rule 4-10(a)(22)(v).¹⁶⁰

However, since these calculations are not designed to result in a calculation of fair value and since the change to the full cost accounting method would effectively eliminate the anomalies caused by the single-day, year-end price currently used in the limitation test, the SEC staff will eliminate portions of Staff Accounting Bulletin (SAB) Topic 12:D.3.c that permit consideration of the impact of price increases subsequent to the period end on the ceiling limitation test.

The combination of adopting a 12-month average pricing mechanism and eliminating portions of SAB Topic 12:D.3.c could have the effect of requiring a company using the full cost accounting method to record a ceiling test write-down in income during periods of rising oil and gas prices. In that situation, it is possible that using a 12-month average price in the ceiling test calculation might result in a write-down that would not otherwise have been required had the full cost company been permitted to use

accounting generally. That is, once the asset is written down, it becomes the new historical cost basis and cannot be reinstated for subsequent increases in the ceiling. See Rule 4-10(c)(4)(i) of Regulation S-X [17 CFR 210.4-10(c)(4)(i)].

¹⁵⁹ The accounting guidance refers to our definition of proved reserves under existing Rule 4-10(a)(2), which currently uses a single-day, year-end price to establish reserves amounts.

¹⁶⁰ See Rule 4-10(c)(8) [17 CFR 210.4-10(c)(8)].

the single-day, year-end price. Conversely, it is also possible that in periods of declining oil and gas prices, the application of this rule could result in the deferral of ceiling test write-downs. In that situation, it is possible that using a 12-month average price in the ceiling limitation test calculation might not result in a write-down in situations where a write down would have otherwise been required had the full cost company been required to use a single-day, year-end price in its ceiling limitation test calculation.

Because the application of the ceiling limitation test is not a fair-value-based calculation but rather a limit on the amount of certain oil and gas related exploration costs that can be capitalized, portions of which would have resulted in write-downs in prior periods under other methods of accounting, we believe the benefits of using a single pricing mechanism justify the potential changes to the timing of those ceiling test write-downs or amortizations amounts. However, as discussed in Section V of this release, we believe that the company should discuss such situations, if material, particularly when pricing trends indicate the possibility of future write-downs, in Management's Discussion and Analysis and, where appropriate, the notes to the financial statements.

IV. Update and Codification of the Oil and Gas Disclosure Requirements in Regulation S-K

The Proposing Release proposed to update and codify Securities Act and Exchange Act Industry Guide 2: Disclosure of Oil and Gas Operations (Industry Guide 2).¹⁶¹ Industry Guide 2 currently sets forth most of the disclosures that an oil and gas company provides regarding its reserves, production, property, and operations.

Regulation S-K references Industry Guide 2 in Instruction 8 to Item 102 (Description of

¹⁶¹ Exchange Act Industry Guide 2 merely references, and therefore is identical to, Securities Act Industry Guide 2.

Property), Item 801 (Securities Act Industry Guides), and Item 802 (Exchange Act Industry Guides). However, Industry Guide 2 itself does not appear in Regulation S-K or in the Code of Federal Regulations. The rules that we adopt today codify the contents of Industry Guide 2 in a new Subpart 1200 of Regulation S-K.

A. Revisions to Items 102, 801, and 802 of Regulation S-K

The instructions to Item 102 of Regulation S-K, as well as Items 801 and 802 of Regulation S-K, currently reference the industry guides. Because we are codifying the Industry Guide 2 disclosures in a new Subpart 1200 of Regulation S-K, we are revising the instructions to Item 102 to reflect this change.¹⁶² We also are eliminating the references in Items 801 and 802 to Industry Guide 2 because that industry guide will cease to exist upon effectiveness of the amendments we adopt today.¹⁶³

In addition, Instruction 5 to Item 102 of Regulation S-K currently prohibits the disclosure of reserves other than proved oil and gas reserves. Because we are adopting rules to permit disclosure of probable and possible oil and gas reserves, we are revising Instruction 5 to limit its applicability to extractive enterprises other than oil and gas producing activities, such as mining activities.¹⁶⁴ Similarly, Instruction 3 of Item 102, regarding production, reserves, locations, development and the nature of the company's interests, will no longer apply to oil and gas producing activities, so we also are limiting that instruction to mining activities.¹⁶⁵

¹⁶² See revised Instructions 4 and 8 to Item 102 [17 CFR 229.102].

¹⁶³ See revised Item 801 and 802 [17 CFR 229.801 and 802].

¹⁶⁴ See revised Instruction 5 to Item 102 [17 CFR 229.102]. Extractive enterprises include enterprises such as mining companies that extract resources from the ground.

¹⁶⁵ See revised Instruction 3 to Item 102 [17 CFR 229.102].

Finally, we are eliminating Instruction 4 to Item 102 regarding the ability of the Commission's staff to request supplemental information, including reserves reports. This instruction is duplicative of Securities Act Rule 418¹⁶⁶ and Exchange Act 12b-4,¹⁶⁷ regarding the staff's general ability to request supplemental information.

B. Proposed New Subpart 1200 to Regulation S-K Codifying Industry Guide 2 Regarding Disclosures by Companies Engaged in Oil and Gas Producing Activities

1. Overview

We are adding a new Subpart 1200 to Regulation S-K that codifies the disclosure requirements related to companies engaged in oil and gas producing activities. This new subpart largely includes the existing requirements of Industry Guide 2. However, we have revised these requirements to update them, provide better clarity with respect to the level of detail required in oil and gas disclosures, including the geographic areas by which disclosures need to be made, and provide formats for tabular presentation of these disclosures. In addition, Subpart 1200 contains the following new disclosure requirements, many of which have been requested by industry participants:

- Disclosure of reserves from non-traditional sources (e.g., bitumen, shale, coal) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves;

¹⁶⁶ 17 CFR 230.418.

¹⁶⁷ 17 CFR 240.12b-4.

- Disclosure of technologies used to establish additions to reserves estimates;
- Disclosure of a company's internal controls over reserves estimation and the qualifications of the business entity or individual preparing or auditing the reserves estimates; and
- Disclosure based on a new definition of the term "by geographic area."

We discuss each of these proposed new Items below.

2. Item 1201 (General instructions to oil and gas industry-specific disclosures)

We are adding new Item 1201 to Regulation S-K. This item sets forth the general instructions to Subpart 1200. The new item contains three paragraphs that perform the following tasks:

- Instruct companies for which oil and gas producing activities are material to provide the disclosures specified in Subpart 1200;¹⁶⁸
- Clarify that, although a company must present specified Subpart 1200 information in tabular form, the company may modify the format of the table for ease of presentation, to add additional information or to combine two or more required tables;
- State that the definitions in Rule 4-10(a) of Regulation S-X apply to Subpart 1200; and
- Define the term "by geographic area."

¹⁶⁸ This paragraph would maintain the existing exclusion in Industry Guide 2 for limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water.

a. Geographic area

We received significant comments regarding the proposed definition of the term “by geographic area.” We proposed to require disclosure by continent, country containing 15% of more of the company’s reserves, and sedimentary basin or field containing 10% or more of the company’s reserves. Several commenters were concerned that the proposed definition would add too much detail to the disclosures, particularly at the basin or field level.¹⁶⁹ They were concerned that this amount of detail would make disclosures too complex and incoherent.¹⁷⁰ They were particularly concerned with the extension of this standard to disclosures other than reserves, such as production, wells, and acreage.¹⁷¹ Commenters also believed that the disclosures, in particular by field, could cause competitive harm in future property sales transactions, unitization agreements, and other asset transfers.¹⁷²

Some commenters also believed that some of these disclosures may be prohibited by foreign governments.¹⁷³ One commenter noted that separate determination of field or basin reserves within a larger production sharing agreement may not be possible due to concession-wide cost sharing terms.¹⁷⁴ Eight commenters recommended that the determination of appropriate geographic disclosure should remain with management,

¹⁶⁹ See letters from Apache, CAPP, Devon, ExxonMobil, Imperial, Nexen, Repsol, Shell, and StatoilHydro.

¹⁷⁰ See letters from Apache, CAPP, ExxonMobil, Imperial, Nexen, and Repsol.

¹⁷¹ See letters from ExxonMobil, Imperial, and Total.

¹⁷² See letters from Apache, API, BHP, Canadian Natural, CAPP, Devon, EnCana, Eni, Newfield, Nexen, Petro-Canada, Shell, StatoilHydro, and Total.

¹⁷³ See letters from Apache, API, CAPP, Eni, Newfield, Petro-Canada, and Total.

¹⁷⁴ See letter from Apache.

consistent with Statement of Financial Accounting Standard No. 69 (SFAS 69).¹⁷⁵

However, two commenters indicated that a country-by-country breakdown would be adequate.¹⁷⁶

Four commenters supported the proposed percentage thresholds for geographic disclosure, stating that they would increase understanding of the total energy supply, leading to better decisions by policy makers.¹⁷⁷ One commenter supported the 15% threshold for countries.¹⁷⁸

As we noted in the Proposing Release, there have been differing interpretations among oil and gas companies as to the level of specificity required when a company is breaking out its reserves disclosures based on geographic area as required by Instruction 3 of Item 102 of Regulation S-K.¹⁷⁹ Some companies currently broadly organize their reserves only by hemisphere or continent. SFAS 69 requires reserves disclosure to be separately disclosed for the company's home country and foreign geographic areas. It defines "foreign geographic areas" as "individual countries or groups of countries as appropriate for meaningful disclosure in the circumstances." Since SFAS 69 was issued, the operations of oil and gas companies have become much more diversified globally. For many large U.S. oil and gas producers, the majority of reserves are now overseas, with material amounts in individual countries and even individual fields or basins.

¹⁷⁵ See letters from Apache, API, Canadian Natural, CAPP, Eni, ExxonMobil, Imperial, and Petro-Canada.

¹⁷⁶ See letters from ExxonMobil and Nexen.

¹⁷⁷ See letters from AAPG, CFA, Chesapeake, and E&Y.

¹⁷⁸ See letter from Shell.

¹⁷⁹ 17 CFR 229.102.

We think that greater specificity than simply disclosing reserves within “groups of countries” would benefit investors and, in certain cases, may be necessary to meet the requirements of Item 102 of Regulation S-K. Some countries in which many of these companies operate and may have significant reserves are subject to unique risks, such as political instability. However, we recognize that disclosure that is too detailed may detract from the overall disclosure. Thus, we have revised the definition of the term “by geographic area” to mean, as appropriate for meaningful disclosure under a company’s particular circumstances:

- (1) By individual country;
- (2) By groups of countries within a continent; or
- (3) By continent.¹⁸⁰

This definition is substantially the same as the definition currently provided in SFAS 69. However, as proposed, we are adopting specific percentage thresholds to the geographic breakdowns of reserves estimates and production. With respect to production, the final rules require disclosure of production in each country or field containing 15% or more of the company’s proved reserves unless prohibited by the country in which the reserves are located. We are raising the proposed 10% threshold for field disclosure of production to 15% to make the threshold consistent. However, rather than requiring disclosure based on a percentage of the amount of the company’s reserves of an individual product, as proposed, the final rules require disclosure based on a

¹⁸⁰

See Item 1201(d) [17 CFR 229.1201(d)].

percentage of a company's total global oil and gas proved reserves, based on barrels of oil equivalent.¹⁸¹

With respect to reserves estimates, the final rules require disclosure of reserves in countries containing more than 15% of the company's proved reserves. As with the production disclosure, this 15% threshold would be based on the company's total global oil and gas proved reserves, rather than on individual products, as proposed.¹⁸² A registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure of reserves in that country.

We are not adopting the requirement that we proposed to disclose reserves by sedimentary basin or field. We share commenters' concerns that there is potential for competitive harm from such disclosure in future property sales transactions, unitization agreements, and other asset transfers. Moreover, we recognize that there may be situations in which a particular field may encompass a significant portion of a company's reserves in a foreign country. To avoid compelling a company to provide, in effect, field disclosure, the rule does not require disclosure of reserves in a country containing 15% of the company's reserves if that country prohibits disclosure of reserves in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.¹⁸³ For example, if a company has 25% of its reserves in Country A and Country A's government prohibits disclosure of reserves by field within Country A, if

¹⁸¹ See Item 1204(a) [17 CFR 229.1204(a)].

¹⁸² See Item 1202(a)(2) [17 CFR 229.1202(a)(2)].

¹⁸³ See Instruction 4 to Item 1202(a)(2).

almost all of that company's reserves in Country A are located in a single field, the company would not be required to specify the amount of its reserves located in Country A.

b. Tabular disclosure

We proposed to require much of the reserves disclosures and other disclosures in Industry Guide 2 to be presented in tabular format. Two commenters encouraged using a standardized table for reserves disclosure.¹⁸⁴ Another believed that companies should be able to reorganize, supplement, or combine tables for better presentation of the company's strategy.¹⁸⁵ However, two commenters believed that the rules should not propose a specified tabular format in general.¹⁸⁶ These commenters believed that companies should have the flexibility to present data in a format that is most relevant and meaningful to investors, whether it is tabular or narrative.¹⁸⁷ We continue to believe that in certain circumstances, the required disclosures lend themselves to a tabular disclosure format. We believe that standardizing such tables will improve the readability and comparability of disclosures among companies. However, in response to comments received, we have made several revisions to the individual disclosure items, including whether the disclosure item must be presented in tabular format. We discuss each below.

3. Item 1202 (Disclosure of reserves)

Existing Instruction 3 to Item 102 of Regulation S-K requires disclosure of an extractive enterprise's proved reserves. With respect to oil and gas producing companies,

¹⁸⁴ See letters from Devon and Petrobras.

¹⁸⁵ See letter from Petro-Canada.

¹⁸⁶ See letters from Apache and ExxonMobil.

¹⁸⁷ See letters from Apache and ExxonMobil.

we are replacing this Instruction by adding a new Item 1202 to Regulation S-K that contains a similar disclosure requirement regarding a company's proved reserves.¹⁸⁸ However, new Item 1202 expands on the requirements of Item 102 by specifically permitting the disclosure of probable and possible reserves and permitting the disclosure of reserves from non-traditional sources. In addition, because we are no longer distinguishing between types of accumulations, the item contains only one table with separate columns for different final products, specifically, oil, gas, synthetic oil, synthetic gas, and other natural resources sold by the company.

a. Oil and gas reserves tables

New Item 1202 requires disclosure, in the aggregate and by geographic area, of reserves estimates using prices and costs under existing economic conditions, for each product type, in the following categories:

- Proved developed reserves;
- Proved undeveloped reserves;
- Total proved reserves;
- Probable developed reserves (optional);
- Probable undeveloped reserves (optional);
- Possible developed reserves (optional); and
- Possible undeveloped reserves (optional).

A form of this table is set forth below:

¹⁸⁸ See Item 1202 [17 CFR 229.1202].

**Summary of Oil and Gas Reserves as of Fiscal-Year End
Based on Average Fiscal-Year Prices**

	Reserves				
	Oil	Natural Gas	Synthetic Oil	Synthetic Gas	Product A
Reserves category	(mbbls)	(mmcf)	(mbbls)	(mmcf)	(measure)
PROVED					
Developed					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
Undeveloped					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
TOTAL PROVED					
PROBABLE					
Developed					
Undeveloped					
POSSIBLE					
Developed					
Undeveloped					

i. Disclosure by final product sold

The table requires disclosure by final product sold by the company, specifically, oil, gas, synthetic oil, synthetic gas, or other natural resource. Thus, if the company processes a natural resource that it has extracted, such as bitumen, into synthetic oil or gas prior to selling the product, it may include such reserves under the synthetic oil or gas columns. As noted below, we have revised the proposal that would have required disclosure by type of accumulation. In addition, in response to commenters, we have revised the definition of “oil and gas producing activities” so that a company can use the price of that synthetic oil or gas to determine the economic producibility of the reserves

because the economics of the processing activity are relevant to the determination of whether to extract the underlying resource.¹⁸⁹

However, if a company extracts a resource other than oil or gas, such as bitumen, and sells the product without processing it into synthetic oil or gas, it must disclose reserves of that other natural resource. Although that company's extractive activities would be considered an oil and gas producing activity under the definition of that term, such a company would not benefit from the economics of processing of that resource because the price that determines whether such a company extracts the resource is the price of the unprocessed resource and therefore the company may not establish reserves estimates based on the price of the upgraded product. Similarly, if the company does not itself extract the natural resource, but purchases the natural resource for processing or is paid to process the natural resource, it may not claim reserves either of the resource or of the processed product.

ii. Aggregation

As proposed, the reserves to be reported in these tables would be aggregations (to the company total level) of reserves determined for individual wells, reservoirs, properties, fields, or projects. Regardless of whether the reserves were determined using deterministic or probabilistic methods, the reported reserves should be simple arithmetic sums of all estimates at the well, reservoir, property, field, or project level within each reserves category. Eight commenters agreed that aggregation should not be permitted beyond the field, property or project level, consistent with PRMS.¹⁹⁰

¹⁸⁹ See Section II.C.2 of this release.

¹⁹⁰ See letters from Devon, Evolution, ExxonMobil, Ryder Scott, Shell, SPE, Talisman, and Wagner.

iii. Optional disclosure of probable and possible reserves

A company may, but is not required to, disclose probable or possible reserves in these tables. If a company discloses probable or possible reserves, it must provide the same level of geographic detail as it must with respect to proved reserves and must state whether the reserves are developed or undeveloped. In addition, Item 1202 requires the company to disclose the relative uncertainty associated with these classifications of reserves estimations. By permitting disclosure of all three of these classifications of reserves, our objective is to enable companies to provide investors with more insight into the potential reserves base that managements of companies may use as their basis for decisions to invest in resource development.

Most commenters addressing this issue supported permitting the disclosure of probable and possible reserves in filed documents.¹⁹¹ They believed that such disclosure would provide a more complete picture of a company's full portfolio of opportunities.¹⁹² One commenter noted that this information often is already available on company websites and in press releases.¹⁹³ However, several commenters supporting the proposal cautioned that there could be significant variability among disclosures.¹⁹⁴

Other commenters expressed concern about disclosure of unproved reserves, but conceded that voluntary disclosure would be acceptable.¹⁹⁵ These commenters were

¹⁹¹ See letters from CFA, Chesapeake, Deloitte, EnCana, Evolution, McMoRan, Newfield, Petrobras, Petro-Canada, Questar, Ryder Scott, Sasol, Ryder Scott, Shell, SPE, Three Senators, Wagner, and Zakaib.

¹⁹² See letters from CFA, Evolution, Petro-Canada, Ryder Scott, and Wagner.

¹⁹³ See letter from Evolution.

¹⁹⁴ See letter from EnCana.

¹⁹⁵ See letters from API, ExxonMobil, Imperial, Repsol, and Total.

concerned that such disclosure may confuse investors and expose companies to increased litigation because of the inherent uncertainty associated with probable and possible reserves.¹⁹⁶ They noted that various technologies may be used to support these estimates.¹⁹⁷

Several commenters opposed permitting disclosure of probable and possible reserves in Commission filings for similar reasons.¹⁹⁸ Again, they were concerned that the inherent uncertainty associated with such reserves estimates may lead to investor confusion and misunderstanding.¹⁹⁹ They believed that the broad range of technologies and methods used by companies to support these estimates would lead to inconsistent disclosure among companies.²⁰⁰

We note that numerous oil and gas companies already disclose unproved reserves on their Web sites and in press releases. This practice does not appear to have created confusion in the market. However, we understand commenters' concerns that probable and possible reserves estimates are less certain than proved reserves estimates and so may increase litigation risk. By making these disclosures voluntary, a company could exercise its own discretion as to whether to provide the market with this disclosure.

Some commenters were concerned that voluntary disclosure by some companies may raise confusion as to why other companies do not disclose these classifications of

¹⁹⁶ See letters from API, ExxonMobil, Imperial, and Repsol.

¹⁹⁷ See letters from API, ExxonMobil, and Imperial.

¹⁹⁸ See letters from Apache, Devon, Energen, Eni, and Southwestern.

¹⁹⁹ See letters from Apache, Devon, Eni, and Southwestern.

²⁰⁰ See letters from Devon, Eni, and Southwestern.

reserves.²⁰¹ One commenter was concerned that voluntary disclosure may increase market pressure on all companies to disclose probable and possible reserves estimates.²⁰²

Considering the fact that many companies already make these disclosures public, we do not believe that this is an adequate reason for prohibiting from filings disclosure that may be helpful to investors.

iv. Resources not considered reserves

Because we are permitting disclosure of probable and possible reserves, we are revising existing Instruction 5 to Item 102 of Regulation S-K to continue to prohibit disclosure of estimates of oil or gas resources other than reserves, and any estimated values of such resources, in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law.²⁰³

Five commenters recommended that the rules permit disclosure of all categories of resources, including those that do not qualify as reserves.²⁰⁴ One commenter believed that the prohibition against disclosing all resources deprives public markets of significant information without meaningfully enhancing investor protection and ultimately may harm the efficiency and development of U.S. markets and U.S. companies raising capital.²⁰⁵ That commenter also thought such a restriction could also encourage companies to form outside of the U.S.²⁰⁶ Another commenter believed that the

²⁰¹ See letters from Apache and Total.

²⁰² See letter from Eni.

²⁰³ See Instruction 5 to Item 102 [17 CFR 229.102].

²⁰⁴ See letters from Davis Polk, Petro-Canada, Shearman & Sterling, SPE, and Zakaib.

²⁰⁵ See letter from Shearman & Sterling.

²⁰⁶ Id.

uncertainty of resource estimates is best communicated by reporting the full range of estimates.²⁰⁷ In addition, another commenter believed that clear disclosure would allay concerns about investor misunderstanding of estimates of resources that do not qualify as reserves.²⁰⁸ That commenter noted that excluding resources that are not reserves is inconsistent with international standards and the fact that these resources are disclosed in the U.S. on websites and in press releases.²⁰⁹ We continue to be concerned that such resources are too speculative and may lead investors to incorrect conclusions. Therefore, we are adopting the proposal to prohibit disclosure of resources other than reserves.

However, consistent with existing Instruction 5, a company may continue to disclose such estimates of non-reserves resources in a Commission filing related to an acquisition, merger, or consolidation if the company previously provided those estimates to a person that is offering to acquire, merge, or consolidate with the company or otherwise to acquire the company's securities.²¹⁰ Several commenters recommended that the Commission maintain this exception so that the company's shareholders would not be at an informational disadvantage compared to the counterparty when assessing a merger.²¹¹ We agree with these commenters and have retained the exception in the revised Instruction 5 adopted today.

²⁰⁷ See letter from SPE.

²⁰⁸ See letter from Davis Polk.

²⁰⁹ See letter from Davis Polk.

²¹⁰ Id.

²¹¹ See letters from Devon, ExxonMobil, Shell, and Total.

b. Optional reserves sensitivity analysis table

The rules that we are adopting require a company to determine whether its oil or gas resources are economically producible based on a 12-month average price. We also proposed, and are adopting, an optional reserves sensitivity table. This table would permit companies to disclose additional information to investors, such as the sensitivity that oil and gas reserves have to price fluctuations. If a company chooses to provide such disclosure, it may choose the different scenario or scenarios, if any, that it wishes to disclose in the table, provided that it also discloses the price and cost schedules and assumptions on which the alternate reserves estimates are based.

Twelve commenters supported permitting such sensitivity analyses.²¹² Some believed that this would provide investors with a better view of management's analysis of future prices.²¹³ One recommended providing a set price change of 10% for the sensitivity analysis.²¹⁴ Two other commenters believed that different circumstances may require different types of sensitivity analyses, both with respect to the range of prices used and the format of the presentation.²¹⁵ We agree that the appropriate range for a sensitivity analysis may vary depending on the situation, and therefore, as proposed, we are not specifying a range of prices to be used.

²¹² See letters from Canadian Natural, CAPP, CFA, Chesapeake, Deloitte, Devon, Evolution, ExxonMobil, McMoRan, Nexen, Petro-Canada, and Total.

²¹³ See letters from Chesapeake, Deloitte, and McMoRan.

²¹⁴ See letter from CFA.

²¹⁵ See letters from Evolution and Total.

However, five commenters specifically opposed requiring such an analysis.²¹⁶ They believed that such a requirement would cause confusion and harm comparability.²¹⁷ Three commenters opposed such a sensitivity analysis because using different prices could mislead investors.²¹⁸ We are adopting this table, as proposed, as a voluntary disclosure rather than a requirement. However, as proposed, the table would require disclosure of the assumptions behind varying estimates. We believe this disclosure will mitigate any investor confusion.

In addition, we remind companies that Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations)²¹⁹ requires discussion of known trends and uncertainties, which may include changes to prices and costs. A form of this optional reserves sensitivity analysis table is set forth below.

**Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario**

Price Case	Proved Reserves			Probable Reserves			Possible Reserves		
	Oil	Gas	Product A	Oil	Gas	Product A	Oil	Gas	Product A
	Mbbls	mmcf	measure	mbbls	mmcf	measure	mbbls	mmcf	measure
Scenario 1									
Scenario 2									

c. Separate disclosure of conventional and continuous accumulations

Under the proposal, new Item 1202 would have required companies to disclose reserves from conventional accumulations separately from reserves in continuous

²¹⁶ See letters from Canadian Natural, CAPP, Devon, EnCana, and ExxonMobil.

²¹⁷ See letters from EnCana and Ryder Scott.

²¹⁸ See letters from Apache, Petrobras, and Wagner.

²¹⁹ See Item 303 of Regulation S-K [17 CFR 229.303].

accumulations. Nine commenters recommended disclosure based on the final product.²²⁰ These commenters opposed segregating disclosure based on the type of accumulation that is involved.²²¹ They believed that such disclosure would be too complex and detailed and of little use to investors.²²² In addition, seven commenters pointed out that separation may be impossible because some fields contain both conventional and continuous accumulations.²²³ This would make allocation of costs arbitrary.²²⁴ However, four commenters supported the definitions and separate disclosure by type of accumulation.²²⁵ One commenter believed that such disclosure would allow investors to assess the impact of unconventional sources on reserves.²²⁶

Although we agree conceptually that the focus of reserves disclosure should be on the final product, we also recognize that the production of oil and gas from varying sources can have significantly different economics. Extraction of oil and gas from continuous accumulations can be much more labor and resource intensive than extraction of oil and gas from traditional wells. They often require greater ongoing efforts and expense after the initial extraction equipment is in place, making such operations more sensitive to price fluctuations.

²²⁰ See letters from Apache, API, Canadian Natural, CAPP, EnCana, ExxonMobil, Imperial, Petro-Canada, and Total.

²²¹ See letters from Apache, API, CAPP, Chesapeake, Devon, ExxonMobil, Imperial, Repsol, and Shell.

²²² See letters from Apache, API, BP, CAPP, Chesapeake, Chevron, Devon, E&Y, EnCana, ExxonMobil, Imperial, Petro-Canada, Repsol, and Southwestern.

²²³ See letters from BP, Canadian Natural, CAPP, EnCana, Petro-Canada, Ryder Scott, and Talisman.

²²⁴ See letters from EnCana and Ryder Scott.

²²⁵ See letters from Davis Polk, EIA, Petrobras, and Wagner.

²²⁶ See letter from Wagner.

We agree with the commenters that disclosure based on the end product sold would provide a more effective basis for distinguishing reserves that disclosure based on the type of accumulation in which the reserves are held. Therefore, we have revised the disclosure to be based on the end product that is sold by the company.²²⁷ However, with respect to the end product, new Item 1202 makes a distinction between oil and gas, on the one hand, and synthetic oil and gas, on the other. Synthetic products require processing of the raw resource material, either while it is still in the ground ("in situ") or after it is extracted, before it can be used as refinery feedstock or as natural gas. Such processes currently include bitumen upgrading as well as coal liquefaction and gasification. However, resources from some continuous accumulations, such as coalbed methane, do not require such processing and therefore are not associated with the same level of ongoing costs once a well has been drilled because the in-ground resource is already oil or gas (in the case of coalbed methane, the in-ground resource is methane, trapped in a coalbed). Thus, coalbed methane would not be considered a synthetic product.

d. Preparation of reserves estimates or reserves audits

In the Proposing Release, we proposed to require a company to disclose whether or not the technical person²²⁸ primarily responsible for preparing the reserves estimate possessed certain specified qualifications and was subject to a list of controls for maintaining objectivity. Most commenters addressing the issue opposed this proposed

²²⁷ See Item 1202 [17 CFR 229.1202].

²²⁸ With regard to the objectivity of a technical person, the "person" could be an individual or an entity, as appropriate. However, with regard to the qualifications of a person, the disclosure would relate to the individual who is primarily responsible for the technical aspects of the reserves estimation or audit. Thus, this individual is not necessarily the individual generally overseeing the estimation or audit, but the individual who is primarily responsible for the actual calculations and estimation or audit.

requirement.²²⁹ However, many of these commenters appeared to believe that the disclosure requirement would pertain to every person involved with the estimation process.²³⁰ If adopted, they noted that such disclosure would be voluminous, adding unnecessary complexity to disclosures.²³¹ Four commenters suggested that we clarify that the disclosure is limited to the chief technical person who oversees the company's overall reserves estimation process,²³² which was the intent of the proposal. Five commenters supported this disclosure because it helps users understand the objectivity and quality of reserves estimates.²³³

It was our intent to limit the disclosure to the technical person primarily responsible for overseeing the reserves estimates. However, there may have been confusion with respect to this point based on a footnote which stated that we sought disclosure about the person who "is primarily responsible for the actual calculations and estimation or audit." By that term, we did not intend to include any person making "actual calculations." We recognize that, ultimately, the reserves estimates are overseen by top management, which may or may not have reserves estimation expertise. The focus of the final rule is the primary technical person responsible for overseeing the preparation of the reserves estimation process. We have revised the language in the rule to clarify this point.²³⁴

²²⁹ See letters from Apache, API, Chevron, Energen, Eni, ExxonMobil, Newfield, Nexen, PEMEX, Petro-Canada, Ryder Scott, Shell, and Total.

²³⁰ See letters from Apache, API, ExxonMobil, Newfield, Nexen, PEMEX, Ryder Scott, and Total.

²³¹ See letters from Apache, API, ExxonMobil, Newfield, Nexen, PEMEX, Repsol, and Total.

²³² See letters from API, ExxonMobil, PEMEX, and Petro-Canada.

²³³ See letters from CFA, Devon, EnCana, Southwestern, and Wagner.

²³⁴ See Item 1202(a)(7) [17 CFR 229.1202(a)(7)].

Two commenters noted that it was inconsistent to require such precise disclosure about reserves experts, but not other experts.²³⁵ One of those commenters recommended that the rule require expert language, including clear disclosure of which portion of the reserves estimate the third party is expertising and filed consents.²³⁶ The concept of an expert under the Securities Act is different from the disclosures that we seek regarding the qualifications and objectivity of persons responsible for the preparation or audit of oil and gas reserves. Under the Securities Act, disclosure must be made when the company represents that disclosure is based on the authority of an expert. Although the Securities Act concept of experts will continue to be relevant when the reserves disclosures are in, or incorporated into, a Securities Act filing and the company represents that disclosure is based on the authority of an expert, the new rules requiring disclosure about the reserves preparer or auditor in a company's Exchange Act reports are intended to help investors determine whether reserves estimates, which are highly technical, have been prepared by a qualified, objective person, regardless of whether that person is an employee of the company.

However, we agree with commenters that a prescribed list of qualifications and objectivity requirements may be too rigid for all situations. With respect to technical qualifications, several commenters noted that licensing requirements can vary greatly among jurisdictions.²³⁷ Commenters also believed that disclosure of a person's objectivity was unnecessary because management is required to install appropriate

²³⁵ See letters from API and Deloitte.

²³⁶ See letter from Deloitte.

²³⁷ See letters from AAPG, API, Chevron, Eni, Petro-Canada, Questar, and SPE.

internal controls to ensure the reliability of reserves estimates.²³⁸ In fact, some commenters recommended that we limit the disclosure to a description of a company's internal controls, including the company's technical assessment routine, management and board review and approval processes, the internal audit process, the extent to which the company uses external parties to estimate or audit reserves estimates, and a summary description of the qualifications of the company's typical reserves estimators.²³⁹ We are following these commenters' recommendations and adopting a rule that requires a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process and disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit if the company discloses that such a reserves audit has been performed, regardless of whether the technical person is an employee or an outside third party.²⁴⁰

We did not propose, but sought comment on, whether the rules should require a company to retain an independent third party to prepare, or conduct a reserves audit of, the company's reserves estimates. Most commenters urged the Commission not to adopt such a requirement.²⁴¹ They believed that a company's internal staff, particularly at larger companies, is generally in a better position to prepare those estimates²⁴² and that there is a potential lack of qualified third party engineers and other professionals

²³⁸ See letters from API, Chevron, Energen, ExxonMobil, Newfield, Nexen, Petrobras, Ryder Scott, Shell, StatoilHydro, and Total.

²³⁹ See letters from ExxonMobil, Nexen, Shell, and StatoilHydro.

²⁴⁰ See Item 1202(a)(7) [17 CFR 229.1202(a)(7)].

²⁴¹ See letters from API, BHP, BP, CFA, CNOOC, Denbury, Devon, Eni, Energy Literacy, ExxonMobil, Imperial, R. Jones, D. McBride, Newfield, Nexen, Petro-Canada, Ross, D. Ryder, Sasol, Shell, Talisman, Total, and W. van de Vijver.

²⁴² See letters from API, Denbury, ExxonMobil, Imperial, Nexen, Shell, and Talisman.

available to conduct the increased work that would result from such a requirement.²⁴³

We agree with these commenters and are not adopting a requirement that an independent third party prepare, or conduct a reserves audit of, the company's reserves estimates.

e. Reserve audits and the contents of third-party reports

In the Proposing Release, we proposed that, if a company represents that its estimates of reserves are prepared or audited by a third party, the company must file a report of the third party as an exhibit to the relevant registration statement or report. Two commenters believed that a company description of the third party's report would be sufficient because the reports can contain sensitive information.²⁴⁴ However, another commenter was concerned that not filing the report may lead to mischaracterizations by the company.²⁴⁵ This commenter supported the filing of a report by the third party reserves estimator or auditor, but believed that the Commission should determine the contents of such a report.²⁴⁶ Two commenters supported the filing of the report "letter" as an exhibit, but not the full reserves report because it may contain proprietary information.²⁴⁷

As proposed, we are adopting a new rule to require that if the company represents that a third party prepared the reserves estimate or conducted a reserves audit of the reserves estimates, the company must file a report of the third party as an exhibit to the

²⁴³ See letters from AAPG, API, BP, Devon, ExxonMobil, Imperial, D. McBride, Newfield, D. Ryder, and Sasol.

²⁴⁴ See letters from Evolution and Petro-Canada.

²⁴⁵ See letter from Wagner.

²⁴⁶ See letter from Wagner.

²⁴⁷ See letters from Devon and Ryder Scott.

relevant registration statement or report.²⁴⁸ These reports need not be the full “reserves report,” which is often very detailed and voluminous. Rather, these reports could be shorter form reports that summarize the scope of work performed by, and conclusions of, the third party. These reports must include the following disclosure, based on the Society of Petroleum Evaluation Engineers’s audit report guidelines:

- The purpose for which the report is being prepared and for whom it is prepared;
- The effective date of the report and the date on which the report was completed;
- The proportion of the company’s total reserves covered by the report and the geographic area in which the covered reserves are located;
- The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of company’s total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- A discussion of primary economic assumptions;
- A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- A discussion regarding the inherent risks and uncertainties of reserves estimates;

²⁴⁸ See Item 1202(a)(8) [17 CFR 229.1202(a)(8)].

- A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report; and
- The signature of the third party.

In addition, if the report is related to a reserves audit, it must contain a brief summary of the third party's conclusions with respect to the reserves estimates. Finally, if the disclosures are made in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to the filing.

In the Proposing Release, we proposed to define the term "reserves audit" as "the process of reviewing certain of the pertinent facts interpreted and assumptions made that have resulted in an estimate of reserves prepared by others and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities. In order to disclose that a 'reserves audit' has been conducted, the report resulting from this review must represent an examination of at least 80% of the portion of the registrant's reserves covered by the reserves audit." We are substantively adopting the first sentence of this definition as proposed.

However, in response to comments received, we are not adopting the proposed second sentence of the definition of the term "reserves audit." Two commenters supported the proposed 80% threshold regarding the proportion of reserves that a reserves auditor must review in order for the company to characterize that auditor's work as a

“reserves audit.”²⁴⁹ Another commenter believed that the 80% threshold was appropriate for preparing reserves estimates.²⁵⁰ But three commenters believed that an audit should simply disclose the percentage that was audited.²⁵¹ One of these noted that it has its reserves audit performed on a rolling basis.²⁵² We believe that disclosure of the work done in the required third-party report makes a bright-line percentage test unnecessary. If a company conducts its reserves audit on a rolling basis, it is appropriate for its shareholders to be aware of that fact. Therefore, we are not adopting the proposed 80% threshold. We believe that disclosure of the scope of the review will enable investors to assess the significance to attribute to a reserves audit.

f. Process reviews

In the Proposing Release, we solicited comment regarding whether we should permit a company to disclose that it has hired a third party to perform a process review under the Society of Petroleum Engineers’ (SPE’s) reserves auditing standards.²⁵³ Those standards define a process review as an investigation by a person who is qualified by experience and training equivalent to that of a reserves auditor to address the adequacy and effectiveness of an entity’s internal processes and controls relative to reserves estimation. However, those standards also note that a process review should not include an opinion relative to the reasonableness of the reserves quantities and should be limited to the processes and control system reviewed. The SPE’s standards state that, although

²⁴⁹ See letters from Evolution and Wagner.

²⁵⁰ See letter from Ryder Scott.

²⁵¹ See letters from Devon, Ryder Scott, and Talisman.

²⁵² See letter from Talisman.

²⁵³ See SPE Reserves Auditing Standards.

such reviews may provide value to the entity, an external or internal process review is not of sufficient rigor to establish appropriate classifications and quantities of reserves and should not be represented to the public as being equivalent to a reserves audit.

Five commenters believed that internal process reviews are helpful in promoting accuracy and effectiveness, so companies should be permitted to disclose them.²⁵⁴

However, one commenter was concerned that, although a process review can be helpful for a company, disclosure may give investors a false sense of security.²⁵⁵ Two commenters suggested that, if a company discloses that it performed a process review, it should clearly disclose what a process review is.²⁵⁶

We agree that a process review can be helpful to the company and ultimately to investors. However, we also agree that if a company discloses that it has hired a third party to perform a process review, it must clearly disclose the details surrounding that process review. As such, the new rules treat a process review similar to a reserves audit. If the company discloses that it has hired a third party to conduct a process review, it must file a report of the third party as an exhibit to the relevant registration statement or report and, if the disclosures are made in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to the filing.²⁵⁷

²⁵⁴ See letters from Devon, ExxonMobil, Petro-Canada, Ryder Scott, and Shell.

²⁵⁵ See letter from Wagner.

²⁵⁶ See letters from Devon and Petro-Canada.

²⁵⁷ See Item 1202(a)(8) [17 CFR 229.1202(a)(8)].

4. Item 1203 (Proved undeveloped reserves)

We proposed requiring tabular disclosure of the aging of proved undeveloped reserves (PUDs). Proposed Item 1203 would have required an oil and gas company to prepare a table showing, for each of the last five fiscal years and by product type, proved reserves estimated using current prices and costs in the following categories:

- Proved undeveloped reserves converted to proved developed reserves during the year; and
- Net investment required to convert proved undeveloped reserves to proved developed reserves during the year.²⁵⁸

Numerous commenters were concerned that the proposed five-year table would be too complex for investors to understand.²⁵⁹ They expressed concern that the proposed table may mislead investors by not clearly attributing costs to the year in which the corresponding PUDs are converted because much of the costs may have been spent in previous years.²⁶⁰ In addition, commenters noted that maintenance of such data would be costly²⁶¹ and that companies currently do not always capture this type of information because management does not use it to run the business.²⁶²

Eight commenters suggested an alternative of disclosing (1) the quantity of undeveloped reserves if material, (2) the progress in converting PUDs, and (3) any

²⁵⁸ See Item 1204 [17 CFR 229.1204].

²⁵⁹ See letters from API, BP, Canadian Natural, CAPP, Chevron, Eni, Equitable, ExxonMobil, Nexen, Petrobras, Repsol, Shell, and Wagner.

²⁶⁰ See letters from API, ExxonMobil, Petrobras, Ryder Scott, Total, and Wagner.

²⁶¹ See letters from API, Canadian Natural, CAPP, Chevron, Eni, Equitable, ExxonMobil, Nexen, Petrobras, Southwestern, and Wagner.

²⁶² See letter from Apache.

material changes in the current year.²⁶³ Three U.S. Senators recommended requiring disclosure of development plans in addition to the table.²⁶⁴ They believed that requiring reporting of investments and planned investments in oil and gas development would provide investors with certainty about companies' intentions to develop the federal lands that they have at their disposal.²⁶⁵ However, three commenters opposed disclosure of a company's plans to drill and expected capital expenditures because disclosing their business plan may cause competitive harm and might expose them to litigation if results differ from their plan.²⁶⁶ Six commenters supported the proposed table.²⁶⁷

We recognize the concern that the PUD table that we proposed may be confusing to investors because it would not attribute capital expenditures to the corresponding reserves as they are developed. As an alternative to the proposed table, we are adopting rules that require a company to disclose the following in narrative form:

- The total quantity of PUDs at year end;
- Any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves;
- Investments and progress made during the year to convert PUDs to proved developed oil and gas reserves; and

²⁶³ See letters from API, Canadian Natural, Chevron, ExxonMobil, Newfield, Nexen, Petrobras, and Ryder Scott.

²⁶⁴ See letter from Three Senators.

²⁶⁵ See letter from Three Senators.

²⁶⁶ See letters from Chesapeake, Devon, and Newfield.

²⁶⁷ See letters from Chesapeake, Deloitte, Devon, Three Senators, Talisman, and Wagner.

- An explanation of the reasons why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after disclosure as PUDs.²⁶⁸

These disclosures would have been required under the proposal, but much of it would have been presented in tabular format. We believe that a narrative approach to these disclosures will provide companies with a better vehicle to explain the status of their PUDs and their track record for developing such reserves. Rather than requiring forward-looking information about a company's plans to develop reserves that may lead to exaggeration of a company's capability to actually convert such reserves, we believe that disclosure of a company's verifiable, established track record of converting such reserves, including its ability to obtain financing for such activities, would be a better indication of the likelihood of that company's success in developing reserves in the future. Specific required disclosure regarding a company's failure to develop material concentrations of PUDs for five or more years should address commenters' concerns that the company may have no intention to develop such reserves.

5. Item 1204 (Oil and gas production)

We proposed to codify the Industry Guide 2 disclosure regarding oil and gas production as Item 1204 of Regulation S-K, in tabular form and with greater detail. One commenter did not believe that separating production, sales price and production costs based on whether they were related oil wells or gas wells would be valuable to investors.²⁶⁹ It believed that companies do not use this information to manage their

²⁶⁸ See Item 1203 [17 CFR 229.1203].

²⁶⁹ See letter from Apache.

business and do not maintain systems to capture this information on that basis, so tracking such data would require costly changes to their systems.²⁷⁰ Two commenters also believed that it would not be possible to separate production cost by product because many units extract different products.²⁷¹ One commenter also recommended that production not be segregated by type of accumulation.²⁷²

We have decided not to adopt Item 1204 as proposed. Rather, we are codifying the existing Industry Guide 2 disclosure item with several revisions. Consistent with the Industry Guide 2 disclosure item, the Item 1204, as adopted, requires disclosure, for each of the prior three fiscal years, of production, by final product sold, of oil, gas, and other products. In addition, for the same time period, the company must disclose, by geographical area:

- The average sales price (including transfers) per unit of oil, gas and other products produced; and
- The average production cost, not including ad valorem and severance taxes, per unit of production.

However, unlike the Industry Guide disclosure item, this disclosure must be made by geographical area and for each country and field containing 15% or more of the registrant's proved reserves, expressed on an oil-equivalent-barrels basis.

Similarly, we are codifying the instructions to the Industry Guide 2 item. One commenter recommended that we maintain some of the existing instructions from the

²⁷⁰ See letter from Apache.

²⁷¹ See letters from Total and ExxonMobil.

²⁷² See letter from ExxonMobil.

Industry Guide.²⁷³ The first instruction codified from the Industry Guide clarifies that net production should include only production that is owned by the registrant and produced to its interest, less royalties and production due others. However, in special situations (e.g., foreign production), net production before any royalties may be provided, if more appropriate. If “net before royalty” production figures are furnished, the change from the usage of “net production” should be noted.

The second instruction, which is also from the Industry Guide, states that production of natural gas should include only marketable production of natural gas on an “as sold” basis. Production will include dry, residue, and wet gas, depending on whether liquids have been extracted before the registrant transfers title. Flared gas, injected gas, and gas consumed in operations should be omitted. Recovered gas-lift gas and reproduced gas should not be included until sold. Synthetic gas, when marketed as such, should be included in natural gas sales.

We are adding a third instruction that was not in the Industry Guide. This instruction states that, if any product, such as bitumen, is sold or custody is transferred prior to conversion to synthetic oil or gas, the product’s production, transfer prices, and production costs should be disclosed separately from all other products. This instruction is necessary because the existing Industry Guide 2 disclosure requirement only required separate disclosure based on whether the end product was oil or gas. This instruction merely clarifies that disclosures under this item must be based on the end product, which may not be oil or gas because the amendments will permit the disclosure of reserves of other end products, such as bitumen.

²⁷³

See letter from ExxonMobil.

The fourth instruction codified from the Industry Guide states that the transfer price of oil and gas (natural and synthetic) produced should be determined in accordance with SFAS 69. And the fifth instruction codified from the Industry Guide clarifies that the average production cost per unit of production should be computed using production costs disclosed pursuant to SFAS 69. Units of production should be expressed in common units of production with oil, gas, and other products converted to a common unit of measure on the basis used in computing amortization. This instruction also adds products from unconventional sources to the existing disclosure Item in Industry Guide 2.

6. Item 1205 (Drilling and other exploratory and development activities)

We proposed to codify the Industry Guide 2 disclosure item regarding drilling activities as Item 1205 of Regulation S-K, in tabular form, with several revisions to that Industry Guide 2 disclosure item, including applying a new definition of the term “geographic area” and adding two categories of wells:

- Extension wells; and
- Suspended wells.

Three commenters believed that the disclosures required under this proposed Item would become too detailed.²⁷⁴ One of these commenters also believed that the number of wells being drilled does not provide an accurate picture of a company’s drilling activities because of the increased usage of horizontal wells.²⁷⁵

²⁷⁴ See letters from Apache, ExxonMobil, and Total.

²⁷⁵ See letter from ExxonMobil.

Some commenters also did not believe that creating new categories for extension wells and suspended wells would be meaningful.²⁷⁶ They noted the burden of the added detail would exceed the value of the information to investors.²⁷⁷ One pointed out that determining whether a well constitutes an extension well would be difficult because of multipurpose drilling.²⁷⁸

After considering the above comments, we have decided not to adopt all of the proposed revisions to the existing Industry Guide 2 disclosure. We recognize that, for some companies that use advanced drilling techniques, the proposed disclosure may not be a good indicator of the extent of their exploratory and development activities, although we believe that this disclosure is still important for many companies. Therefore, we have decided to codify the existing disclosures found in Industry Guide 2 related to drilling activities without revision and to not require tabular disclosure.²⁷⁹ However, as proposed, we are adding a new provision to this Item that requires companies to discuss their exploratory and development activities regarding oil and gas resources that are extracted by mining techniques because we are now including such resources under the definition of "oil and gas producing activities."

7. Item 1206 (Present activities)

Item 1206 codifies existing Item 7 of Industry Guide 2, which calls for disclosure of present activities, including the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed,

²⁷⁶ See letters from Apache, API, and Imperial.

²⁷⁷ See letters from Apache and Southwestern.

²⁷⁸ See letter from Total.

²⁷⁹ See Item 1205 [17 CFR 229.1205].

pressure maintenance operations, and any other related activities of material importance.²⁸⁰ We are adopting Item 1206 substantially as proposed.

8. Item 1207 (Delivery commitments)

Item 1207 codifies existing Item 8 of Industry Guide 2, which calls for disclosure of arrangements under which the company is required to deliver specified amounts of oil or gas and how the company intends to meet such commitments.²⁸¹ We are not adopting any substantive changes to the disclosure currently called for by Item 8 of Industry Guide 2. However, we are restructuring and rewording the disclosure item to make it easier to understand, including separating embedded lists into separate subparagraphs and making general plain English revisions. As proposed, these revisions are not intended to change the substance of the disclosures.

9. Item 1208 (Oil and gas properties, wells, operations, and acreage)

We proposed to codify disclosure about oil and gas properties, wells, operations, and acreage as Item 1208 of Regulation S-K, in tabular form, as well as make several revisions to the existing disclosures, including applying a new definition of the term “geographic area” and adding language that better illustrates the types of properties and the types of disclosures for those properties, including the following:

- Identification and description generally of the company’s material properties, plants, facilities, and installations;
- Identification of the geographic area in which they are located;
- Indication of whether they are located onshore or offshore; and

²⁸⁰ See Item 1206 [17 CFR 229.1206].

²⁸¹ See Item 1207 [17 CFR 229.1207].

- Description of any statutory or other mandatory relinquishments, surrenders, back-ins, or changes in ownership.

Six commenters believed that it is not necessary to enhance this section from Industry Guide 2 because the requirements are already covered by Item 102 of Regulation S-K.²⁸² Commenters were particularly concerned with the segmentation of this disclosure by product, by type of accumulation, and by geographic location.²⁸³ They believed that this level of detail would not be helpful to investors and would impose added costs on companies because they currently do not collect this detailed information.²⁸⁴ Moreover, seven commenters thought that the well count disclosure is no longer meaningful because of technologies such as horizontal drilling.²⁸⁵ They thought that, in light of these new technologies, well count disclosure could be misleading.²⁸⁶

As with the case of drilling activities, we agree that the proposed added detail could make the disclosures too cumbersome. In addition, such disclosure may be of less importance to many companies because of new drilling technology. Therefore, we are merely codifying the existing Industry Guide 2 disclosure, without revision.²⁸⁷

V. Guidance for Management's Discussion and Analysis for Companies Engaged in Oil and Gas Producing Activities

We proposed to add a new Item 1209, which would have specified topics that a company should address either as part of its Management's Discussion and Analysis of

²⁸² See letters from API, Chevron, ExxonMobil, Imperial, Shell, and Total.

²⁸³ See letters from Apache, ExxonMobil, Shell, and Total.

²⁸⁴ See letters from Apache, ExxonMobil, and Petro-Canada.

²⁸⁵ See letters from API, BP, Chevron, ExxonMobil, Imperial, StatoilHydro, and Total.

²⁸⁶ See letters from API and Imperial.

²⁸⁷ See Item 1208 [17 CFR 229.1208].

Financial Condition and Results of Operations (MD&A) or in a separate section.²⁸⁸ Four commenters were concerned that, although the proposed Item was intended to provide more guidance regarding the disclosures required, it would effectively require companies to address all of the issues listed in the Item.²⁸⁹ One recommended that, instead of a detailed list, the requirement should clarify that companies should address “material changes due to technology, prices, concession conditions, commercial terms, known trends, demands, commitments, uncertainties and any events that are reasonably likely to have a material effect on reserves estimates and financial condition.”²⁹⁰ Similarly, another commenter recommended that the Commission clarify that the Item is limited to material impacts.²⁹¹

We are not adopting the proposed Item as part of Regulation S-K because it is intended to be guidance, rather than a specific disclosure Item. We agree that, if companies were to discuss every issue provided in the list, the disclosure would be too long and detailed to be of much use to most investors. Important issues could be hidden amid unnecessary detail. However, we believe that added guidance would be beneficial to companies regarding the issues that the Commission’s staff commented upon in its review of the MD&A section of filings made by oil and gas companies.

To begin, a fundamental premise of MD&A is that the information provided should be related to issues that are material to a company. Although we discuss a list of topics that a company might need to discuss, a company need only discuss a topic if it

²⁸⁸ See Item 303 of Regulation S-K [17 CFR 229.303].

²⁸⁹ See letters from Chevron, ExxonMobil, Petrobras, and Shell.

²⁹⁰ See letter from Repsol.

²⁹¹ See letter from Total.

constitutes, involves, or indicates known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company. These topics include:

- Changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to:
 - Changes in prices;
 - Technical revisions; and
 - Changes in the status of any concessions held (such as terminations, renewals, or changes in provisions);
- Technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates, including any material additions or increases to reserves estimates that are the result of any of the final rules adopted in this release;
- Prices and costs, including the impact on depreciation, depletion and amortization as well as the full cost ceiling test;
- Performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;
- Performance of any mining-type activities for the production of hydrocarbons;

- The company's recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;
- The minimum remaining terms of leases and concessions;
- Material changes to any line item in the tables described in Items 1202 through 1208 of Regulation S-K;
- Potential effects of different forms of rights to resources, such as production sharing contracts, on operations; and
- Geopolitical risks that apply to material concentrations of reserves.

The MD&A is typically presented in a self-contained section of the registration statement or report. However, the disclosure requirements that comprise new Subpart 1200 of Regulation S-K will cause a substantial amount of an oil and gas company's disclosure to appear in tabular format, providing an outline of much of a company's operations. Because the tables will present many of the types of changes that management often discusses in its MD&A, we believe it may be more helpful to investors to locate such discussion close to the tables themselves. Thus, to the extent that any discussion or analysis of known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company is directly relevant to a particular disclosure required by Subpart 1200, the company may include that discussion or analysis with the relevant table, with appropriate cross-references, rather than including it in its general MD&A section.

VI. Conforming Changes to Form 20-F

Form 20-F is the form on which foreign private issuers file their annual reports and Exchange Act registration statements. Currently, Form 20-F contains instructions that are similar to those in Item 102 of Regulation S-K. However, rather than referring to Industry Guide 2 for disclosures regarding oil and gas producing activities, Form 20-F contains its own “Appendix A to Item 4.D—Oil and Gas” (Appendix A) that provides guidance for oil and gas disclosures for foreign private issuers.²⁹² Appendix A is significantly shorter, and provides far less guidance regarding disclosures, than Subpart 1200 or Industry Guide 2. We proposed to revise Form 20-F to eliminate the reference to Appendix A, and rather refer to Subpart 1200, which would expand the disclosures required by foreign private issuers.

Six commenters supported harmonizing the Form 20-F disclosures with Regulation S-K.²⁹³ One noted that the proposal would make disclosure more consistent and comparable among oil companies.²⁹⁴ It believed the proposal would put all oil companies on a level playing field.²⁹⁵

However, one commenter recommended that the Commission exempt companies reporting under International Financial Reporting Standards (IFRS).²⁹⁶ It also recommended that instead of applying the proposed Subpart 1200 to foreign private issuers, the Commission should revise Appendix A to Form 20-F itself, making

²⁹² See Appendix A to Item 4.D—Oil and Gas of Form 20-F [17 CFR 249.220f].

²⁹³ See letters from CAQ, Deloitte, ExxonMobil, KPMG, PWC, and Shell.

²⁹⁴ See letter from ExxonMobil.

²⁹⁵ See letter from ExxonMobil.

²⁹⁶ See letter from Total.

appropriate limitations for foreign private issuers, such as eliminating the disclosure of wells and acreage.²⁹⁷ Another commenter was concerned because the proposals may hinder, rather than facilitate, transition to the use of IFRS.²⁹⁸

We continue to believe that Subpart 1200 would be appropriate disclosure for all public companies engaged in oil and gas producing activities, including foreign private issuers. The added guidance in Subpart 1200 should promote more consistent and comparable disclosures among oil and gas companies. It is our understanding that many of the larger foreign private issuers already provide disclosure in their filings with the Commission comparable to the disclosure provided by domestic companies. Thus, we are revising Form 20-F to incorporate Subpart 1200 with respect to oil and gas disclosures and delete Appendix A to Item 4.D in that form. We recognize that this requirement may require a foreign private issuer to prepare two different reserves estimates if the rules in their home jurisdiction require a different pricing standard than the 12-month average that we adopt in this release. However, we believe the same conflict would have existed under our previous rule to the extent our pricing method differed from the home jurisdiction's method.

Appendix A currently allows a foreign private issuer to exclude required disclosures about reserves and agreements if its home country prohibits the disclosures. Two commenters suggested that the rule continue to provide an exception for disclosures about reserves and agreements that are prohibited by foreign laws.²⁹⁹ However, another

²⁹⁷ See letter from Total.

²⁹⁸ See letter from Ross.

²⁹⁹ See letters from Shell and Total.

commenter believed that a company taking advantage of such an exception should be required to disclose the country, the citation of the relevant law or regulation, and the fact that the disclosed estimates do not include amounts from the named country.³⁰⁰ We are not revising this provision. Rather, because these considerations still apply to such foreign private issuers, we are moving that provision from Appendix A and adopting it as Instruction 2 to Item 4 of Form 20-F, as proposed.³⁰¹

One commenter recommended clarifying that the new disclosures would not apply to foreign private issuers under the Multi-Jurisdictional Disclosure System (MJDS) using Form 40-F that comply with NI 51-101 in Canada because those rules already are broadly consistent with PRMS.³⁰² We agree with this commenter and believe that such issuers need not provide disclosures beyond those required in Canada.

VII. Impact of Amendments on Accounting Literature

A. Consistency with FASB and IASB Rules

Numerous commenters recommended that the SEC generally coordinate its efforts with the IASB and FASB to create a cohesive whole and not adopt competing models.³⁰³ We have begun, and will continue, to work with both of these organizations to ensure a smooth transition to the new reporting rules.

B. Change in Accounting Principle or Estimate

In the Proposing Release, we expressed our view that the change from using single-day year-end price to an average price should be treated as a change in accounting

³⁰⁰ See letter from ExxonMobil.

³⁰¹ Id.

³⁰² See letter from Deloitte.

³⁰³ See letters from CAQ, CFA, Eni, Grant Thornton, KPMG, and PWC.

principle, or a change in the method of applying an accounting principle, that is inseparable from a change in accounting estimate. Therefore, this change would be considered a change in accounting estimate pursuant to Statement of Financial Accounting Standard No. 154 "Accounting Changes and Error Corrections" (SFAS 154) and would be accounted for prospectively.

Commenters believed that the change would be best described as:

- A change in accounting estimate;³⁰⁴
- A change in accounting principle that is inseparable from a change in accounting estimate; or³⁰⁵
- A change in accounting estimate effected by a change in accounting principle.³⁰⁶

We believe that any accounting change resulting from the changes in definitions and required pricing assumptions in Rule 4-10, should be treated as a change in accounting principle that is inseparable from a change in accounting estimate, which does not require retroactive revision. We note that pursuant to AU 420.13, such a change requires recognition in the independent auditor's report through the addition of an explanatory paragraph.

All commenters on the issue agreed that adoption of the rules should not require retroactive revision of past reserves estimates.³⁰⁷ Some believed retroactive revision of

³⁰⁴ See letters from CAQ, Canadian Natural, CAPP, Deloitte, Devon, KPMG, Petrobras, PWC, Repsol, Shell, and StatoilHydro.

³⁰⁵ See letter from Deloitte.

³⁰⁶ See letter from Petro-Canada.

³⁰⁷ See letters from Apache, CAQ, Canadian Natural, CAPP, Deloitte, Devon, Evolution, ExxonMobil, Petrobras, Petro-Canada, PWC, Repsol, Shell, StatoilHydro, and Total.

reserves estimates would be very burdensome or impossible because such data was not maintained.³⁰⁸ We agree with those commenters and believe that no retroactive revisions will be necessary.

Three commenters recommended that the FASB revise Statement of Financial Accounting Standard No. 19 (SFAS 19) to include unconventional resources currently accounted for as mining activities and also provide guidance that no retroactive revisions would be required in that scenario.³⁰⁹ We will continue to work with the FASB on this issue.

C. Differing Capitalization Thresholds Between Mining Activities and Oil and Gas Producing Activities

As noted elsewhere in this release, extraction of products such as bitumen now will be considered oil and gas producing activities, and not mining activities. Under current U.S. accounting guidance, costs associated with proven plus probable mining reserves may be capitalized for operations extracting products through mining methods, like bitumen. Under the new rules, bitumen extraction and operations that produce oil or gas through mining methods are included under oil and gas accounting rules, which only permit capitalization of costs associated with proved reserves.³¹⁰ Moreover, the mining guidelines do not provide specified percentages for establishing levels of certainty for proven or probable reserves for mining activities. It is possible that these differences could result in changing reserves estimates for these resources during the transition to the new rules.

³⁰⁸ See letters from Canadian Natural, Deloitte, Evolution, Petrobras, and Shell.

³⁰⁹ See letters from CAQ, Petrobras, and PWC.

³¹⁰ See Rule 4-10(c) of Regulation S-X [17 CFR 210.4-10(c)].

One commenter believed that the industry would need guidance regarding how to transition operations that are disclosed and accounted for as mining operations to oil and gas disclosure and accounting.³¹¹ It noted that this issue would be relevant not only coincident with the new rules, but could be relevant to future events, such as a coal mining company that in subsequent years changes its operations to in situ coal gasification.³¹² That commenter believed that, without guidance, the change from mining treatment to oil and gas treatment could be considered a change in accounting principle which requires retroactive revision.³¹³ We acknowledge this commenter's concerns. With respect to resources formerly considered mining activities, we view the change from mining treatment to oil and gas treatment as a change in accounting principle that is inseparable from a change in accounting estimate, which does not require retroactive revision.

VIII. Application of Interactive Data Format to Oil and Gas Disclosures

In the Proposing Release, we sought comment on the desirability of rules that would permit, or require, oil and gas companies to present the tabular disclosures in Subpart 1200 in interactive data format in addition to the currently required format. Most commenters addressing the topic supported the use of XBRL for oil and gas disclosures.³¹⁴ They believed using interactive data would be very helpful to investors and analysts.³¹⁵

³¹¹ See letter from KPMG.

³¹² See letter from KPMG.

³¹³ See letter from KPMG.

³¹⁴ See letters from Audit Policy, CFA, Deloitte, Devon, E&Y, ExxonMobil, PWC, Shell, Standard Advantage, StatoilHydro, and Zakaib.

³¹⁵ See letters from CFA, Devon, E&Y, StatoilHydro, and Zakaib.

However, they also recommended that the Commission wait until a well-developed taxonomy exists.³¹⁶ Some recommended that the Commission implement it in stages, initially with a voluntary program.³¹⁷ One commenter recommended that the SEC work with other groups like SPE, IASB, and the United Nations to ensure tags ultimately become the industry standard.³¹⁸

We agree that much of the disclosures regarding oil and gas companies would be conducive to interactive data. We intend to continue to work on developing a taxonomy for such disclosure. Once a well-developed taxonomy is created, we will address this issue further. We are not, however, adopting interactive data requirements in this release. We will continue to consider whether to require interactive oil and gas disclosure filings in the future and, if so, when such filings should be required based on the development status of an oil and gas disclosure taxonomy.

IX. Implementation Date

A. Mandatory Compliance

We proposed to require companies to begin complying with the disclosure requirements for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. A company may not apply the new rules to disclosures in quarterly reports prior to the first annual report in which the revised disclosures are required.

³¹⁶ See letters from Audit Policy, Deloitte, Devon, E&Y, ExxonMobil, PWC, Shell, StatoilHydro, and Zakaib.

³¹⁷ See letters from Audit Policy, Devon, E&Y, PWC, StatoilHydro, and Zakaib.

³¹⁸ See letter from Zakaib.

Fifteen commenters agreed that a delayed compliance date would be helpful in allowing companies to familiarize themselves with the new disclosure requirements before having to comply with them.³¹⁹ Four commenters supported the proposed January 1, 2010 compliance date of Securities Act filings and Exchange Act filings related to fiscal periods ending on or after December 31, 2009.³²⁰ However, one conditioned this approval upon the adoption of the rules before December 31, 2008.³²¹ Another suggested one year after adoption of the rules.³²²

Four commenters believed that the proposed compliance date would be too soon.³²³ One recommended a compliance date of December 31, 2010 to enable companies to make necessary changes in IT systems and data processing.³²⁴ Another noted the magnitude of the proposed changes, length of time to design, program and implement system changes, and the goal of getting the best possible disclosure.³²⁵ One commenter suggested delaying implementation for two years after adoption.³²⁶

We continue to believe that the proposed compliance dates are appropriate. However, as we discuss our revisions with the FASB and IASB, we will consider whether to delay the compliance date further.

³¹⁹ See letters from Apache, Chevron, Davis Polk, Deloitte, ExxonMobil, KPMG, Newfield, Petrobras, Petro-Canada, PWC, Ryder Scott, Shell, Southwestern, Talisman, and Total.

³²⁰ See letters from Davis Polk, ExxonMobil, Shell, and StatoilHydro.

³²¹ See letter from ExxonMobil.

³²² See letter from Talisman.

³²³ See letters from Apache, Petrobras, PWC, and Total.

³²⁴ See letter from Petrobras.

³²⁵ See letter from Apache.

³²⁶ See letter from Devon.

B. Voluntary Early Compliance

Seven commenters recommended that early compliance not be permitted to maintain consistency and comparability of disclosure among issuers, which could be misleading or confusing to investors.³²⁷ However, one commenter believed that the Commission should permit early adoption of the new rules because companies with different fiscal year ends are not comparable anyway.³²⁸ One commenter suggested that the Commission permit companies to provide the new disclosures supplementally.³²⁹ We agree that voluntary compliance may make disclosures incomparable. Therefore, companies may not elect to follow the new disclosure rules prior to the effective date.

X. Paperwork Reduction Act

A. Background

Our new rules and amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").³³⁰ We submitted the new rules and amendments to the Office of Management and Budget (OMB) for review in accordance with the PRA.³³¹ OMB has approved the revisions. The titles for these collections of information are:

- (1) "Regulation S-K" (OMB Control No. 3235-0071);³³²

³²⁷ See letters from Davis Polk, Devon, ExxonMobil, Petrobras, Ryder Scott, Shell, and Wagner.

³²⁸ See letter from Evolution.

³²⁹ See letter from Davis Polk.

³³⁰ 44 U.S.C. 3501 *et seq.*

³³¹ 44 U.S.C. 3507(d) and 5 CFR 1320.11.

³³² The paperwork burden from Regulation S-K and the Industry Guides is imposed through the forms that are subject to the disclosures in Regulation S-K and the Industry Guides and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience, we estimate the burdens imposed by each of Regulation S-K and the Industry Guides to be a total of one hour.

- (2) "Industry Guides" (OMB Control No. 3235-0069);
- (3) "Regulation S-X" (OMB Control No. 3235-0009);
- (4) "Form S-1" (OMB Control No. 3235-0065);
- (5) "Form S-4" (OMB Control No. 3235-0324);
- (6) "Form F-1" (OMB Control No. 3235-0258);
- (7) "Form F-4" (OMB Control No. 3235-0325);
- (8) "Form 10" (OMB Control No. 3235-0064);
- (9) "Form 10-K" (OMB Control No. 3235-0063); and
- (10) "Form 20-F" (OMB Control No. 3235-0063).

We adopted all of the existing regulations and forms pursuant to the Securities Act and the Exchange Act. These regulations and forms set forth the disclosure requirements for annual reports³³³ and registration statements that are prepared by issuers to provide investors with the information they need to make informed investment decisions in registered offerings and in secondary market transactions. The industry guides supplement the existing regulations and forms and provide guidance with respect to industry-specific disclosures.

Our amendments to these existing forms are intended to modernize and update our reserves definitions to better reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's

³³³

The pertinent annual reports are those on Forms 10-K and 20-F.

reserves, as well as providing information regarding a company's internal controls over reserves estimation and the qualifications of person preparing reserves estimates or conducting reserves audits. The new rules and amendments also are intended to codify, modernize, and centralize the disclosure items for oil and gas companies in Regulation S-K. Finally, the new rules and amendments are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the new rules and amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Many, but not all, of the information collection requirements related to annual reports and registration statements will be mandatory. There is no mandatory retention period for the information disclosed, and the information will be publicly available on the EDGAR filing system.

B. Summary of Information Collections

The new rules and amendments increase existing disclosure burdens for annual reports on Forms 10-K³³⁴ and 20-F and registration statements on Forms 10, 20-F, S-1,

³³⁴ The disclosure requirements regarding oil and gas properties and activities are in Form 10-K as well as the annual report to security holders required pursuant to Rule 14a-3(b) [17 CFR 240.14a-3(b)]. Form 10-K permits the incorporation by reference of information from the Rule 14a-3(b) annual report to security holders to satisfy the Form 10-K disclosure requirements. The analysis that follows assumes that companies would either provide the proposed disclosure in a

S-4, F-1, and F-4 by creating the following new disclosure requirements, many of which were requested by industry participants:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

Form 10-K or incorporate the required disclosure into the Form 10-K by reference to the Rule 14a-3(b) annual report to security holders if the company is subject to the proxy rules. This approach takes into account the burden from the proposed disclosure requirements that are included in both Form 10-K and Regulation 14A or 14C.

In addition, the amendments harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, foreign private issuers must disclose the information required by Items 1205 through 1208 of Regulation S-K regarding drilling activities, present activities, delivery commitments, wells, and acreage, which previously were not specified in Appendix A to Form 20-F. These disclosure items codify the substantive disclosures called for by Items 4 through 8 of Industry Guide 2, although much of this disclosure may have been disclosed by some companies under the more general discussions of business and property on that form.

C. Revisions to PRA Burden Estimates

For purposes of the PRA, we estimated, in the Proposing Release, the total annual increase in the paperwork burden for all affected companies to comply with our proposed collection of information requirements to be approximately 7,472 hours of in-house company personnel time and to be approximately \$1,659,000 for the services of outside professionals.³³⁵ These estimates included the time and the cost of preparing and reviewing disclosure and filing documents. Our methodologies for deriving the above estimates are discussed below.

Our estimates represented the burden for all oil and gas companies that file annual reports or registration statements with the Commission. Based on filings received during the Commission's last fiscal year, we estimate that 241 oil and gas companies file annual reports and 67 oil and gas companies file registration statements. Most of the

³³⁵ For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest thousand.

information called for by the new disclosure requirements, including the optional disclosure items, is readily available to oil and gas companies and includes information that is regularly used in their internal management systems. These disclosures include:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

We estimated that, on average, each company would incur a burden of 35 hours to prepare these disclosures in an annual report or registration statement.

The amendments also apply several disclosure items to foreign private issuers that previously did not apply to them. As noted above, many of these disclosure items, such as drilling activities, wells and acreage, require the issuer to provide more specificity about its business and property. Foreign private issuers that do not currently provide such specificity would incur an added burden to present such disclosures in their filings. In the Proposing Release, we estimated that this burden would be 20 hours per foreign private issuer.

We received few comments regarding our estimates. Several large oil companies, and an industry organization that primarily represents large oil companies, believed that the estimates were too low. They believed that the new rules and amendments would increase their burden by 10,000 to 15,000 hours per year. However, these commenters included the initial cost to change their internal systems to provide the new required disclosures in their estimates. Based on conversations with these commenters, the staff understands that they believed that the ongoing burden would be approximately one third of that estimate. For purposes of its Paperwork Reduction Act estimate, the staff considers the ongoing annual burden and spreads the initial transitional burden of compliance with new rules and regulations over a three year period.

In addition, these commenters indicated that the two most significant burdens that stemmed from the proposed use of different prices for disclosure and accounting purposes and the increased detail in disclosures that would result from the proposed definition of the term "geographic area" and the proposed disclosure by type of accumulation. It should be noted that these commenters have significant reserves spread worldwide. Some of these large companies have as much as 10,000 times the amount of

reserves of the median oil and gas company. These large companies likely would be more significantly impacted by the level of detailed disclosure that the proposals would have required compared to the vast majority of oil and gas companies in our reporting system, which do not have such extensive global operations. Therefore, we do not believe that the estimate provided by those large oil and gas companies necessarily would be applicable to most oil and gas companies. However, in response to the concerns that they expressed, the final rules do not require the use of different prices for disclosure and full cost accounting purposes. We also intend to continue to work with the FASB to align the accounting standards with that pricing mechanism. In addition, we have significantly reduced the level of detailed geographic and product disclosure that the rules require. Finally, we are providing for a substantial transition period to allow companies to adjust their systems to comply with the new rules. We believe that these changes will help to mitigate the increased burden of the new rules.

We do, however, believe that our initial burden estimates may have been too low. We are therefore adjusting our burden estimate to reflect an additional increase of 100 hours per company per year. In addition, we are increasing our burden estimate for foreign private issuers by an additional 150 hours per company per year. Consistent with current Office of Management and Budget estimates and recent Commission rulemakings, we estimate that 25% of the burden of preparation of registration statements on Forms S-1, S-4, F-1, F-4, 10, and 20-F is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average

cost of \$400 per hour.³³⁶ We estimate that 75% of the burden of preparation of annual reports on Form 10-K or Form 20-F is carried by the company internally and that 25% of the burden is carried by outside professionals retained by the company at an average cost of \$400 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. The following tables summarize the additional changes to the PRA estimates:

Table 1: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Exchange Act Periodic Reports

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	75% Issuer	25% Professional	\$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*\$400
10-K ³³⁷	206	100	20,600	15,450	5,150	2,060,000
20-F	35	150	5,250	3,938	1,312	525,000
Total	241		25,850	19,388	6,462	2,585,000

Table 2: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Securities Act Registration Statements and Exchange Act Registration Statements

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	25% Issuer	75% Professional	\$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*\$400
10	5	100	500	125	375	150,000
20-F	2	150	300	75	225	90,000
S-1	38	100	3,800	950	2,850	1,140,000
S-4	17	100	1,700	425	1,275	510,000
F-1	2	150	300	75	225	90,000
F-4	3	150	450	112.5	337.5	135,000
Total	67		7,050	1762.5	5,287.5	2,115,000

D. Request for Comment

We request comment in order to evaluate the accuracy of our estimates of the burden of the revised information collections. Any member of the public may direct to us

³³⁶ In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of \$400 as the average cost of outside professionals that assist issuers in preparing disclosures and conducting registered offerings.

³³⁷ The burden estimates for Form 10-K assume that the requirements are satisfied by either including information directly in the annual reports or incorporating the information by reference from the Rule 14a-3(b) annual report to security holders.

any comments concerning the accuracy of these burden estimates. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington DC 20503, and should send a copy of the comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-15-08. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-15-08, and be submitted to the Securities and Exchange Commission, Records Management Branch, 100 F Street NE, Washington, DC 20549-1126. Because OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if OMB receives them within 30 days of publication.

XI. Cost-Benefit Analysis

A. Background

We are adopting revisions to the oil and gas reserves disclosure regime of Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934 and Industry Guide 2. The revisions are intended to modernize and update oil and gas disclosure. The oil and gas industry has experienced significant changes since the Commission initially adopted its current rules and disclosure regime between 1978 and 1982, including advancements in technology and changes in the types of projects in which oil and gas companies invest. The revisions also are intended to

provide investors with improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability.

B. Description of New Rules and Amendments

Currently, Industry Guide 2 specifies many of the disclosure guidelines for oil and gas companies. The Industry Guide calls for disclosure relating to reserves, production, property, and operations in addition to that which is required by Regulation S-K. Generally, the new rules and amendments codify and update the existing Industry Guide 2 disclosures in a new Subpart 1200 of Regulation S-K, clarify the level of detail required to be disclosed, and require reserves disclosure in a tabular presentation. The changes relate primarily to disclosure of the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen, shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;

- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

The new rules and amendments also make revisions and additions to the definitions section of Rule 4-10 of Regulation S-X. These revisions update and extend reserves definitions to reflect changes in the oil and gas industry and new technologies.

In particular, the new and revised definitions:

- Expand the definition of "oil and gas producing activities" to include the extraction of hydrocarbons from oil sands, shale, coalbeds, or other natural resources and activities undertaken with a view to such extraction;
- Add a definition of "reasonable certainty" to provide better guidance regarding the meaning of that term;
- Add a definition of "reliable technology" to permit the use of new technologies to establish proved reserves;
- Define probable and possible reserves estimates; and
- Add definitions to explain new terms used in the revised definitions.

In addition, the amendments harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, the amendments to Form 20-F will

require foreign private issuers to disclose the information required by Items 1205 through 1208 of Regulation S-K regarding drilling activities, present activities, delivery commitments, wells, and acreage, which are not currently specified under Appendix A to Form 20-F, although much of this disclosure is often disclosed by companies under the more general discussions of business and property on that form.

C. Benefits

We expect that the new rules and amendments will increase transparency in disclosure by oil and gas companies by providing improved reporting standards. The revisions to the definitions should align our disclosure rules with the realities of the modern oil and gas markets. For example, we believe that the inclusion of bitumen and other resources from continuous accumulations as oil and gas producing activities is consistent with company practice to treat these operations as part of, rather than separate from, their traditional oil and gas producing activities. Similarly, the expansion of permissible technologies for determining certainty levels of reserves recognizes that companies now take advantage of these technological advances to make business decisions. We expect these new rules and amendments to improve disclosure by aligning the required disclosure more closely with the way companies conduct their business.

Allowing companies to disclose probable and possible reserves is designed to improve investors' understanding of a company's unproved reserves. For those companies that already disclose such reserves on their Web sites, the new rules and amendments permit them to unify such disclosures into a single, filed document. Disclosure of these categories of reserves beyond proved reserves may foster better company valuations by investors, creditors, and analysts, thus improving capital

allocation and reducing investment risk. Because some of the disclosure items are optional, the amount of increased transparency will depend on the extent to which companies elect to provide the additional disclosures permitted under the new rules. If companies elect not to provide the optional disclosure, then the benefits from increased transparency would be limited to the extent that the new rules improve the transparency of proved reserves disclosure.

By permitting increased disclosure and promoting more consistency and comparability among disclosures, the new rules and amendments provide a mechanism for oil and gas companies to seek more favorable financing terms through more disclosure and increased transparency. Investors may be able to request such additional disclosure in Commission filings during negotiations regarding bond and debt covenants. Thus, we expect that, as a result of competing factors in the marketplace, the new rules and amendments will result in increased transparency, either because companies elect to voluntarily provide increased disclosure, or because investors may discount companies that do not do so. We believe that the benefits and costs of disclosing unproved reserves ultimately will be determined by market conditions, rather than regulatory requirements.

We expect that permitting companies to disclose probable and possible reserves will increase market transparency, provide investors with more reserves information, and allow for more accurate production forecasts. By relating standards used in deterministic methods to comparable percentage thresholds used in probabilistic methods for establishing a given level of certainty, the new rules and amendments should result in increased standardization in reporting practices which would promote comparability of reserves across companies. The new rules would define the term "reliable technology" to

permit oil and gas companies to prepare their reserves estimates using new types of technology that companies are not permitted to use under the current rules. This new definition also is designed to encompass new technologies as they are developed in the future, thereby providing investors and the market with a more comprehensive understanding of a company's estimated reserves.

We expect that replacing the Industry Guide with new Regulation S-K items will provide greater certainty because the disclosure requirements would be in rules established by the Commission. In addition, we believe that disclosure of reserves concentrated in particular countries should provide better information to investors regarding the geopolitical risk to which some companies may be exposed. Overall, we believe that the amendments, as a whole, will provide investors with more information that management uses to make business decisions in the oil and gas industry.

1. Average price and first of the month price

The revision to change the price used to calculate reserves from a year-end single-day price to an historical average price over the company's most recently ended fiscal year is expected to reduce the effects of seasonality. In particular, many commenters suggested the use of a 12-month average price to mitigate the risk of a year-end price affected by short-term price volatility such that it does not reflect the true nature of a company investment, planning, and performance. Our Office of Economic Analysis studied the publicly-available pricing data and found evidence of year-end price volatility. The historical volatility of year-end prices is between 16% and 41% higher than the volatility of annual average prices depending on the grade and geography of oil or gas prices considered. This difference demonstrates variability in oil and gas prices,

likely due to seasonal demands, that does not reflect long term fundamental values, but that cannot be immediately corrected due to the costs of transportation and speed of delivery. Given this variability, it is likely that a 12-month average price will yield better reserves estimates—that reflect management planning and investment to the extent that they discount the short-term component of oil and gas prices—than a year-end spot price.

Many of the commenters to the Proposing Release supported the use of an historical price, even though this approach may be less useful in determining the fair value of a company's reserves compared to a futures market price. We believe investors are concerned not only about the quantity of a company's reserves, but also about the profitability of those reserves. We also recognize that some reserves will be of more value than others due to extraction and transportation costs. As a result, since the new rules and amendments require the use of a single price to estimate reserves and since that price may not be as informative of value as a futures price, the new rules and amendments also gives companies the option of providing a sensitivity analysis and reporting reserves based on additional price estimates.

If companies elect to provide a sensitivity analysis, we expect this to benefit investors by allowing them to formulate better projections of company prospects that are more consistent with management's planning price and prices higher and lower that may reasonably be achieved. In particular, it allows companies the flexibility to communicate how their reserves would change under alternative economic conditions, including those that they may believe better reflect their future prospects. We expect that companies would be more likely to adopt a sensitivity analysis approach if investors and other market participants determine that this information would reduce investment risk, or if

companies believe such disclosure will reduce the cost of capital formation. The new rules and amendments should result in increased price stability in determining whether reserves are economically producible. This should mitigate seasonal effects, resulting in reserves estimates that more closely reflect those used by management in planning and investment decisions. We expect this to allow for more accurate company assessments and improve projections of company prospects.

In addition to an average annual price, many of the commenters suggested that the price be computed on the first day of the month. Two reasons were given. First, beginning month prices would allow an additional month of preparation time in calculating reserves for financial reporting. Second, some commenters suggested that month-end, and in particular year-end, prices were subject to additional short-term volatility because many oil and gas financial contracts expire on those days, resulting in higher than normal trading activity. While the staff of the Office of Economic Analysis did not find systematic evidence of increased volatility around month-end or year-end oil and gas prices relative to other days in the month, we agree that additional preparation time is beneficial because reserves estimations require significant time and resources. An additional month would help reduce errors that might otherwise result from the financial reporting time constraints.

Finally, we believe that revising the full cost accounting method to use the same pricing mechanism as the reserves disclosure requirements should provide consistency between the disclosure and accounting presentations. The use of a single pricing method should also minimize the incremental burden placed on companies as a result of the rule changes because they would not be required to prepare two separate estimates.

2. Probable and possible reserves

We anticipate that disclosure of probable and possible reserves, if companies elect to do so, will allow investors, creditors, and other users to better assess a company's reserves. In addition, the tabular format for disclosing probable and possible reserves should reduce investor search costs by making it easier to locate reserves disclosures and facilitating comparability among oil and gas companies.

While we recognize that many companies already communicate with investors about their unproved and other reserves through alternative means, such as company Web sites or press releases, some commenters remarked that an objective comparison among companies is difficult because different companies have defined such reserves classifications differently. We believe that permitting disclosure of this information in Commission filings will provide a more consistent means of comparison because disclosure in our filings must comply with our definitions. Although our new rules make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit because of the relative uncertainty of those estimates, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers. Regardless, since the disclosure decision is voluntary, it should occur only to the extent that companies find that the benefits justify the costs of doing so.

We believe that permitting the disclosure of probable and possible reserves will benefit smaller companies, in particular. Larger issuers tend to already have large amounts of proved reserves. The new rules and amendments permit smaller companies, who often participate in a significant amount of exploratory activity, to better disclose their business prospects. Consequently, we anticipate that the new rules and amendments could lead to efficiencies in capital formation, as more information will be available regarding the prospects of smaller issuers.

3. Reserves estimate preparers and reserves auditors

We believe that investors would benefit from a greater level of assurance with respect to the reliability of reserve estimates, particularly if companies are allowed to disclose unproved reserves because unproved reserves are inherently less certain than proved reserves. We proposed disclosure requirements relating to whether the person primarily responsible for preparing reserves estimates or conducting a reserves audit, if the company represents that it has enlisted a third party to conduct a reserves audit, met a specified list of qualifications based on the Society of Petroleum Engineers's reserves audit guidelines. However, commenters expressed concern that many of these qualifications such as membership in professional societies were not standardized worldwide. Without control over those standards, the disclosures would not be comparable. We agree with those commenters and, as suggested, have adopted a more principles-based disclosure requirement. Under the adopted rules, a company must disclose its internal controls over reserves estimations and disclose the qualifications of the primary technical person in charge of overseeing the reserves estimations or reserves audit. We believe that disclosure of the individual qualifications, rather than simple

acknowledgement of meeting certain criteria, which may differ within countries, will provide investors with better information to compare companies and the qualifications of persons in charge of the reserves estimations and reserves audits, which should enable more accurate assessments of the quality of audit reports. We believe that disclosure of a company's internal controls over reserves estimates will allow investors to assess whether a company has implemented appropriate controls without dictating to companies specified criteria for establishing those controls.

Although we do not expect all companies to undertake a third-party reserves audit because our rules do not require such a reserves audit, third party participation in the estimation of reserves should add credibility to a company's public disclosure. The opinion of an objective, qualified person on the reserves estimates is designed to increase the reliability of these estimates and investor confidence.

4. Development of proved undeveloped reserves

The new rules and amendments also require disclosure of a company's progress in developing undeveloped reserves and the reasons why any PUDs have remained undeveloped for five years or more. We believe that such disclosure supplements our amendments that ease the requirements for recognizing PUDs and thereby should increase the amount of PUDs disclosed in filings, even though the properties representing such proved reserves have not yet been developed and therefore do not provide the company with cash flow. We believe that the disclosure requirements will increase the accountability of companies that disclose reserves for extended periods of time without adequate justification for their failure to develop those reserves.

5. Disclosure guidance

The release also provides guidance about the type of information that companies should consider disclosing in Management's Discussion and Analysis, and allows companies to include this information with the relevant tables. Providing the additional guidance should assist companies in preparing their disclosure, improving the quality and consistency of this disclosure. Locating this discussion with the tables themselves should benefit investors by simplifying the presentation of disclosure, and providing insight into the information disclosed in the tables.

6. Updating of definitions related to oil and gas activities

The new rules and amendments also update the definition of the term "oil and gas producing activities" as well as updating or creating new definitions for other terms related to such activities, including "proved oil and gas reserves" and "reasonable certainty." We believe that updating these definitions will help companies disclose oil and gas operations in the same way that companies manage and assess those operations. This includes resources extracted from nontraditional sources that companies consider oil and gas activities, which previously were excluded them from the definition of "oil and gas producing activities." In addition, adding definitions for terms like "reasonable certainty" (which currently is in the definition of "proved oil and gas reserves," but not defined) will provide companies with added guidance and assist them in providing consistent disclosures between companies.

7. Harmonizing foreign private issuer disclosure

We believe that the harmonization of foreign private issuer disclosure will help make disclosures of foreign private issuers more comparable with domestic companies.

The oil and gas industry has changed significantly since the rules were adopted. Today, many companies have interests that span the globe. In addition, many of these projects are joint ventures between foreign private issuers and domestic companies. Having differing levels of disclosure for companies that may be participating in the same projects harms comparability between investment choices. The harmonization of foreign private issuer disclosure is intended to promote comparability among all oil companies.

D. Costs

We expect that the new rules and amendments will result in initial and ongoing costs to oil and gas companies. These burdens will vary significantly among companies. Based on disclosures in company filings, the largest oil and gas companies can have as much as 10,000 times the reserves of the median reporting oil and gas company. As would be expected, companies that have more reserves and larger operations will have a correspondingly larger amount of information that they must disclose and, therefore, the burden of complying with our disclosure requirements would be greater for larger companies.

Although we are adding a new subpart to Regulation S-K to set forth the disclosure requirements that are unique to oil and gas companies, the subpart, for the most part, codifies the substantive disclosure called for by Industry Guide 2. The disclosure requirements have been updated and clarified, and require the disclosure to be presented in a tabular format, where appropriate. Although many companies already present this information in tabular form, for companies that do not, this requirement could impose a burden on companies as they transition from a narrative to tabular disclosure format. We expect, however, that any increased preparation costs would be

highest in the first year after adoption, but would decline in subsequent years as companies adjust to the new format. We think this burden is justified because tabular disclosure will increase comparability and facilitate understanding and analysis by investors.

1. Probable and possible reserves

Allowing disclosure of probable and possible reserves could create an increased risk of litigation because these categories of reserves estimates are less certain than proved reserves. Companies may choose not to disclose such reserves, in part, because of the risk of incurring litigation costs to defend their disclosures due to the increased uncertainty of these categories. Disclosure of probable and possible reserves may also result in revealing competitive information because it might reveal a company's business strategy, such as the geographic location and nature of its exploration and discoveries. For example, if geographical detail can be inferred from estimates of unproved reserves, this might reveal information about the value of a company's assets to competitors and could put the producer at a competitive disadvantage. We have reduced the level of geographical detail to reduce the burden on companies, while still providing sufficient information to investors regarding concentrations of risk, including political risk.

We expect companies will incur costs in preparing the additional disclosures such as calculating and aggregating the reserve projections in a prescribed format. However, if probable and possible categories of reserves have different extraction cost structures and they are not disclosed separately from proved reserves, this could result in increased uncertainty in an investor's assessment of a company's prospects.

Companies also expressed concern that mandatory disclosure of probable and possible reserves could expose them to increased litigation risk. We believe that making these disclosures voluntary mitigates these concerns. Companies unwilling to bear the added risk can simply opt not to provide this disclosure.

2. Reserves estimate preparers and reserves auditors

If a company chooses to use a third party to prepare or audit reserve estimates, it will incur costs to hire these outside consultants. The new rules and amendments do not require companies to hire such a person. If enough companies that currently do not use such consultants begin to hire them, we believe that industry wages could potentially increase due to increased demand for reserves calculating specialists unless that demand is compensated by an increase in the supply of such persons. If wages increased, then all companies, not just those employing third party consultants, would incur added costs.

Large companies may be less likely to hire third parties because they tend to have staff to make reserves estimates. However, if such large companies chose to hire third-party consultants, third parties would expend significantly more effort on such projects than for smaller companies because larger companies have more properties to evaluate. Thus, we expect third-party fees, and the time required to conduct such projects, would scale upwards with the quantity of company reserves.

Disclosure of unproved reserves without third-party certification may present a risk with respect to smaller oil and gas producers because smaller companies are likely to have less in-house expertise and ability to accurately estimate such reserves than larger companies. However, we understand that the vast majority of smaller oil and gas companies already hire third parties to estimate their reserves or certify their estimates.

3. Consistency with IASB

Some commenters remarked that the International Accounting Standards Board is currently preparing a set of guidelines for oil and gas extractive activities, including definitions of oil and gas reserves, and recommended that the Commission align its regulations with those guidelines. We intend to monitor this initiative and work with the IASB, but our new rules may differ from the guidelines ultimately established by the International Accounting Standards Board. This could make it more difficult for investors to compare foreign and domestic companies.

4. Change in pricing mechanism

We do not anticipate significant costs with the change in pricing mechanisms for establish reserves. Companies simply will apply a different price scenario to determine the economic producibility of reserves. It is possible that the use of a 12-month average price may reduce the cost of disclosure because it should reduce the volatility of reserves estimates and therefore reduce the need to make significant adjustments to those estimates on a yearly basis due to daily price swings.

5. Disclosure of PUD development

The required disclosure of a company's progress in developing PUDs will increase the cost of reporting. However, we believe that companies regularly track their progress in this arena. Until a company develops a property, it cannot begin to realize the cash flows from production and the actual sale of products. Thus, the development of reserves is of utmost importance to an oil and gas company's business.

6. Increased geographic disclosure

The requirements to provide increased geographic disclosure of reserves and production, in certain circumstances, may increase the amount of disclosure that a company must present. However, because the threshold that we are adopting in the release is 15% of the company's total reserves, a company would be required to disclose, at most, reserves and production in six countries. Considering the relatively large proportion of reserves that must exist in a country before a company is required to provide country-level disclosure, we believe that such information is readily available to companies. As noted in the body of this release, we have attempted to draft this provision to minimize any competitive harm that such disclosure may cause a company.

7. Harmonizing foreign private issuer disclosure

The harmonization of foreign private issuer disclosure regarding oil and gas activities may increase the burden on foreign private issuers. However, it is our understanding that the large foreign private issuers already voluntarily provide disclosure comparable to the level required from domestic companies. Much of the added new disclosure relates to the day-to-day business and properties of these companies, including drilling activities, number of wells and acreage. This is information that is central to the activities of oil and gas companies, and therefore is readily known to these companies. We believe that applying Subpart 1200 to these companies could prompt more detailed disclosure regarding these activities, which would cause these companies to incur some cost. The provision permitting foreign private issuers to omit disclosures if prohibited from making those disclosures by their home jurisdiction could mitigate some of these costs.

XII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Securities Act Section 2(b)³³⁸ and Section 3(f) of the Exchange Act³³⁹ require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act³⁴⁰ requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We expect the new rules and amendments to increase efficiency and enhance capital formation, and thereby benefit investors, by providing the market with better information based on updated technology as well as increased information covering a broader range of reserves classifications held by a company and reserves found in non-traditional sources of oil and gas. Such increased and improved information should permit investors to better assess a company's prospects. In particular, the existing prohibitions against disclosing reserves other than proved reserves, using modern technology to determine the certainty level of reserves, and including resources from non-traditional sources can lead to incomplete disclosures about a company's actual

³³⁸ 15 U.S.C. 77b(b).

³³⁹ 15 U.S.C. 78c(f).

³⁴⁰ 15 U.S.C. 78w(a)(2).

resources and prospects. The new rules and amendments are designed to better align the disclosure requirements with the way companies make business decisions.

We believe that permitting the disclosure of probable and possible reserves will benefit smaller companies, in particular. Larger issuers tend to already have large amounts of proved reserves. The new rules and amendments permit smaller companies, who often participate in a significant amount of exploratory activity, to better disclose their business prospects. Consequently, we anticipate that the new rules and amendments could lead to efficiencies in capital formation, as more information will be available regarding the prospects of smaller issuers.

The effects of the new rules and amendments on competition are difficult to predict, but it is possible that permitting public issuers to disclose probable and possible reserves will lead to a reallocation of capital, as companies that previously could show few proved reserves will be able to disclose a broader range of its business prospects, making it easier for these issuers to raise capital and compete with companies that have large proved reserves. Although our new rules make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit because of the relative uncertainty associated with such reserves, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers.

XIII. Final Regulatory Flexibility Analysis

We have prepared this Final Regulatory Flexibility Analysis in accordance with Section 603 of the Regulatory Flexibility Act.³⁴¹ This analysis relates to the modernization of the oil and gas disclosure requirements. An Initial Regulatory Flexibility Analysis (IRFA) was prepared in accordance with the Regulatory Flexibility Act in conjunction with the Proposing Release. The Proposing Release included, and solicited comment on, the IRFA.

A. Reasons for, and Objectives of, the New Rules and Amendments

The Commission adopted the current disclosure regime for oil and gas producing companies in 1978 and 1982, respectively. Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital. On December 12, 2007, the Commission published a Concept Release on possible revisions to the disclosure requirements relating to oil and gas reserves.³⁴² Prior to our issuance of the Concept Release, many industry participants had expressed concern that our disclosure rules are no longer in alignment with current industry practices and therefore have limited usefulness to the market and investors.

Our new rules and amendments to these existing forms are intended to modernize and update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing

³⁴¹ 5 U.S.C. 603.

³⁴² See Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's reserves, as well as providing information regarding the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit, and the qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates. The amendments also harmonize our full cost accounting rules with the changes that we are adopting with respect to disclosure of oil and gas reserves. The new rules and amendments also are intended to codify, modernize and centralize the disclosure items for oil and gas companies into Regulation S-K. Finally, the new rules and amendments are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the new rules and amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

B. Significant Issues Raised by Commenters

We did not receive comments specifically addressing the impact of the proposed rules and amendments on small entities. However, several of the comments related to burdens that would be placed on all companies affected by the proposals. In particular, commenters believed that the proposal to require the use of different prices for disclosure and accounting purposes would impose a significant burden on all oil and gas companies. We have considered those comments and are adopting amendments to our disclosure

rules and the full cost accounting method that will require the use of a single price for both purposes. Similarly, commenters were concerned that certain aspects of the proposal, such as the new definition of geographic area and disclosure by accumulation type would increase the detail in the disclosures significantly. We agree with those commenters and have significantly reduced the level of detail required in the disclosure requirements.

C. Small Entities Subject to the New Rules and Amendments

The new rules and amendments affect small entities that are engaged in oil and gas producing activities, the securities of which are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. The new rules and amendments also would affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn. Securities Act Rule 157³⁴³ and Exchange Act Rule 0-10(a)³⁴⁴ define an issuer to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year. The new rules and amendments affect small entities that are operating companies and engage in oil and gas producing activities. Based on filings in 2007, we estimate that there are approximately 28 oil and gas companies that may be considered small entities.

³⁴³ 17 CFR 230.157.

³⁴⁴ 17 CFR 240.0-10(a).

D. Reporting, Recordkeeping, and Other Compliance Requirements

The new rules and amendments to Regulation S-K expand some existing disclosures, and eliminate others. In particular, the new disclosure requirements, many of which were requested by industry participants, include the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen and shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for 5 years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- Disclosure of the company's internal controls over reserves estimates and the qualifications the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

There would be no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

E. Agency Action to Minimize Effect on Small Entities

We considered different compliance standards for the small entities that will be affected by the new rules and amendments. In the Proposing Release, we solicited comment regarding the possibility of different standards for small entities. We did not receive comment on this particular issue. However, we believe that such differences would be inconsistent with the purposes of the rules.

The new rules and amendments are designed to modernize the disclosure requirements for oil and gas companies. As such, we believe all oil and gas companies will benefit from the modernization of the rules. Under the new rules and amendments, all companies will be allowed to use modern technologies to establish reserves and include operations in unconventional resources in their oil and gas reserves estimates. Adopting differing standards for disclosure for small entities would significantly reduce the comparability between companies. However, the new rules and amendments do permit companies to disclose probable and possible reserves. We believe the removal of the prohibition against such reserves will enable companies to disclose a broader view of their prospects. We believe this will particularly benefit smaller oil and gas companies that may have significant unproved reserves in their portfolio. Such disclosure may assist smaller companies in raising capital for development projects in those properties.

XIV. Update to Codification of Financial Reporting Policies

The Commission amends the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) [47 FR 21028] as follows:

1. By removing the seven introductory paragraphs before Section 406.01, the last sentence of Section 406.01.c.vi., the first paragraph of Section 406.01.d, the introductory paragraph of Section 406.02.d, and removing and reserving Sections 406.01.a., 406.02.a, 406.02.b., 406.02.d.iii., and 406.02.e.

2. By revising Section 406.01B to read as follows:

The rules in Rule 4-10(b) specify that the application of successful efforts shall comply with SFAS 19. In 2008, the Commission published amendments to the definitions in Rule 4-10(a) that may not align completely with SFAS 19's existing terminology and application. Further, paragraph 7 of SFAS 25 states: "For purposes of applying this Statement and Statement 19, the definition of proved reserves, proved developed reserves, and proved undeveloped reserves shall be the definitions adopted by the SEC for its reporting purposes that are in effect on the date(s) as of which the reserve disclosures are to be made. Previous reported quantities shall not be revised retroactively if the SEC definitions are changed." In any case, the Commission expects the practical application of SFAS 19 will remain unchanged other than incorporating the effects of the new definitions.

3. By removing the first three sentences of Section 406.02.c. and in the fourth sentence replacing the phrase "this sort of information" with "information to assess the impact of oil and gas producing activities on near term cash flows and liquidity".

4. By adding a new Section 406.03 entitled "Transition" and including the text of the 3rd paragraph of Section VII.B and the last sentence of the 2nd paragraph of Section VII.C of this release.

5. By adding a new Section 406.04 entitled "MD&A Guidance" and including the text beginning with the last sentence of the 2nd paragraph of Section V of this release through the end of that Section.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register or Code of Federal Regulations.

XV. Statutory Basis and Text of Amendments

We are adopting the amendments pursuant to Sections 3(b), 6, 7, 10 and 19(a) of the Securities Act and Sections 12, 13, 14(a), 15(d), and 23(a) of the Exchange Act, as amended.

TEXT OF AMENDMENTS

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 211, 229 and 249

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20,

80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Amend § 210.4-10 by:

a. Redesignating the subparagraphs in paragraph (a) as follows:

Old paragraph number	New paragraph number
(a)(1)	(a)(16)
(a)(2)	(a)(24)
(a)(3)	(a)(22)
(a)(4)	(a)(25)
(a)(5)	(a)(23)
(a)(6)	(a)(34)
(a)(7)	(a)(21)
(a)(8)	(a)(15)
(a)(9)	(a)(29)
(a)(10)	(a)(13)
(a)(11)	(a)(9)
(a)(12)	(a)(32)
(a)(13)	(a)(33)
(a)(14)	(a)(1)
(a)(15)	(a)(12)
(a)(16)	(a)(7)
(a)(17)	(a)(20)

b. Adding new paragraphs (a)(2), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (a)(10), (a)(11), (a)(14), (a)(17), (a)(18), (a)(19), (a)(26), (a)(27), (a)(28), (a)(30), (a)(31), and (c)(8);

c. Revising newly redesignated paragraphs (a)(13), (a)(16), (a)(22), (a)(24), and (a)(25); and

d. Removing the authority citations following the section.

The additions and revisions read as follows:

§ 210.4-10 Financial accounting and reporting for oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975.

* * * * *

(a) Definitions. * * *

* * * * *

(2) Analogous reservoir. Analogous reservoirs, as used in resources assessments, have similar rock and fluid properties, reservoir conditions (depth, temperature, and pressure) and drive mechanisms, but are typically at a more advanced stage of development than the reservoir of interest and thus may provide concepts to assist in the interpretation of more limited data and estimation of recovery. When used to support proved reserves, an "analogous reservoir" refers to a reservoir that shares the following characteristics with the reservoir of interest:

- (i) Same geological formation (but not necessarily in pressure communication with the reservoir of interest);
- (ii) Same environment of deposition;
- (iii) Similar geological structure; and
- (iv) Same drive mechanism.

Instruction to paragraph (a)(2): Reservoir properties must, in the aggregate, be no more favorable in the analog than in the reservoir of interest.

(3) Bitumen. Bitumen, sometimes referred to as natural bitumen, is petroleum in a solid or semi-solid state in natural deposits with a viscosity greater than 10,000 centipoise measured at original temperature in the deposit and atmospheric pressure, on a gas free basis. In its natural state it usually contains sulfur, metals, and other non-hydrocarbons.

(4) Condensate. Condensate is a mixture of hydrocarbons that exists in the gaseous phase at original reservoir temperature and pressure, but that, when produced, is in the liquid phase at surface pressure and temperature.

(5) Deterministic estimate. The method of estimating reserves or resources is called deterministic when a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation is used in the reserves estimation procedure.

(6) Developed oil and gas reserves. Developed oil and gas reserves are reserves of any category that can be expected to be recovered:

(i) Through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and

(ii) Through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well.

* * * * *

(8) Development project. A development project is the means by which petroleum resources are brought to the status of economically producible. As examples, the development of a single reservoir or field, an incremental development in a producing field, or the integrated development of a group of several fields and associated facilities with a common ownership may constitute a development project.

* * * * *

(10) Economically producible. The term economically producible, as it relates to a resource, means a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation. The value of the products that generate

revenue shall be determined at the terminal point of oil and gas producing activities as defined in paragraph (a)(16) of this section.

(11) Estimated ultimate recovery (EUR). Estimated ultimate recovery is the sum of reserves remaining as of a given date and cumulative production as of that date.

* * * * *

(13) Exploratory well. An exploratory well is a well drilled to find a new field or to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir. Generally, an exploratory well is any well that is not a development well, an extension well, a service well, or a stratigraphic test well as those items are defined in this section.

(14) Extension well. An extension well is a well drilled to extend the limits of a known reservoir.

* * * * *

(16) Oil and gas producing activities. (i) Oil and gas producing activities include:

(A) The search for crude oil, including condensate and natural gas liquids, or natural gas ("oil and gas") in their natural states and original locations;

(B) The acquisition of property rights or properties for the purpose of further exploration or for the purpose of removing the oil or gas from such properties;

(C) The construction, drilling, and production activities necessary to retrieve oil and gas from their natural reservoirs, including the acquisition, construction, installation, and maintenance of field gathering and storage systems, such as:

(1) Lifting the oil and gas to the surface; and

(2) Gathering, treating, and field processing (as in the case of processing gas to extract liquid hydrocarbons); and

(D) Extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.

Instruction 1 to paragraph (a)(16)(i): The oil and gas production function shall be regarded as ending at a "terminal point", which is the outlet valve on the lease or field storage tank. If unusual physical or operational circumstances exist, it may be appropriate to regard the terminal point for the production function as:

a. The first point at which oil, gas, or gas liquids, natural or synthetic, are delivered to a main pipeline, a common carrier, a refinery, or a marine terminal; and

b. In the case of natural resources that are intended to be upgraded into synthetic oil or gas, if those natural resources are delivered to a purchaser prior to upgrading, the first point at which the natural resources are delivered to a main pipeline, a common carrier, a refinery, a marine terminal, or a facility which upgrades such natural resources into synthetic oil or gas.

Instruction 2 to paragraph (a)(16)(i): For purposes of this paragraph (a)(16), the term saleable hydrocarbons means hydrocarbons that are saleable in the state in which the hydrocarbons are delivered.

(ii) Oil and gas producing activities do not include:

(A) Transporting, refining, or marketing oil and gas;

(B) Processing of produced oil, gas or natural resources that can be upgraded into synthetic oil or gas by a registrant that does not have the legal right to produce or a revenue interest in such production;

(C) Activities relating to the production of natural resources other than oil, gas, or natural resources from which synthetic oil and gas can be extracted; or

(D) Production of geothermal steam.

(17) Possible reserves. Possible reserves are those additional reserves that are less certain to be recovered than probable reserves.

(i) When deterministic methods are used, the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves. When probabilistic methods are used, there should be at least a 10% probability that the total quantities ultimately recovered will equal or exceed the proved plus probable plus possible reserves estimates.

(ii) Possible reserves may be assigned to areas of a reservoir adjacent to probable reserves where data control and interpretations of available data are progressively less certain. Frequently, this will be in areas where geoscience and engineering data are unable to define clearly the area and vertical limits of commercial production from the reservoir by a defined project.

(iii) Possible reserves also include incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than the recovery quantities assumed for probable reserves.

(iv) The proved plus probable and proved plus probable plus possible reserves estimates must be based on reasonable alternative technical and commercial

interpretations within the reservoir or subject project that are clearly documented, including comparisons to results in successful similar projects.

(v) Possible reserves may be assigned where geoscience and engineering data identify directly adjacent portions of a reservoir within the same accumulation that may be separated from proved areas by faults with displacement less than formation thickness or other geological discontinuities and that have not been penetrated by a wellbore, and the registrant believes that such adjacent portions are in communication with the known (proved) reservoir. Possible reserves may be assigned to areas that are structurally higher or lower than the proved area if these areas are in communication with the proved reservoir.

(vi) Pursuant to paragraph (a)(22)(iii) of this section, where direct observation has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves should be assigned in the structurally higher portions of the reservoir above the HKO only if the higher contact can be established with reasonable certainty through reliable technology. Portions of the reservoir that do not meet this reasonable certainty criterion may be assigned as probable and possible oil or gas based on reservoir fluid properties and pressure gradient interpretations.

(18) Probable reserves. Probable reserves are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered.

(i) When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there should be at least a 50% probability

that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.

(ii) Probable reserves may be assigned to areas of a reservoir adjacent to proved reserves where data control or interpretations of available data are less certain, even if the interpreted reservoir continuity of structure or productivity does not meet the reasonable certainty criterion. Probable reserves may be assigned to areas that are structurally higher than the proved area if these areas are in communication with the proved reservoir.

(iii) Probable reserves estimates also include potential incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than assumed for proved reserves.

(iv) See also guidelines in paragraphs (a)(17)(iv) and (a)(17)(vi) of this section.

(19) Probabilistic estimate. The method of estimation of reserves or resources is called probabilistic when the full range of values that could reasonably occur for each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.

* * * * *

(22) Proved oil and gas reserves. Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the

right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time.

(i) The area of the reservoir considered as proved includes:

(A) The area identified by drilling and limited by fluid contacts, if any, and

(B) Adjacent undrilled portions of the reservoir that can, with reasonable certainty, be judged to be continuous with it and to contain economically producible oil or gas on the basis of available geoscience and engineering data.

(ii) In the absence of data on fluid contacts, proved quantities in a reservoir are limited by the lowest known hydrocarbons (LKH) as seen in a well penetration unless geoscience, engineering, or performance data and reliable technology establishes a lower contact with reasonable certainty.

(iii) Where direct observation from well penetrations has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves may be assigned in the structurally higher portions of the reservoir only if geoscience, engineering, or performance data and reliable technology establish the higher contact with reasonable certainty.

(iv) Reserves which can be produced economically through application of improved recovery techniques (including, but not limited to, fluid injection) are included in the proved classification when:

(A) Successful testing by a pilot project in an area of the reservoir with properties no more favorable than in the reservoir as a whole, the operation of an installed

program in the reservoir or an analogous reservoir, or other evidence using reliable technology establishes the reasonable certainty of the engineering analysis on which the project or program was based; and

(B) The project has been approved for development by all necessary parties and entities, including governmental entities.

(v) Existing economic conditions include prices and costs at which economic producibility from a reservoir is to be determined. The price shall be the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.

* * * * *

(24) Reasonable certainty. If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate. A high degree of confidence exists if the quantity is much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease.

(25) Reliable technology. Reliable technology is a grouping of one or more technologies (including computational methods) that has been field tested and has been

demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in an analogous formation.

(26) Reserves. Reserves are estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.

Note to paragraph (a)(26): Reserves should not be assigned to adjacent reservoirs isolated by major, potentially sealing, faults until those reservoirs are penetrated and evaluated as economically producible. Reserves should not be assigned to areas that are clearly separated from a known accumulation by a non-productive reservoir (i.e., absence of reservoir, structurally low reservoir, or negative test results). Such areas may contain prospective resources (i.e., potentially recoverable resources from undiscovered accumulations).

* * * * *

(28) Resources. Resources are quantities of oil and gas estimated to exist in naturally occurring accumulations. A portion of the resources may be estimated to be recoverable, and another portion may be considered to be unrecoverable. Resources include both discovered and undiscovered accumulations.

* * * * *

(30) Stratigraphic test well. A stratigraphic test well is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. Such wells customarily are drilled without the intent of being completed for hydrocarbon production. The classification also includes tests identified as core tests and all types of expendable holes related to hydrocarbon exploration. Stratigraphic tests are classified as "exploratory type" if not drilled in a known area or "development type" if drilled in a known area.

(31) Undeveloped oil and gas reserves. Undeveloped oil and gas reserves are reserves of any category that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

(i) Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances.

(ii) Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time.

(iii) Under no circumstances shall estimates for undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir, as defined in paragraph

(a)(2) of this section, or by other evidence using reliable technology establishing reasonable certainty.

* * * * *

(c) * * *

(8) For purposes of this paragraph (c), the term “current price” shall mean the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.

* * * * *

PART 211—INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

3. Amend Part 211, subpart A, by adding “Modernization of Oil and Gas Reporting,” Release No. FR-78 and the release date of December 31, 2008, to the list of interpretive releases.

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S-K

4. The authority citation for part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

5. Amend § 229.102 by revising the introductory text of Instruction 3 and Instructions 4, 5 and 8 to read as follows.

§ 229.102 (Item 102) Description of property.

* * * * *

Instructions to Item 102: * * *

3. In the case of an extractive enterprise, not involved in oil and gas producing activities, material information shall be given as to production, reserves, locations, development, and the nature of the registrant's interest. If individual properties are of major significance to an industry segment:

* * * * *

4. A registrant engaged in oil and gas producing activities shall provide the information required by Subpart 1200 of Regulation S-K.

5. In the case of extractive reserves other than oil and gas reserves, estimates other than proven or probable reserves (and any estimated values of such reserves) shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant, or otherwise to acquire the registrant's securities, such estimates may be included in documents relating to such acquisition.

* * * * *

8. The attention of certain issuers engaged in oil and gas producing activities is directed to the information called for in Securities Act Industry Guide 4 (referred to in §229.801(d)).

* * * * *

6. Amend § 229.801 by removing and reserving paragraph (b) and removing the authority citation following the section.

7. Amend § 229.802 by removing and reserving paragraph (b) and removing the authority citation following the section.

8. Add Subpart 229.1200 to read as follows:

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

Sec.

229.1201 (Item 1201) General instructions to oil and gas industry-specific disclosures.

229.1202 (Item 1202) Disclosure of reserves.

229.1203 (Item 1203) Proved undeveloped reserves.

229.1204 (Item 1204) Oil and gas production, production prices and production costs.

229.1205 (Item 1205) Drilling and other exploratory and development activities.

229.1206 (Item 1206) Present activities.

229.1207 (Item 1207) Delivery commitments.

229.1208 (Item 1208) Oil and gas properties, wells, operations, and acreage.

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

§ 229.1201 (Item 1201) General instructions to oil and gas industry-specific disclosures.

(a) If oil and gas producing activities are material to the registrant's or its subsidiaries' business operations or financial position, the disclosure specified in this Subpart 229.1200 should be included under appropriate captions (with cross references, where applicable, to related information disclosed in financial statements). However, limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water, need not include such disclosure.

(b) To the extent that Items 1202 through 1208 (§§ 229.1202 – 229.1208) call for disclosures in tabular format, as specified in the particular Item, a registrant may modify such format for ease of presentation, to add information or to combine two or more required tables.

(c) The definitions in Rule 4–10(a) of Regulation S-X (17 CFR 210.4-10(a)) shall apply for purposes of this Subpart 229.1200.

(d) For purposes of this Subpart 229.1200, the term by geographic area means, as appropriate for meaningful disclosure in the circumstances:

- (1) By individual country;
- (2) By groups of countries within a continent; or
- (3) By continent.

§ 229.1202 (Item 1202) Disclosure of reserves.

(a) Summary of oil and gas reserves at fiscal year end. (1) Provide the information specified in paragraph (a)(2) of this Item in tabular format as provided below:

**Summary of Oil and Gas Reserves as of Fiscal-Year End
Based on Average Fiscal-Year Prices**

	Reserves				
	Oil	Natural Gas	Synthetic Oil	Synthetic Gas	Product A
Reserves category	(mbbls)	(mmcf)	(mbbls)	(mmcf)	(measure)
PROVED					
Developed					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
Undeveloped					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
TOTAL PROVED					
PROBABLE					
Developed					
Undeveloped					
POSSIBLE					
Developed					
Undeveloped					

(2) Disclose, in the aggregate and by geographic area and for each country containing 15% or more of the registrant's proved reserves, expressed on an oil-equivalent-barrels basis, reserves estimated using prices and costs under existing economic conditions, for the product types listed in paragraph (a)(4) of this Item, in the following categories:

- (i) Proved developed reserves;
- (ii) Proved undeveloped reserves;
- (iii) Total proved reserves;
- (iv) Probable developed reserves (optional);
- (v) Probable undeveloped reserves (optional);

- (vi) Possible developed reserves (optional); and
- (vii) Possible undeveloped reserves (optional).

Instruction 1 to paragraph (a)(2): Disclose updated reserves tables as of the close of each fiscal year.

Instruction 2 to paragraph (a)(2): The registrant is permitted, but not required, to disclose probable or possible reserves pursuant to paragraphs (a)(2)(iv) through (a)(2)(vii) of this Item.

Instruction 3 to paragraph (a)(2): If the registrant discloses amounts of a product in barrels of oil equivalent, disclose the basis for such equivalency.

Instruction 4 to paragraph (a)(2): A registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure of reserves in that country. In addition, a registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.

(3) Reported total reserves shall be simple arithmetic sums of all estimates for individual properties or fields within each reserves category. When probabilistic methods are used, reserves should not be aggregated probabilistically beyond the field or property level; instead, they should be aggregated by simple arithmetic summation.

- (4) Disclose separately material reserves of the following product types:
 - (i) Oil;
 - (ii) Natural gas;

(iii) Synthetic oil;

(iv) Synthetic gas; and

(v) Sales products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and gas.

(5) If the registrant discloses probable or possible reserves, discuss the uncertainty related to such reserves estimates.

(6) If the registrant has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to its reserves estimates, the registrant shall provide a general discussion of the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. The particular properties do not need to be identified.

(7) Preparation of reserves estimates or reserves audit. Disclose and describe the internal controls the registrant uses in its reserves estimation effort. In addition, disclose the qualifications of the technical person primarily responsible for overseeing the preparation of the reserves estimates and, if the registrant represents that a third party conducted a reserves audit, disclose the qualifications of the technical person primarily responsible for overseeing such reserves audit.

(8) Third party reports. If the registrant represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review, the registrant shall file a report of the third party as an exhibit to the relevant registration statement or other Commission filing. If the report relates to the preparation of, or a reserves audit of, the registrant's reserves estimates, it must include the following disclosure, if applicable to the type of filing:

- (i) The purpose for which the report was prepared and for whom it was prepared;
 - (ii) The effective date of the report and the date on which the report was completed;
 - (iii) The proportion of the registrant's total reserves covered by the report and the geographic area in which the covered reserves are located;
 - (iv) The assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
 - (v) A discussion of primary economic assumptions;
 - (vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
 - (vii) A discussion regarding the inherent uncertainties of reserves estimates;
 - (viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;
 - (ix) A brief summary of the third party's conclusions with respect to the reserves estimates; and
 - (x) The signature of the third party.
- (9) For purposes of this Item 1202, the term reserves audit means the process of reviewing certain of the pertinent facts interpreted and assumptions underlying a reserves estimate prepared by another party and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data

relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities.

(b) Reserves sensitivity analysis (optional). (1) The registrant may, but is not required to, provide the information specified in paragraph (b)(2) of this Item in tabular format as provided below:

**Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario**

Price Case	Proved Reserves					Probable Reserves					Possible Reserves				
	Oil	Gas	Syn. Oil	Syn. Gas	Product A	Oil	Gas	Syn. Oil	Syn. Gas	Product A	Oil	Gas	Syn. Oil	Syn. Gas	Product A
	mbbls	mmcf	mbbls	mmcf	measure	mbbls	mmcf	mbbls	mmcf	measure	mbbls	mmcf	mbbls	mmcf	measure
Scenario 1															
Scenario 2															

(2) The registrant may, but is not required to, disclose, in the aggregate, an estimate of reserves estimated for each product type based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts.

(3) If the registrant provides disclosure under this paragraph (b), disclose the price and cost schedules and assumptions on which the disclosed values are based.

Instruction to Item 1202: Estimates of oil or gas resources other than reserves, and any estimated values of such resources, shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant or otherwise to acquire the registrant's securities, such estimate may be included in documents related to such acquisition.

§ 229.1203 (Item 1203) Proved undeveloped reserves.

- (a) Disclose the total quantity of proved undeveloped reserves at year end.
- (b) Disclose material changes in proved undeveloped reserves that occurred during the year, including proved undeveloped reserves converted into proved developed reserves.
- (c) Discuss investments and progress made during the year to convert proved undeveloped reserves to proved developed reserves, including, but not limited to, capital expenditures.
- (d) Explain the reasons why material amounts of proved undeveloped reserves in individual fields or countries remain undeveloped for five years or more after disclosure as proved undeveloped reserves.

§ 229.1204 (Item 1204) Oil and gas production, production prices and production costs.

- (a) For each of the last three fiscal years disclose production, by final product sold, of oil, gas, and other products. Disclosure shall be made by geographical area and for each country and field that contains 15% or more of the registrant's total proved reserves expressed on an oil-equivalent-barrels basis unless prohibited by the country in which the reserves are located.
- (b) For each of the last three fiscal years disclose, by geographical area:
 - (1) The average sales price (including transfers) per unit of oil, gas and other products produced; and
 - (2) The average production cost, not including ad valorem and severance taxes, per unit of production.

Instruction 1 to Item 1204: Generally, net production should include only production that is owned by the registrant and produced to its interest, less royalties and production due others. However, in special situations (e.g., foreign production) net production before any royalties may be provided, if more appropriate. If “net before royalty” production figures are furnished, the change from the usage of “net production” should be noted.

Instruction 2 to Item 1204: Production of natural gas should include only marketable production of natural gas on an “as sold” basis. Production will include dry, residue, and wet gas, depending on whether liquids have been extracted before the registrant transfers title. Flared gas, injected gas, and gas consumed in operations should be omitted. Recovered gas-lift gas and reproduced gas should not be included until sold. Synthetic gas, when marketed as such, should be included in natural gas sales.

Instruction 3 to Item 1204: If any product, such as bitumen, is sold or custody is transferred prior to conversion to synthetic oil or gas, the product’s production, transfer prices, and production costs should be disclosed separately from all other products.

Instruction 4 to Item 1204: The transfer price of oil and gas (natural and synthetic) produced should be determined in accordance with SFAS 69.

Instruction 5 to Item 1204: The average production cost, not including ad valorem and severance taxes, per unit of production should be computed using production costs disclosed pursuant to SFAS 69. Units of production should be expressed in common units of production with oil, gas, and other products converted to a common unit of measure on the basis used in computing amortization.

§ 229.1205 (Item 1205) Drilling and other exploratory and development activities.

(a) For each of the last three fiscal years, by geographical area, disclose:

(1) The number of net productive and dry exploratory wells drilled; and

(2) The number of net productive and dry development wells drilled.

(b) Definitions. For purposes of this Item 1205, the following terms shall be defined as follows:

(1) A dry well is an exploratory, development, or extension well that proves to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.

(2) A productive well is an exploratory, development, or extension well that is not a dry well.

(3) Completion refers to installation of permanent equipment for production of oil or gas, or, in the case of a dry well, to reporting to the appropriate authority that the well has been abandoned.

(4) The number of wells drilled refers to the number of wells completed at any time during the fiscal year, regardless of when drilling was initiated.

(c) Disclose, by geographic area, for each of the last three years, any other exploratory or development activities conducted, including implementation of mining methods for purposes of oil and gas producing activities.

§ 229.1206 (Item 1206) Present activities.

(a) Disclose, by geographical area, the registrant's present activities, such as the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed, pressure maintenance operations, and any other related activities of material importance.

(b) Provide the description of present activities as of a date at the end of the most recent fiscal year or as close to the date that the registrant files the document as reasonably possible.

(c) Include only those wells in the process of being drilled at the "as of" date and express them in terms of both gross and net wells.

(d) Do not include wells that the registrant plans to drill, but has not commenced drilling unless there are factors that make such information material.

§ 229.1207 (Item 1207) Delivery commitments.

(a) If the registrant is committed to provide a fixed and determinable quantity of oil or gas in the near future under existing contracts or agreements, disclose material information concerning the estimated availability of oil and gas from any principal sources, including the following:

(1) The principal sources of oil and gas that the registrant will rely upon and the total amounts that the registrant expects to receive from each principal source and from all sources combined;

(2) The total quantities of oil and gas that are subject to delivery commitments; and

(3) The steps that the registrant has taken to ensure that available reserves and supplies are sufficient to meet such commitments for the next one to three years.

(b) Disclose the information required by this Item:

(1) In a form understandable to investors; and

(2) Based upon the facts and circumstances of the particular situation, including, but not limited to:

- (i) Disclosure by geographic area;
 - (ii) Significant supplies dedicated or contracted to the registrant;
 - (iii) Any significant reserves or supplies subject to priorities or curtailments which may affect quantities delivered to certain classes of customers, such as customers receiving services under low priority and interruptible contracts;
 - (iv) Any priority allocations or price limitations imposed by Federal or State regulatory agencies, as well as other factors beyond the registrant's control that may affect the registrant's ability to meet its contractual obligations (the registrant need not provide detailed discussions of price regulation);
 - (v) Any other factors beyond the registrant's control, such as other parties having control over drilling new wells, competition for the acquisition of reserves and supplies, and the availability of foreign reserves and supplies, which may affect the registrant's ability to acquire additional reserves and supplies or to maintain or increase the availability of reserves and supplies; and
 - (vi) Any impact on the registrant's earnings and financing needs resulting from its inability to meet short-term or long-term contractual obligations. (See Items 303 and 1209 of Regulation S-K (§§ 229.303 and 229.1209).)
- (c) If the registrant has been unable to meet any significant delivery commitments in the last three years, describe the circumstances concerning such events and their impact on the registrant.
- (d) For purposes of this Item, available reserves are estimates of the amounts of oil and gas which the registrant can produce from current proved developed reserves using presently installed equipment under existing economic and operating conditions

and an estimate of amounts that others can deliver to the registrant under long-term contracts or agreements on a per-day, per-month, or per-year basis.

§ 229.1208 (Item 1208) Oil and gas properties, wells, operations, and acreage.

(a) Disclose, as of a reasonably current date or as of the end of the fiscal year, the total gross and net productive wells, expressed separately for oil and gas (including synthetic oil and gas produced through wells) and the total gross and net developed acreage (i.e., acreage assignable to productive wells) by geographic area.

(b) Disclose, as of a reasonably current date or as of the end of the fiscal year, the amount of undeveloped acreage, both leases and concessions, if any, expressed in both gross and net acres by geographic area, together with an indication of acreage concentrations, and, if material, the minimum remaining terms of leases and concessions.

(c) Definitions. For purposes of this Item 1208, the following terms shall be defined as indicated:

(1) A gross well or acre is a well or acre in which the registrant owns a working interest. The number of gross wells is the total number of wells in which the registrant owns a working interest. Count one or more completions in the same bore hole as one well. In a footnote, disclose the number of wells with multiple completions. If one of the multiple completions in a well is an oil completion, classify the well as an oil well.

(2) A net well or acre is deemed to exist when the sum of fractional ownership working interests in gross wells or acres equals one. The number of net wells or acres is the sum of the fractional working interests owned in gross wells or acres expressed as whole numbers and fractions of whole numbers.

(3) Productive wells include producing wells and wells mechanically capable of production.

(4) Undeveloped acreage encompasses those leased acres on which wells have not been drilled or completed to a point that would permit the production of economic quantities of oil or gas regardless of whether such acreage contains proved reserves. Do not confuse undeveloped acreage with undrilled acreage held by production under the terms of the lease.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

9. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

10. Amend Form 20-F (referenced in §249.220f) by:

- a. Revising “Instruction to Item 4” and the introductory text and paragraph (b) of “Instructions to Item 4.D”; and
- b. Removing paragraph (c) of “Instructions to Item 4.D” and “Appendix A to Item 4.D—Oil and Gas.”

The revisions read as follows:

[Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.]

FORM 20-F

* * * * *

Item 4. Information on the Company

* * * * *

Instructions to Item 4:

1. Furnish the information specified in any industry guide listed in Subpart 229.800 of Regulation S-K (§229.801 et seq. of this chapter) that applies to you.
2. If oil and gas operations are material to you or your subsidiaries' business operations or financial position, provide the information specified in Subpart 1200 of Regulation S-K (§229.1200 et seq. of this chapter).

* * * * *

Instruction to Item 4.D: In the case of an extractive enterprise, other than an oil and gas producing activity:

* * * * *

(b) In documents that you file publicly with the Commission, do not disclose estimates of reserves unless the reserves are proven or probable and do not give estimated values of those reserves, unless foreign law requires you to disclose the information. If these types of estimates have already been provided to any person that is offering to acquire you, however, you may include the estimates in documents relating to the acquisition.

* * * * *

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

December 31, 2008

*Commissioner Paredes
not participating*

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 211, 229, and 249

[Release Nos. 33-8995; 34-59192; FR-78; File No. S7-15-08]

RIN 3235-AK00

MODERNIZATION OF OIL AND GAS REPORTING

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; interpretation; request for comment on Paperwork Reduction Act burden estimates.

SUMMARY: The Commission is adopting revisions to its oil and gas reporting disclosures which exist in their current form in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2. The revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves, which should help investors evaluate the relative value of oil and gas companies. In the three decades that have passed since adoption of these disclosure items, there have been significant changes in the oil and gas industry. The amendments are designed to modernize and update the oil and gas disclosure requirements to align them with current practices and changes in technology. The amendments concurrently align the full cost accounting rules with the revised disclosures. The amendments also codify and revise Industry Guide 2 in Regulation S-K. In addition, they harmonize oil and gas disclosures by foreign private issuers with the disclosures for domestic issuers.

DATES: Effective Date: January 1, 2010.

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Comment Date: Comments on the Paperwork Reduction Act Analysis should be received on or before [insert 30 days after date of publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-08 on the subject line; or
- Use the Federal e-Rulemaking Portal <http://www.regulations.gov>. Follow the instructions for submitting comments.

Paper comments:

- Send paper submissions in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-15-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/concept.shtml>). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Ray Be, Special Counsel, Office of Chief Counsel at (202) 551-3500; Dr. W. John Lee, Academic Petroleum Engineering Fellow, or Brad Skinner, Senior Assistant Chief Accountant, Office of Natural Resources and Food at (202) 551-3740; Leslie Overton, Associate Chief Accountant, Office of Chief Accountant for the Division of Corporation Finance at (202) 551-3400, Division of Corporation Finance; or Mark Mahar, Associate Chief Accountant, Jonathan Duersch, Assistant Chief Accountant, or Doug Parker, Professional Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTAL INFORMATION: We are adopting amendments to Rule 4-10¹ of Regulation S-X² and Items 102, 801 and 802³ of Regulation S-K.⁴ We also are adding new Subpart 1200, including Items 1201 through 1208, to Regulation S-K.

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¹ 17 CFR 210.4-10.

² 17 CFR 210.

³ 17 CFR 229.102, 17 CFR 229.801, and 17 CFR 229.802.

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I. Introduction

A. Background

On June 26, 2008, the Commission issued a proposing release (Proposing Release) seeking public comment on proposed amendments to the disclosure requirements regarding oil and gas companies.⁵ These proposals encompassed issues that were previously addressed more generally in a concept release that the Commission issued on December 12, 2007 (Concept Release),⁶ which solicited comment on possible revisions to the oil and gas reserves disclosure requirements specified in Rule 4-10 of Regulation S-X⁷ and Item 102 of Regulation S-K.⁸ The Proposing Release also contained proposals not addressed by the Concept Release related to the updating and codification of Industry Guide 2.

⁵ Release No. 33-8935 (June 27, 2008) [73 FR 39181].

⁶ Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

⁷ 17 CFR 210.4-10. See Release No. 33-6233 (Sept. 25, 1980) [45 FR 63660] (adopting amendments to Regulation S-X, including Rule 4-10). The precursor to Rule 4-10 was Rule 3-18 of Regulation S-X, which was adopted in 1978. See Accounting Series Release No. 253 (Aug. 31, 1978) [43 FR 40688]. See also Accounting Series Release No. 257 (Dec. 19, 1978) [43 FR 60404] (further amending Rule 3-18 of Regulation S-X and revising the definition of proved reserves).

⁸ Item 102 of Regulation S-K [17 CFR 229.102]. In 1982, the Commission adopted Item 102 of Regulation S-K. Item 102 contains the disclosure requirements previously located in Item 2 of Regulation S-K. See Release No. 33-6383 (March 16, 1982) [47 FR 11380]. The Commission also "recast . . . the disclosure requirements for oil and gas operations, formerly contained in Item 2(b) of Regulation S-K, as an industry guide." See Release No. 33-6384 (Mar. 16, 1982) [47 FR 11476].

We initially adopted our oil and gas disclosure requirements in 1978 and 1982.⁹ Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital.¹⁰ Prior to our issuance of the Concept Release and the Proposing Release, many industry participants had expressed concern that our disclosure rules are no longer in alignment with current industry practices and therefore limit their usefulness to the market and investors.¹¹

B. Issuance of the Concept Release

The Concept Release addressed the potential implications for the quality, accuracy and reliability of oil and gas disclosure if the Commission were to:

- Revise the definition of “proved reserves” in our rules, in particular, the criteria used to assess and quantify resources that can be classified as proved reserves; and
- Expand the categories of resources that may be disclosed in Commission filings to include resources other than proved reserves.

⁹ The disclosure requirements were introduced pursuant to a directive in the Energy Policy and Conservation Act of 1975 (the “EPCA”). The EPCA directed the Commission to “take such steps as may be necessary to assure the development and observance of accounting practices to be followed in the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas in the United States.” See 42 U.S.C. 6201-6422.

¹⁰ See, for example, Daniel Yergin and David Hobbs: “The Search for Reasonable Certainty in Reserves Disclosure,” *Oil and Gas Journal* (July 18, 2005).

¹¹ See, for example, Greg Courturier, “Standard & Poor’s Urges SEC to Change Disclosure Rules,” *International Oil Daily* (Dec. 3, 2007); Steve Levine, “Tracking the Numbers: Oil Firms Want SEC to Loosen Reserves Rules,” *Wall Street Journal Online* (Feb. 7, 2006); Christopher Hope, “Oil Majors Back Attack on SEC Rules,” *The Daily Telegraph* (London) (Feb. 24, 2005); Barrie McKenna, “Rules undervalue reserves report says: Volumes buried in Canada’s oil sands not counted by SEC’s measure,” *The Globe & Mail* (Canada) (Feb. 24, 2005); and “Deloitte Calls on Regulators to Update Rules for Oil and Gas Reserves Reporting,” *Business Wire Inc.* (Feb. 9, 2005).

In addition, the Concept Release questioned whether our revised disclosure rules should be modeled on any particular resource classification framework currently being used within the oil and gas industry. We also asked how any revised disclosure rules could be made flexible enough to address future technological innovation and changes within the oil and gas industry. The Concept Release sought further comment on whether the Commission should require independent third-party assessments of reserves estimates that a company includes in its filings.

In response to the Concept Release, commenters submitted 80 comment letters.¹² We received comment letters from a variety of industry participants such as accounting firms, engineering consulting firms, domestic and foreign oil and gas companies, federal government agencies, individuals, law firms, professional associations, public interest groups, and rating agencies. We considered these comments and addressed many of them in issuing the Proposing Release.

C. Overview of the Comment Letters Received on the Proposing Release

The Proposing Release sought significantly more detailed comment on issues raised in the Concept Release, as well as proposed amendments to the disclosure items in our rules and Industry Guide 2. In response to the Proposing Release, we received 65 comment letters, again from a variety of constituents with interests in oil and gas industry disclosure.

Almost all commenters supported some form of revision to the current oil and gas disclosure requirements, particularly given the length of time that has elapsed since the

¹² The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F St. NE, Washington, DC 20549 in File No. S7-29-07. They are also available on-line at <http://www.sec.gov/comments/s7-29-07/s72907.shtml>.

requirements were initially adopted.¹³ Commenters provided significantly more detailed comments on the Proposing Release than on the Concept Release, which did not include specific proposed regulatory text. We discuss those comments in detail in the relevant sections of this release. However, in general, commenters focused on several key issues raised by the Proposing Release. These issues included the following:

- The proposal to permit disclosure of probable and possible reserves;
- The proposed use of average historical prices to represent existing economic conditions to determine the economic producibility of oil and gas reserves for disclosure purposes while continuing to use a single day

¹³ See letters from American Association of Petroleum Geologists ("AAPG"), American Clean Skies Foundation ("American Clean Skies"), American Petroleum Institute ("API"), AngloGold Ashanti Ltd. ("AngloGold"), Apache Corporation ("Apache"), BHP Billiton Petroleum ("BHP"), BP Plc. ("BP"), Brookwood Petroleum Advisors, Ltd. ("Brookwood"), Canadian Association of Petroleum Producers ("CAPP"), Canadian Natural Resources Ltd. ("Canadian Natural"), Center for Audit Quality ("CAQ"), Center for Corporate Policy ("CCP"), CFA Institute Centre for Financial Market Integrity ("CFA"), Chesapeake Energy Corporation ("Chesapeake"), Chevron Corporation ("Chevron"), Coeur d'Alene Mines Corporation ("Coeur"), Cunningham, Peter ("Cunningham"), Davis, Polk & Wardwell ("Davis Polk"), Deloitte & Touche ("Deloitte"), Devon Energy Corporation ("Devon"), EnCana Corporation ("EnCana"), Energen Corporation ("Energen"), Energy Information Administration (of DOE) ("EIA"), Eni S.p.A. ("Eni"), Equitable Resources, Inc. ("Equitable"), Ernst & Young ("E&Y"), Evolution Petroleum Corporation ("Evolution"), ExxonMobil Corporation ("ExxonMobil"), Federal Energy Regulatory Commission ("FERC"), Graff Consulting Group LLC ("Graff Consulting"), Grant Thornton ("Grant Thornton"), Imperial Oil Ltd. ("Imperial"), Independent Petroleum Association of America ("IPAA"), KPMG ("KPMG"), Luscher, Brian ("Luscher"), Magoto, Joseph ("Magoto"), McMoRan Exploration Co. ("McMoRan"), Newfield Exploration Company ("Newfield"), Nexen, Inc. ("Nexen"), Peabody Energy Corporation ("Peabody"), Petro-Canada ("Petro-Canada"), Petroleo Brasileiro S.A. ("Petrobras"), Petroleos Mexicanos ("PEMEX"), PRA International Ltd. ("PRA"), PriceWaterhouseCoopers ("PWC"), Questar Market Resources ("Questar"), RepsolYPF, S.A. ("Repsol"), Ross Petroleum Ltd. ("Ross"), Ryder Scott Company, L.P. ("Ryder Scott"), Sasol Ltd. ("Sasol"), Senator Robert Menendez, Senator Russell D. Feingold, and Senator Bernard Sanders, U.S. Senate ("Three Senators"), Shearman & Sterling ("Shearman & Sterling"), Shell International B.V. ("Shell"), Society of Exploration Geophysicists ("SEG"), Society of Petroleum Engineers ("SPE"), Society of Petroleum Evaluation Engineers ("SPEE"), Southwestern Energy Production Company ("Southwestern"), Standard Advantage ("Standard Advantage"), StatoilHydro ("StatoilHydro"), Swift Energy Company ("Swift"), Talisman Energy Inc. ("Talisman"), Total, S.A. ("Total"), van Wyk, Mike ("van Wyk"), Wagner, Robert ("Wagner"), Zakaib, Geoff ("Zakaib").

year-end price to determine the economic producibility of reserves for accounting purposes;

- The proposed inclusion of bitumen, oil shales, and other resources in the definition of “oil and gas producing activities”;
- The proposed provision to broaden the types of technology that a company may use to establish reserves estimates and categories;
- The proposed change in the definition of proved undeveloped reserves to eliminate the “certainty” requirement; and
- The increased detail of disclosure that would be required as a result of our proposed definition of “geographic location.”

II. Revisions and Additions to the Definition Section in Rule 4-10 of Regulation S-X

A. Introduction

The revisions and additions to the definition section in Rule 4-10(a) of Regulation S-X¹⁴ update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted. Many of the definitions are designed to be consistent with the Petroleum Resource Management System (PRMS).¹⁵ Among other things, the revisions to these definitions address four issues that have been of particular interest to companies, investors, and securities analysts:

¹⁴ 17 CFR 210.4-10(a).

¹⁵ The Petroleum Resources Management System is a widely accepted standard for the management of petroleum resources developed by several industry organizations. See Society of Petroleum Engineers, the World Petroleum Council, American Association of Petroleum Geologists, and the Society of Petroleum Evaluation Engineers, Petroleum Resources Management System, SPE/WPC/AAPG/SPEE (2007).

- The use of single-day year-end pricing to determine the economic producibility of reserves;
- The exclusion of activities related to the extraction of bitumen and other “non-traditional” resources from the definition of oil and gas producing activities;
- The limitations regarding the types of technologies that an oil and gas company may rely upon to establish the levels of certainty required to classify reserves; and
- The limitation in the current rules that permits oil and gas companies to disclose only their proved reserves.

The revisions of, and additions to, the Rule 4-10 definitions attempt to address these issues without sacrificing clarity and comparability, which provide protection and transparency to investors. In addition, to the extent appropriate, we have revised our proposals so that the final definitions are more consistent with terms and definitions in the PRMS to improve compliance and understanding of our new rules.

B. Pricing Mechanism for Oil and Gas Reserves Estimation

1. 12-month average price

The final rules define the term “proved oil and gas reserves” in part as “those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain,

regardless of whether deterministic or probabilistic methods are used for the estimation.”

The definition states that the economic producibility of a reservoir must be based on existing economic conditions. It specifies that, in calculating economic producibility, a company must use a 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.¹⁶

Most commenters supported the use of a 12-month average price to serve as a proxy for existing economic conditions to determine the economic producibility of reserves.¹⁷ Some noted that a 12-month average price is considered to reflect “current economic conditions” by PRMS.¹⁸ They noted that the use of an average price would reduce the effects of short term volatility¹⁹ and seasonality,²⁰ while maintaining comparability of disclosures among companies.²¹

Seven commenters recommended the use of first-of-the-month prices²² instead of the proposed use of end-of-the-month prices because the use of first-of-the-month prices

¹⁶ See Rule 4-10(a)(22)(v) [17 CFR 210.4-10(a)(22)(v)].

¹⁷ See letters from AngloGold, Apache, API, BHP, BP, Canadian Natural, CAPP, Chesapeake, Chevron, Devon, EIA, EnCana, Equitable, Evolution, ExxonMobil, Newfield, Nexen, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ryder Scott, Sasol, Shell, Southwestern, SPE, Total, and Wagner.

¹⁸ See letters from AngloGold, BHP, Equitable, Ryder Scott, and SPE.

¹⁹ See letters from Apache, API, BHP, BP, Canadian Natural, CAPP, Chesapeake, EIA, EnCana, Equitable, Evolution, ExxonMobil, Imperial, IPAA, Newfield, Petrobras, Petro-Canada, Repsol, Ryder Scott, SPE, Total, and Wagner.

²⁰ See letters from Apache, Canadian Natural, Devon, EnCana, Evolution, IPAA, Petro-Canada, Repsol, and Ryder Scott.

²¹ See letters from BHP, Canadian Natural, CAPP, Deloitte, Devon, IPAA, Newfield, Petro-Canada, Total, and Wagner.

²² See letters from Apache, BP, Chesapeake, Chevron, Devon, Repsol, and Shell.

would provide companies with more time to estimate their reserves²³ and they thought that these prices better reflect the actual price received under typical natural gas contracts.²⁴ Conversely, six commenters recommended the use of a 12-month daily average price²⁵ because they thought that a daily average price would be more appropriate than a monthly average price. These commenters noted that oil sales contracts often are based on daily averages.²⁶ Two commenters expressed concern that end-of-the-month prices are not representative of actual prices because commodity traders often "clear their books" at the end of the month.²⁷

One commenter opposed the use of average prices stating that, conceptually, the use of average prices is poor regulatory policy and may encourage the market to pressure standard setters to use historical average prices for financial instruments and other assets and liabilities associated with volatile markets.²⁸ It noted that volatility reflects the underlying economics of the oil and gas industry.²⁹

The objective of reserves estimation is to provide the public with comparable information about volumes, not fair value, of a company's reserves available to enable investors to compare the business prospects of different companies. The use of a 12-month average historical price to determine the economic producibility of reserves quantities increases comparability between companies' oil and gas reserve disclosures,

²³ See letters from Chesapeake, Devon, and Shell.

²⁴ See letters from Apache, Newfield, and Repsol.

²⁵ See letters from Canadian Natural, CAPP, EnCana, Nexen, Petro-Canada, and Repsol.

²⁶ See letter from Newfield.

²⁷ See letters from Apache and Shell.

²⁸ See letter from CFA.

²⁹ See letter from CFA.

while mitigating any additional variability that a single-day price may have on reserve estimates. Although oil and gas prices themselves are subject to market-based volatility, the estimation of reserves quantities based on any historical price assumption determines those reserves quantities as if the oil or gas already has been produced, even though they have not, and these measures do not attempt to portray a reflection of their fair value. If the objective of reserve disclosures were to provide fair value information, we believe a pricing system that incorporates assumptions about estimated future market prices and costs related to extraction could be a more appropriate basis for estimation.

In order to provide disclosures which are more consistent with the objective of comparability, the amendments state that the existing economic conditions for determining the economic producibility of oil and gas reserves include the 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period.³⁰ For example, a company with a reporting year end of December 31 would determine its reserves estimates for its annual report based on the average of the prices for oil or gas on the first day of every month from January through December. Therefore, the use of a 12-month average price provides companies with the ability to efficiently prepare useful reserve information without sacrificing the objective of comparability. We believe that the revised definition of the term "proved oil and gas reserves" will provide investors with improved reserves information thereby enhancing their ability to analyze the disclosures.

³⁰ See new Rule 4-10(a)(22)(v) of Regulation S-X [17 CFR 210.4-10(a)(22)(v)].

2. Prices used for disclosure and accounting purposes

A proposal that resulted in significant comment was the use of a 12-month average price to estimate reserves for disclosure purposes, but a single-day, year-end price for accounting purposes.³¹ All commenters addressing the issue of using different prices to determine reserves for disclosure and accounting opposed the proposal.³² We are not adopting this aspect of the proposal. Instead, we are revising both our disclosure rules and our full-cost accounting rules related to oil and gas reserves to use a single price based on a 12-month average.³³ We also will continue to communicate with the FASB staff to align their accounting standards with these rules.

Commenters pointed out that the use of two different prices for disclosure and accounting purposes could:

- Confuse investors and other users of financial statements.³⁴
- Create misleading information,³⁵

³¹ Currently, companies use a single-day, year-end price to determine the quantity of its proved reserves. From an accounting perspective, the quantity of those reserves, while not included on the balance sheet, is used to determine the depreciation, depletion and amortization of certain capitalized costs included on the balance sheet. If the final rule retained a single-day, year-end price for determining reserves for accounting purposes (i.e., for determining depreciation, depletion and amortization), then companies would effectively be required to calculate reserves twice, using two different pricing assumptions—once for disclosure purposes and once for accounting purposes. Similarly, under the full cost rules, the full cost ceiling test, as described in Section III of this release, would have similar implications.

³² See letters from Apache, API, Audit Quality, BHP, BP, Canadian Natural, CAPP, CFA, Chesapeake, Chevron, Deloitte, Devon, E&Y, EnCana, Energen, Eni, Equitable, Evolution, ExxonMobil, Grant Thornton, Imperial, KPMG, McMoran, Newfield, Nexen, PEMEX, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ross, Ryder Scott, Sasol, Shell, Southwestern, SPEE, StatoilHydro, Swift, Talisman, Total, and Wagner.

³³ See Rule 4-10.

³⁴ See letters from Audit Quality, BHP, Canadian Natural, CAPP, Chesapeake, Deloitte, Devon, Evolution, ExxonMobil, Imperial, Newfield, Nexen, Petrobras, Petro-Canada, PWC, Questar, Repsol, Ryder Scott, Shell, Swift, Talisman, Total, and Wagner.

³⁵ See letters from BP, CFA, Devon, Eni, Nexen, Repsol, and Wagner.

- Harm comparability;³⁶
- Decrease transparency;³⁷
- Increase costs and burden significantly;³⁸
- Increase the complexity of disclosures;³⁹
- Double record-keeping burden;⁴⁰
- Require more disclosure to explain the differences in reserves estimates; and⁴¹
- Break the connection between disclosures and accounting.⁴²

Some commenters noted that the disclosure and accounting rules and guidance do not use a different pricing method in other situations.⁴³ In addition, several commenters believed that changing to the use of an average price to estimate proved reserves would have a minimal impact on depreciation and net income.⁴⁴ We believe that changing the rules to use a 12-month average price in reserves estimations is not inconsistent with the principles and objectives of financial reporting in authoritative accounting guidance.

³⁶ See letters from Apache, Canadian Natural, CAPP, Questar, StatoilHydro, and Wagner.

³⁷ See letters from Canadian Natural, CAPP, ExxonMobil, Shell, Swift, and Wagner.

³⁸ See letters from Apache, Audit Quality, BHP, Canadian Natural, CAPP, Chevron, Deloitte, Devon, Eni, Equitable, Evolution, ExxonMobil, Imperial, McMoRan, Newfield, Nexen, Petrobras, Questar, Petro-Canada, PWC, Ryder Scott, Shell, Swift, Total, and Wagner.

³⁹ See letters from CAPP, CFA, and Devon.

⁴⁰ See letters from Apache, Chesapeake, Eni, Equitable, and Imperial.

⁴¹ See letters from CAPP, Devon, Eni, ExxonMobil, Imperial, and Wagner.

⁴² See letters from Apache, Audit Quality, CAPP, CFA, Deloitte, E&Y, Energen, Eni, ExxonMobil, Imperial, KPMG, Newfield, PWC, Repsol, and Total.

⁴³ See letters from API, CAPP, and Shell.

⁴⁴ See letters from API, Canadian Natural, EnCana, ExxonMobil, and Total.

With respect to accounting pronouncements that currently make reference to a single-day pricing regime with respect to oil and gas reserves, we are communicating with the FASB staff to align the standards used in its pronouncements with the 12-month average price used in our new rules, as several commenters recommended.⁴⁵ As discussed in more detail below, we are adopting a compliance date that will provide sufficient time to coordinate such activities with the FASB. However, as we discuss our revisions with the FASB, we will consider whether to delay the compliance date further.

3. Alternate pricing schemes

Some commenters on the Proposing Release believed that oil and gas futures prices, or management's forecast of future prices, would better represent the value of the reserves⁴⁶ and be better aligned with fair value of the reserves.⁴⁷ They indicated that management uses futures prices, not historical prices, in its planning and day-to-day decision making.⁴⁸ They suggested that the use of futures prices, combined with disclosure of how management made the estimates, would provide greater transparency⁴⁹ and comparability of disclosure.⁵⁰ One noted that historical prices have little to do with a company's future investments and values.⁵¹ Another commenter noted that differentials can be calculated through established accounting procedures under SFAS 157.⁵²

⁴⁵ See letters from Apache, BHP, Canadian Natural, CAPP, CFA, Deloitte, McMoRan, Newfield, Nexen, Questar, Southwestern, Talisman, and Total.

⁴⁶ See letters from CFA, Deloitte, Grant Thornton, and McMoRan.

⁴⁷ See letters from CFA and Deloitte.

⁴⁸ See letters from CFA, Grant Thornton, and McMoRan.

⁴⁹ See letter from Deloitte.

⁵⁰ See letters from Deloitte and McMoRan.

⁵¹ See letter from McMoRan.

⁵² See letter from CFA.

However, other commenters argued that futures prices are not available for all reserves locations⁵³ and that applying differentials to prices would require subjective estimates and reduce comparability among companies.⁵⁴ Two commenters noted that standard prices are not consistently available in some geographic regions.⁵⁵ Similarly, two commenters were concerned that futures price estimates would have to be accompanied by estimates of future costs, which they thought would be very subjective and not comparable for determining future economic conditions.⁵⁶ One commenter asserted that the use of future prices would require companies to document assumptions about future costs, or else the disclosure would be very inconsistent among reporting companies.⁵⁷ Three commenters believed that futures prices are more subject to market perceptions than market realities and are seldom used in actual physical trading of oil and gas.⁵⁸

We share the concerns of many of these commenters that determinations of expected future prices could require significant estimations which could fall into a wide, albeit reasonable, range. For example, in many situations and parts of the world, natural gas is sold through longer term contracts where observable market inputs are not widely available. As a result, there could be less comparability among different companies depending on their assumptions, which are inherent in determining futures prices.

⁵³ See letters from ExxonMobil and Wagner.

⁵⁴ See letters from EnCana, Evolution, ExxonMobil, Newfield, Ryder Scott, and Total.

⁵⁵ See letters from Ryder Scott and Total.

⁵⁶ See letters from SPE and Total.

⁵⁷ See letter from SPE.

⁵⁸ See letters from Evolution, Ryder Scott, and Wagner.

Difference in assumptions between companies could reduce the comparability of reserves information between those companies.

We believe that the purpose of disclosing reserves estimates is to provide investors with information that is both meaningful and comparable. The reserves estimates in our disclosure rules, however, are not designed to be, nor are they intended to represent, an estimation of the fair market value of the reserves. Rather, the reserves disclosures are intended to provide investors with an indication of the relative quantity of reserves that is likely to be extracted in the future using a methodology that minimizes the use of non-reserves-specific variables. By eliminating assumptions underlying the pricing variable, as any historical pricing method would do, investors are able to compare reserves estimates where the differences are driven primarily by reserves-specific information, such as the location of the reserves and the grade of the underlying resource. We recognize that energy markets are continuing to develop. Therefore, we are not adopting a rule that requires companies to use futures prices to estimate reserves at this time.

4. Time period over which the average price is to be calculated

Numerous commenters on the Proposing Release recommended that the 12-month period used to calculate the average price for estimating reserves should not coincide with the fiscal year, as we proposed.⁵⁹ Most of these commenters recommended a 12-month period running from the beginning of the fourth quarter of the prior fiscal year through the end of the third quarter of the present fiscal year. For example, for a

⁵⁹ See letters from Apache, API, BP, Canadian Natural, CAPP, EnCana, Eni, ExxonMobil, PEMEX, Petro-Canada, Repsol, Ryder Scott, Sasol, Shell, Total, van Wyk, and Wagner.

company with a fiscal year end of December 31, the relevant 12-month period would span from October 1 of the prior year to September 30 of the fiscal year covered by the annual report.⁶⁰ Several commenters suggested that we provide a two-month buffer between the end of the measurement period and the end of the company's fiscal year so that reserves estimates would be based on prices from November 1 through October 31 by a company with a fiscal year ending on December 31.⁶¹ Commenters attributed the need for a buffer period to the accelerated filing dates for annual reports⁶² and stated that they expected that the additional time would result in better, more accurate disclosure.⁶³ Others noted that some agreements, like production sharing contracts and other complex concession agreements, can make calculations difficult.⁶⁴ One commenter also noted that shifting the relevant measurement period so that it ends three-months prior to the fiscal-year end would align economic calculations with technical calculations, which typically occur at the end of the third quarter.⁶⁵

As noted above, we have considered all of these recommendations. We are adopting a pricing formula based on the average of prices at the beginning of each month in the 12-month period prior to the end of the reporting period. A number of commenters believed that the use of first-of-the-month prices essentially would provide companies

⁶⁰ See letters from Apache, API, BP, Canadian Natural, CAPP, Devon, Eni, ExxonMobil, PEMEX, Petro-Canada, Repsol, Ryder Scott, Sasol, Shell, Total, van Wyk, and Wagner.

⁶¹ See letters from Canadian Natural, CAPP, Eni, Nexen, and Petro-Canada.

⁶² See letters from API, Canadian Natural, CAPP, Devon, Evolution, PEMEX, Petrobras, Ryder Scott, Sasol, Shell, Total, and Wagner.

⁶³ See letters from Canadian Natural, CAPP, Nexen, Petrobras, Petro-Canada, Ryder Scott, Sasol, and Wagner.

⁶⁴ See letters from API and Shell.

⁶⁵ See letter from Shell.

with one month more to prepare the reserves disclosures,⁶⁶ while still aligning the time period with the fiscal year.⁶⁷ We agree with the commenters that such an average will provide companies more time to prepare more accurate disclosure, while still tying the pricing formula to the period covered by the annual report.

C. Extraction of Bitumen and Other Non-Traditional Resources

1. Definition of “oil and gas producing activities”

Our current definition of “oil and gas producing activities” explicitly excludes sources of oil and gas from “non-traditional” or “unconventional” sources, that is, sources that involve extraction by means other than “traditional” oil and gas wells.⁶⁸ These other sources include bitumen extracted from oil sands, as well as oil and gas extracted from coal and shales, even though some of these resources are sometimes extracted through wells, as opposed to mining and surface processing. However, such sources are increasingly providing energy resources to the world due in part to advancements in extraction and processing technology.⁶⁹ Therefore, the rules we adopt today revise the definition of “oil and gas producing activities” to include such activities.⁷⁰

All commenters on this issue supported including the extraction of unconventional resources as oil and gas producing activities.⁷¹ They believed that such

⁶⁶ See letters from API, Devon, Eni, Evolution, ExxonMobil, PEMEX, Petrobras, PWC, Repsol, and Total.

⁶⁷ See letters from Devon and ExxonMobil.

⁶⁸ See Rule 4-10(a)(1)(ii)(D) [17 CFR 210.4-10(a)(1)(ii)(D)].

⁶⁹ Commenters noted that unconventional resources currently represent 45% of natural gas production in the U.S. See letters from American Clean Skies and IPAA.

⁷⁰ See Rule 4-10(a)(16) [17 CFR 210.4-10(a)(16)].

⁷¹ See letters from American Clean Skies, Apache, API, Canadian Natural, CAPP, CAQ, CFA, Davis Polk, Devon, E&Y, EnCana, ExxonMobil, FERC, Imperial, IPAA, KPMG, Nexen,

inclusion would greatly improve the quality and completeness of the disclosures.⁷² Eight commenters noted that inclusion would better align disclosure with the way that companies view their operations.⁷³ Some noted that, although the distinction was reasonable decades ago when traditional resources dominated oil and gas production, the reality of today is that such unconventional resources are mainstream and companies invest significant amounts of capital to develop these resources.⁷⁴

The revised definition of “oil and gas producing activities” that we adopt today includes the extraction of the non-traditional resources described above.⁷⁵ This amendment is intended to shift the focus of the definition of “oil and gas producing activities” to the final product of such activities, regardless of the extraction technology used. The amended definition states specifically that oil and gas producing activities include the extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.⁷⁶

Petrobras, Petro-Canada, PRA, PWC, Repsol, Ryder Scott, Sasol, Shell, SPE, StatoilHydro, Talisman, Total, and Wagner.

⁷² See letters from API, CAPP, CAQ, ExxonMobil, Imperial, PWC, Repsol, Ryder Scott, Total, and Wagner.

⁷³ See letters from API, CAQ, E&Y, ExxonMobil, Imperial, Petro-Canada, PWC, and Total.

⁷⁴ See letters from Imperial, IPAA, Repsol, and Total.

⁷⁵ See Rule 4-10(a)(16) [17 CFR 210.4-10(a)(16)].

⁷⁶ A hydrocarbon product is saleable if it is in a state in which it can be sold even if there is no ready market for that hydrocarbon product in the geographic location of the project. The absence of a market does not preclude the activity from being considered an oil and gas producing activity. However, in order to claim reserves for that hydrocarbon product from a particular location, there must be a market, or a reasonable expectation of a market, for that product.

Currently, two types of natural resources pose a unique problem to establishing oil and gas reserves. Coal and, to a lesser degree, oil shale are used both as direct fuel and as feedstock to be converted into oil and gas. In response to our request for comment on how best to treat these resources, several commenters recommended that the extraction of coal⁷⁷ and oil shale⁷⁸ be categorized based on the final product. One commenter noted that investment decisions are based on the value and disposition of the final product.⁷⁹ We agree with these commenters and have revised the proposal to require a company to include coal and oil shale that is intended to be converted into oil and gas as oil and gas reserves. The adopted rules also, however, prohibit a company from including coal and oil shale that is not intended to be converted into oil and gas as oil and gas reserves.

2. Disclosure by final products

We proposed that disclosure of reserves would be organized based on the pre-processed resource extracted from the ground. For example, under the proposal, a company that extracted bitumen and processed that bitumen into synthetic crude oil in its own processing plant would have had to base its reserves disclosure on the amount of bitumen that was economically producible, not taking into account the economics of the processing plant. This proposal was consistent with our traditional separation of "upstream" activities such as drilling and producing oil and gas from "downstream" activities such as refining. Distinguishing between traditional resources and

⁷⁷ See letters from CAPP, ExxonMobil, Ryder Scott, Sasol, Shell, StatoilHydro, and Wagner.

⁷⁸ See letters from CAPP, ExxonMobil, Shell, StatoilHydro, and Wagner.

⁷⁹ See letter from ExxonMobil.

unconventional resources can be significant to investors because unconventional resources often involve significantly different economics and company resources than oil and gas from traditional wells.

Several commenters disagreed with our proposal, recommending that the determining factor should be the final product.⁸⁰ They believed that a company should be able to consider the prices of self-processed resources when estimating oil and gas reserves because the economics of the processing plant are critical to the registrant's evaluation of the economic producibility of the resources.⁸¹ One commenter was concerned that distinguishing bitumen or other intermediate product from traditional oil and gas creates a false and misleading sense of comparability because producers that upgrade bitumen and sell synthetic crude do not face the same risks and rewards as do producers who sell the bitumen itself.⁸²

We are persuaded by these commenters. However, we believe that the distinction between a company's traditional and unconventional activities is an important one from an investor's perspective because many of the unconventional activities are costlier and, therefore, have a much higher threshold of economic producibility. Therefore, we are revising the proposed table in Item 1202 to require separation of reserves based on final product, but distinguishing between final products that are traditional oil or gas from final products of synthetic oil or gas. We believe that with this separate disclosure, investors

⁸⁰ See letters from Apache, Nexen, Petrobras, and Ryder Scott.

⁸¹ See letters from Apache, CAQ, and Nexen.

⁸² See letter from Nexen.

will be able to identify resources in projects that produce synthetic oil or gas that may be more sensitive to economic conditions from other resources.

In addition, as proposed, we are amending the definition of "oil and gas producing activities" to include activities relating to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted. However, the definition would continue to exclude:

- Transporting, refining, processing (other than field processing of gas to extract liquid hydrocarbons by the company and the upgrading of natural resources extracted by the company other than oil or gas into synthetic oil or gas) or marketing oil and gas;
- The production of natural resources other than oil, gas, or natural resources from which synthetic oil and gas can be extracted; and
- The production of geothermal steam.

D. Proved Oil and Gas Reserves

We proposed to significantly revise the definition of "proved oil and gas reserves." We are adopting that definition, substantially as proposed.⁸³ However, as noted above, we have decided to base the price used to establish economic producibility on the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period.

⁸³ See Rule 4-10(a)(22) [17 CFR 210.4-10(a)(22)].

One commenter recommended against using an average price to calculate existing economic conditions if the price is set by contractual arrangements.⁸⁴ We agree that under such circumstances, the appropriate price to use for establishing economic producibility is the price set by those contractual arrangements. Therefore, we have revised the definition to reflect that situation.⁸⁵

The existing definition of the term "proved oil and gas reserves" incorporates certain specific concepts such as "lowest known hydrocarbons" which limit a company's ability to claim proved reserves in the absence of information on fluid contacts in a well penetration,⁸⁶ notwithstanding the existence of other engineering and geoscientific evidence.⁸⁷ We proposed revisions to the definition that would permit the use of new reliable technologies to establish the reasonable certainty of proved reserves. The proposed revisions to the definition of "proved oil and gas reserves" also included provisions for establishing levels of lowest known hydrocarbons and highest known oil through reliable technology other than well penetrations. We are adopting those revisions as proposed.

We also are adopting, as proposed, revisions that permit a company to claim proved reserves beyond those development spacing areas that are immediately adjacent to developed spacing areas if the company can establish with reasonable certainty that these

⁸⁴ See letter from SPE.

⁸⁵ See Rule 4-10(a)(22)(v) [17 CFR 210.4-10(a)(22)(v)].

⁸⁶ In certain circumstances, a well may not penetrate the area at which the oil makes contact with water. In these cases, the company would not have information on the fluid contact and must use other means to estimate the lower boundary depths for the reservoir in which oil is located.

⁸⁷ See previous Rule 4-10(a)(2)(i) [17 CFR 210.4-10(a)(2)(i)].

reserves are economically producible.⁸⁸ These revisions are designed to permit the use of alternative technologies to establish proved reserves in lieu of requiring companies to use specific tests. In addition, they establish a uniform standard of reasonable certainty that applies to all proved reserves, regardless of location or distance from producing wells.

E. Reasonable Certainty

Both the existing definition of the term "proved oil and gas reserves," and the definition of that term that we are adopting in this release, rely on the term "reasonable certainty," which previously was not defined in Rule 4-10. In the Proposing Release, we proposed to define the term "reasonable certainty" as "much more likely to be achieved than not" to avoid ambiguity in that term's meaning. However, several commenters recommended that the rules mirror the PRMS definition more closely.⁸⁹ Four commenters were concerned that a different definition from the PRMS would cause confusion. They recommended using the PRMS standard of "high degree of confidence that the quantities will be recovered."⁹⁰ One commenter recommended that, because the proposed definition is new, the Commission should adopt a safe harbor, to avoid potential uncertainty until a court interprets the phrase.⁹¹ But others believed that the proposed definition is consistent with the PRMS definition.⁹² One commenter opined that the

⁸⁸ See Rule 4-10(a)(22) [17 CFR 210.4-10(a)(22)]. See Section II.G for a more detailed discussion regarding this provision.

⁸⁹ See letters from EIA, ExxonMobil, and Zakaib.

⁹⁰ See letters from Apache, EIA, Energen, and SPE.

⁹¹ See letter from Evolution.

⁹² See letters from EnCana, ExxonMobil, Petrobras, and Ryder Scott.

concept of estimated ultimate recovery (EUR) is appropriate to establish proved oil and gas reserves.⁹³

We believe that the terms “high degree of confidence” from the PRMS and “much more likely to be achieved than not” in our proposal have the same meaning. Our proposed language was not intended to change the level of certainty required to establish reasonable certainty. However, we agree that the use of terminology that is consistent with the PRMS will assist in the understanding of those terms. Therefore, we are adopting the “high degree of confidence” standard that exists in the PRMS. We also are clarifying that having a “high degree of confidence” means that a quantity is “much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease” to provide elaboration to the definition of reasonable certainty.

We are adopting a definition of “reasonable certainty” that addresses, and permits the use of, both deterministic methods and probabilistic methods for estimating reserves, as proposed. Nine commenters supported permitting the use of either deterministic methods or probabilistic methods.⁹⁴ One commenter believed that each method may be more appropriate for different situations.⁹⁵ Other commenters also supported the proposed alignment of the definitions of those terms with the definitions in the PRMS

⁹³ Total.

⁹⁴ See letters from Apache, Devon, Evolution, Petro-Canada, Ryder Scott, Shell, SPE, Total, and Wagner.

⁹⁵ See letter from Wagner.

definitions.⁹⁶ The definition that we are adopting states that, if deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered.⁹⁷ Consistent with the PRMS definition, if probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.

F. Developed and Undeveloped Oil and Gas Reserves

We proposed to revise the definitions of the terms “proved developed oil and gas reserves” and “proved undeveloped oil and gas reserves.” One commenter noted that the terms “developed” and “undeveloped” are not restricted to proved oil and gas reserves, but could apply to all classifications of reserves, including probable and possible reserves.⁹⁸ We agree with that commenter. Although the development of a prospect may provide the company with more information and data to determine reserves amounts more accurately, companies may estimate proved, probable, and possible volumes regardless of the development stage. In the past, these terms were linked to the concept of proved reserves because our disclosure rules permitted the disclosure only of proved reserves. In light of our revision to allow disclosure of probable and possible reserves, the final rules define the terms “developed oil and gas reserves” and “undeveloped oil

⁹⁶ See letters from AAPG, SPE, and Southwestern.

⁹⁷ See Rule 4-10(a)(24) [17 CFR 210.4-10(a)(24)].

⁹⁸ See letter from SPE. We note that with respect to oil and gas reserves, the term “classification” is used to indicate the level of certainty that estimated amounts will be recovered. Thus, although the terms “developed” and “undeveloped” may be considered means in which to generically “classify” reserves, for clarity, we use that term to be consistent with industry usage.

and gas reserves” to indicate that the development status of the reserves is relevant to all classifications of oil and gas reserves.⁹⁹

1. Developed oil and gas reserves

Other than the change discussed above to eliminate “proved” from the term being defined, we are adopting a definition of “developed oil and gas reserves” substantially as proposed. We proposed to define the term “proved developed oil and gas reserves” as proved reserves that:

- In projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and
- In projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.

Two commenters suggested that, consistent with the PRMS, reserves should be considered developed if the cost of any required equipment is relatively minor compared to the cost of a new well or the installed equipment.¹⁰⁰ Again, we agree that consistency with PRMS would improve compliance with our rules. In addition, such a revision is consistent with our existing definition of the term “proved undeveloped reserves” which includes reserves on which a well exists, but a relatively “major” expenditure is required for recompletion.¹⁰¹ Therefore, the final rules provide that reserves also are developed if

⁹⁹ See Rules 4-10(a)(6) and (31) [17 CFR 210.4-10(a)(6) and (31)].

¹⁰⁰ See letters from SPE and Total.

¹⁰¹ See previous Rule 4-10(a)(4) [17 CFR 210.4-10(a)(4)].

the cost of any required equipment is relatively minor compared to the cost of a new well.¹⁰²

2. Undeveloped oil and gas reserves

In the Proposing Release, we proposed a significantly revised definition of the term “proved undeveloped oil and gas reserves.” The most significant aspect of the proposed revision was the replacement of the existing “certainty” test for areas beyond one offsetting drilling unit¹⁰³ from a productive well with a “reasonable certainty” test.

Currently, the definition of the term “proved undeveloped reserves” imposes a “reasonable certainty” standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well and a “certainty” standard for reserves in drilling units beyond the immediately adjacent drilling units.¹⁰⁴ All commenters on this issue supported the proposal.¹⁰⁵ Three commenters noted that a single standard—reasonable certainty—should apply to all proved reserves.¹⁰⁶ We are adopting this aspect of the definition as proposed.

Many commenters opposed the proposed language that would have imposed a five-year limit on maintaining undeveloped reserves unless “unusual” circumstances

¹⁰² See Rule 4-10(a)(6) [17 CFR 210.4-10(a)(6)].

¹⁰³ As noted later in this section of the release, we are replacing the term “drilling unit” with the term “development spacing area” in the final rules. However, for purposes of discussing the proposal and the existing rules, we continue to use the term “drilling unit” because that is the term used in the proposal and the existing rules.

¹⁰⁴ See previous Rule 4-10(a)(4) [17 CFR 210.4-10(a)(4)]. A drilling unit refers to the spacing between wells required by some local jurisdictions to prevent wasting resources and optimize recovery.

¹⁰⁵ See letters from American Clean Skies, Apache, API, Canadian Natural, CAPP, Chesapeake, Devon, Evolution, ExxonMobil, McMoRan, Petro-Canada, Questar, Repsol, Southwestern, Shell, SPE, Total, and Wagner.

¹⁰⁶ See letters from Devon, EnCana, and Equitable.

existed.¹⁰⁷ They asserted that large projects, projects in remote areas, and projects in continuous accumulations, such as oil sands, typically take more than five years to develop, but they do not view such projects as “unusual.”¹⁰⁸ One commenter noted that the proposed rule is not consistent with the PRMS, which uses the term “specific circumstances,” rather than “unusual circumstances.”¹⁰⁹ Other commenters suggested that we require the company to explain why it has not developed any undeveloped reserves for more than five years.¹¹⁰ The intent of the proposal was not to exclude projects that typically take more than five years to develop from being considered reserves. We agree that the rule should allow the recognition of reserves in projects that are expected to run more than five years, regardless of whether “unusual” circumstances exist. Therefore, we have revised the rule to replace the term “unusual” with the term “specific.”¹¹¹ We note that, as proposed, Item 1203 of Regulation S-K would require disclosure regarding why such undeveloped reserves have not been developed.¹¹²

We also proposed to broaden the definition of the term “proved undeveloped reserves” to permit a company to include, in its undeveloped reserves estimates, quantities of oil that can be recovered through improved recovery projects and to expand the technologies that a company can use to establish reserves. Under the existing definition, a company can include such quantities only if techniques have been proved

¹⁰⁷ See letters from American Clean Skies, Apache, CAPP, Chesapeake, EnCana, ExxonMobil, Luscher, Newfield, Nexen, Petrobras, Petro-Canada, Ryder Scott, Shell, SPE, and Total.

¹⁰⁸ See letters from American Clean Skies, CAPP, Chesapeake, EnCana, ExxonMobil, Newfield, Nexer, Petrobras, Petro-Canada, Ryder Scott, Shell, and Total.

¹⁰⁹ See letter from SPE.

¹¹⁰ See letters from Devon, Ryder Scott, and Wagner.

¹¹¹ See Rule 4-10(a)(31) [17 CFR 210.4-10(a)(31)].

¹¹² See Item 1203(d) [17 CFR 229.1203(d)].

effective by actual production from projects in the area and in the same reservoir. As proposed, we are expanding this definition of the term "undeveloped oil and gas reserves" to permit the use of techniques that have been proved effective by actual production from projects in the same reservoir or an analogous reservoir or "by other evidence using reliable technology that establishes reasonable certainty."¹¹³

We also are making other, less substantive revisions to the definition of "undeveloped oil and gas reserves." First, commenters suggested that we use the term "development spacing"¹¹⁴ or "drainage areas"¹¹⁵ instead of "drilling units" because the term "drilling units" is only relevant in jurisdictions that establish such units. They noted that many foreign jurisdictions do not establish such units. We concur with those commenters and have replaced the term "drilling units" with the term "development spacing areas."

One commenter also noted that the PRMS guidance on the use of analogs for improved recovery projects does not limit such use to "within the immediate area" and recommended that we delete this phrase from the definition.¹¹⁶ Again, we agree that consistency with PRMS would be beneficial in this instance and have deleted that phrase from the definition. We also have eliminated two paragraphs of the proposed definition because they were largely repetitive of other aspects of the definition and were unnecessary.¹¹⁷

¹¹³ See Rule 4-10(a)(31) [17 CFR 210.4-10(a)(31)].

¹¹⁴ See letter from Total.

¹¹⁵ See letter from SPE.

¹¹⁶ See letter from SPE.

¹¹⁷ These paragraphs would have clarified (1) in a conventional accumulation, offsetting productive units must lie within an area in which economic producibility has been established by reliable

G. Reliable Technology

1. Definition of the term "reliable technology"

We are adopting, substantially as proposed, a new definition of "reliable technology" that would broaden the types of technologies that a company may use to establish reserves estimates and categories. All commenters on this topic supported the proposed principles-based definition for reliable technology.¹¹⁸

The current rules limit the use of alternative technologies as the basis for determining a company's reserves disclosures. For example, under the current rules, a company must use actual production or flow tests to meet the "reasonable certainty" standard necessary to establish the proved status of its reserves.¹¹⁹ Similarly, the current rules provide bright line tests for determining fluid contacts, such as lowest known hydrocarbons and highest known oil, which establish the volume of the hydrocarbons in place.

We recognize that technologies have developed, and will continue to develop, improving the quality of information that can be obtained from existing tests and creating entirely new tests that we cannot yet envision. Thus, the new definition of the term

technology to be reasonably certain and (2) proved reserves can be claimed in a conventional or continuous accumulation in a given area in which engineering, geoscience, and economic data, including actual drilling statistics in the area, and reliable technology show that, with reasonable certainty, economic producibility exists beyond immediately offsetting drilling units. We do not believe that these statements, based on the terms "conventional accumulation" and "continuous accumulation" which are no longer being defined continue to serve a helpful purpose. See Section II.J.5 of this release.

¹¹⁸ See letters from AAPG, American Clean Skies, Apache, CFA, Davis Polk, Devon, EnCana, ExxonMobil, Petrobras, Ryder Scott, Sasol, Shell, SPE, Southwestern, and Wagner.

¹¹⁹ However, in the past, the Commission's staff has recognized that flow tests can be impractical in certain areas, such as the Gulf of Mexico, where environmental restrictions effectively prohibit these types of tests. The staff has not objected to disclosure of reserves estimates for these restricted areas using alternative technologies.

“reliable technology” permits the use of technology (including computational methods) that has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. This new standard will permit the use of a new technology or a combination of technologies once a company can establish and document the reliability of that technology or combination of technologies.

We are adopting certain revisions to our proposed definition of the term “reliable technology.” The proposal also would have required reliable technology to be “widely accepted.” However, some commenters were concerned that this requirement would exclude proprietary technologies that companies develop internally that have proven to be reliable.¹²⁰ We concur with these commenters and have removed the “widely accepted” requirement from the final rule.

We also proposed to define the term “reliable technology,” expressed in probabilistic terms, as technology that has been proven empirically to lead to correct conclusions in 90% or more of its applications. Several commenters expressed concern that this proposed 90% threshold would be difficult to verify and support on an ongoing basis.¹²¹ We agree that a bright line test would be difficult to apply to a particular technology or mix of technologies to determine their reliability. Therefore, we are not adopting the 90% threshold as part of the definition.

2. Disclosure of technologies used

The proposal would have required a company to disclose the technology used to establish reserves estimates and categories for material properties in a company’s first

¹²⁰ See letters from Chesapeake, ExxonMobil, Shell, and Total.

¹²¹ See letters from AAPG, Apache, EIA, Evolution, Ryder Scott, Shell, SPE, and Wagner.

filing with the Commission and for material additions to reserves estimates in subsequent filings because, under the proposal, a company would be able to select the technology or mix of technologies that it uses to establish reserves. Two commenters supported the proposal because they believed that disclosure of the technologies used is reasonable if the definition of "reliable technology" is principles-based.¹²² However, many other commenters were concerned that the proposed requirement to disclose the technologies used to establish levels of certainty for reserves estimates would lead to very complex, technical disclosures that would have little meaning to investors.¹²³ Others were concerned that disclosure of the technology, or the mix of technologies, might cause competitive harm.¹²⁴

As an alternative, some commenters recommended that the rule require a more general overview of the technologies used.¹²⁵ We are clarifying that the required disclosure would be limited to a concise summary of the technology or technologies used to create the estimate.¹²⁶ A company would not be required to disclose proprietary technologies, or a proprietary mix of technologies, at a level of specificity that would cause competitive harm. Rather, the disclosure may be more general. For example, a company may disclose that it used a combination of seismic data and interpretation, wireline formation tests, geophysical logs, and core data to calculate the reserves estimate. As noted, however, the Commission's staff, as part of the review and comment

¹²² See letters from Davis Polk and Sasol.

¹²³ See letters from API, Devon, Eni, ExxonMobil, PEMEX, Petro-Canada, Questar, Repsol, Ryder Scott, Shell, Southwestern, StatoilHydro, and Total.

¹²⁴ See letters from API, Devon, Evolution, ExxonMobil, Ryder Scott, StatoilHydro, and Total.

¹²⁵ See letters from EnCana, Eni, Evolution, Ryder Scott, and Shell.

¹²⁶ See Item 1202(a)(6) [17 CFR 229.1202(a)(6)].

process, may continue to request companies to provide supplemental data, consistent with current practice,¹²⁷ which, under the new rules, may include information sufficient to support a company's conclusion that a technology or mix of technologies used to establish reserves meets the definition of "reliable technology."

Two commenters supported the proposal to limit the disclosures to technologies used to establish reserves in a company's first filing with the Commission and material additions to reserves.¹²⁸ We are adopting this limitation as proposed.¹²⁹ If the company has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to its reserves estimates, the company must disclose the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed and the particular properties do not need to be identified. We believe that requiring such disclosure when reserves, or material additions to reserves, are reported for the first time will discourage the use of questionable technologies to establish reserves. However, we do not believe it is necessary to require a company to disclose the technology or technologies relied upon to establish reserves previously disclosed under our rules because the permitted technologies have been limited to those permitted by our existing rule. In addition, we believe that ongoing disclosure of the technologies used to establish all of a company's reserves would become unnecessarily cumbersome.

¹²⁷ Currently, the Commission's staff requests supplemental data pursuant to Instruction 4 to Item 102 of Regulation S-K [17 CFR 229.102], Rule 418 [17 CFR 230.418], and Rule 12b-4 [17 CFR 240.12b-4]

¹²⁸ See letters from Southwestern and Wagner.

¹²⁹ See Item 1202(a)(6) [17 CFR 229.1202(a)(6)].

H. Unproved Reserves—"Probable Reserves" and "Possible Reserves"

As discussed more fully in Section IV.B.3 of this release addressing the disclosure requirements of new Subpart 1200, we are adopting the proposal to permit disclosure of probable and possible reserves. Therefore, we are adopting the proposed definitions of the terms "probable reserves" and "possible reserves" as proposed.

When producing an estimate of the amount of oil and gas that is recoverable from a particular reservoir, a company can make three types of estimates:

- An estimate that is reasonably certain;
- An estimate that is as likely as not to be achieved; and
- An estimate that might be achieved, but only under more favorable circumstances than are likely.

These three types of estimates are known in the industry as (1) proved, (2) proved plus probable, and (3) proved plus probable plus possible reserves estimates.

1. Probable reserves

We are adopting the definition of the term "probable reserves" as proposed. It states that "probable reserves" are those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered.¹³⁰ This definition provides guidance for the use of both deterministic and probabilistic methods. The definition clarifies that, when deterministic methods are used, it is as likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves. Similarly, when probabilistic

¹³⁰ See Rule 4-10(a)(18) [17 CFR 210.4-10(a)(18)].

methods are used, there must be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates. This definition was derived from the PRMS definition of the term "probable reserves." Several commenters agreed with the proposed definition of this term, noting that it is roughly consistent with PRMS.¹³¹

2. Possible reserves

We also are adopting the definition of the term "possible reserves" as proposed. The new definition states that possible reserves include those additional reserves that are less certain to be recovered than probable reserves.¹³² It clarifies that, when deterministic methods are used, the total quantities ultimately recovered from a project have a low probability to exceed the sum of proved, probable, and possible reserves. When probabilistic methods are used, there must be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable, and possible estimates. Several commenters noted that our proposed definition of the term "possible reserves" was consistent with PRMS, which also uses a 10% threshold.¹³³ One commenter recommended that the threshold for "possible reserves" should be a 25% likelihood of recovery because that percentage would be more meaningful than 10%.¹³⁴ We believe that a definition consistent with the PRMS will provide the most certainty and clarity for companies and investors.

¹³¹ See letters from Devon, EnCana, SPE, and StatoilHydro.

¹³² See Rule 4-10(a)(17) [17 CFR 210.4-10(a)(17)].

¹³³ See letters from Devon, EnCana, SPE, and StatoilHydro.

¹³⁴ See letter from Evolution.

I. Reserves

We proposed to add a definition of the term "reserves" to our rules. The proposed definition would have described the criteria that an accumulation of oil, gas, or related substances must satisfy to be considered reserves (of any classification), including non-technical criteria such as legal rights. Specifically, we proposed to define reserves as the estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on:

- Analysis of geoscience and engineering data;
- The use of reliable technology;
- The legal right to produce;
- Installed means of delivering the oil, gas, or related substances to markets, or the permits, financing, and the appropriate level of certainty (reasonable certainty, as likely as not, or possible but unlikely) to do so; and
- Economic producibility at current prices and costs.

The proposed definition also would have clarified that reserves are classified as proved, probable, and possible according to the degree of uncertainty associated with the estimates. We are not adopting the definition as proposed. Four commenters recommended clarification that the term "legal right to produce" extends beyond the initial term of an oil and gas concession if there is a reasonable expectation that the concession will be renewed, consistent with the PRMS and current staff position.¹³⁵ We

¹³⁵ See letters from API, CAQ, Grant Thornton, and KPMG.

are adopting a definition of the term "reserves" that more closely parallels the PRMS definition of that term.

Our final rules define the term "reserves" as the estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations.¹³⁶ In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production of oil and gas, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.

A note to the definition clarifies that reserves should not be assigned to adjacent reservoirs isolated by major, potentially sealing, faults until those reservoirs are penetrated and evaluated as economically producible and that reserves should not be assigned to areas that are clearly separated from a known accumulation by a non-productive reservoir (i.e., absence of reservoir, structurally low reservoir, or negative test results). Such areas may contain prospective resources (i.e., potentially recoverable resources from undiscovered accumulations).¹³⁷

One notable difference between our final definition of "reserves" and the PRMS definition is that our definition is based on "economic producibility" rather than "commerciality." One commenter believed that reserves must be "commercial," as stated in the PRMS definition.¹³⁸ However, commerciality introduces a subjective aspect to the

¹³⁶ See Rule 4-10(a)(26) [17 CFR 210.4-10(a)(26)].

¹³⁷ See Note to Rule 4-10(a)(26) [17 CFR 210.4-10(a)(26)].

¹³⁸ See letter from StatoilHydro.

price used to establish existing economic conditions by factoring in the rate of return required by a particular company before it will commit resources to the project. This rate of return will vary among companies, reducing the comparability among disclosures. Therefore, the adopted definition of the term "reserves" relies on economic producibility, as proposed.

J. Other Supporting Terms and Definitions

We also proposed to define several other terms primarily to support and clarify the definitions of the key terms. We are adopting most of those supporting definitions as discussed in further detail below.

1. Deterministic estimate

A company can derive two different types of reserves estimates depending on the method used to calculate the estimates. These two types of estimates are known as "deterministic estimates" and "probabilistic estimates."¹³⁹ In the Proposing Release, we proposed to define the term "deterministic estimate" as an estimate based on a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation that is used in the reserves estimation procedure. We are adopting that definition as proposed.

2. Probabilistic estimate

We are adopting a new definition of the term "probabilistic estimate" substantially as proposed. The new rule defines the term "probabilistic estimate" as an

¹³⁹ See Rules 4-10(a)(5) and (a)(19) [17 CFR 210.4-10(a)(5) and (a)(19)]. These definitions are based on the Canadian Oil and Gas Evaluation Handbook (COGEH). This handbook was developed by the Calgary Chapter of the Society of Petroleum Evaluation Engineers and the Petroleum Society of CIM to establish standards to be used within the Canadian oil and gas industry in evaluating oil and gas reserves and resources.

estimate that is obtained when the full range of values that could reasonably occur from each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.¹⁴⁰ In response to a comment received, however, we revised the definition so that it does not include the application of a range of values with respect to economic conditions because those conditions, such as prices and costs, are based on historical data, and therefore are an established value, rather than a range of estimated values.¹⁴¹

3. Analogous reservoir

We proposed a definition of the term “analogous formation in the immediate area.” As noted above, we received comment indicating that the use of appropriate analogs should not be limited to the immediate area in which the reserves are being estimated.¹⁴² Therefore, we have changed the defined term to “analogous reservoir.”¹⁴³ In addition, based on commenters’ remarks, we are defining the term “analogous reservoir” in a manner that is more consistent with the PRMS, which addresses more specifically the types of reservoirs that may be used as analogues. The new definition of the term “analogous reservoir” states that analogous reservoirs, as used in resources assessments, have similar rock and fluid properties, reservoir conditions (depth, temperature, and pressure) and drive mechanisms, but are typically at a more advanced stage of development than the reservoir of interest and thus may provide concepts to

¹⁴⁰ See Rule 4-10(a)(19) [17 CFR 210.4-10(a)(19)].

¹⁴¹ See letter from Shell.

¹⁴² See letter from SPE.

¹⁴³ See Rule 4-10(a)(2) [17 CFR 210.4-10(a)(2)].

assist in the interpretation of more limited data and estimation of recovery.¹⁴⁴ When used to support proved reserves, an "analogous reservoir" refers to a reservoir that shares the following characteristics with the reservoir of interest:

- Same geological formation (but not necessarily in pressure communication with the reservoir of interest);
- Same environment of deposition;
- Similar geological structure; and
- Same drive mechanism.

As proposed, the new definition includes an instruction that clarifies that reservoir properties must, in the aggregate, be no more favorable in the analog than in the reservoir of interest. The new definition also clarifies that, although an analogous reservoir must be in the same geological formation as the reservoir of interest, it need not be in pressure communication with the reservoir of interest.

4. Definitions of other terms

We received no comment with regard to several of the proposed supporting definitions. We are adopting those definitions substantially as proposed without material changes. They include the following terms:

- "Condensate";¹⁴⁵
- "Development project";¹⁴⁶

¹⁴⁴ See Rule 4-10(a)(2) [17 CFR 210.4-10(a)(2)].

¹⁴⁵ See Rule 4-10(a)(4) [17 CFR 210.4-10(a)(4)].

¹⁴⁶ See Rule 4-10(a)(8) [17 CFR 210.4-10(a)(8)].

- “Economically producible”;¹⁴⁷
- “Estimated ultimate recovery,”¹⁴⁸
- “Exploratory well”;¹⁴⁹
- “Extension well”;¹⁵⁰ and
- “Resources.”¹⁵¹

Most of these supporting terms and their definitions are based on similar terms in the PRMS. The definition of “resources” is based on the Canadian Oil and Gas Evaluation Handbook (COGEH).

In the Proposing Release, we solicited comment on whether we should adopt any other supporting definitions. One commenter submitted an appendix to its letter containing numerous other terms that it thought we should adopt.¹⁵² We have decided not to adopt those additional definitions because we feel that they are unnecessary at this time. However, we have decided to adopt a definition for the term “bitumen.” We believe that providing a definition for this term will lead to more consistency among disclosures because there currently are several competing definitions of that term used in the industry.

We are defining the term “bitumen” as “petroleum in a solid or semi-solid state in natural deposits. In its natural state, it usually contains sulfur, metals, and other non-

¹⁴⁷ See Rule 4-10(a)(10) [17 CFR 210.4-10(a)(10)].

¹⁴⁸ See Rule 4-10(a)(11) [17 CFR 210.4-10(a)(11)].

¹⁴⁹ See Rule 4-10(a)(13) [17 CFR 210.4-10(a)(13)].

¹⁵⁰ See Rule 4-10(a)(14) [17 CFR 210.4-10(a)(14)].

¹⁵¹ See Rule 4-10(a)(28) [17 CFR 210.4-10(a)(28)].

¹⁵² See letter from SPE.

hydrocarbons. Bitumen has a viscosity greater than 10,000 centipoise measured at original temperature in the deposit and atmospheric pressure, on a gas free basis.”¹⁵³ This definition is similar to the PRMS definition of “natural bitumen.”

5. Proposed terms and definitions not adopted

We proposed definitions for the terms “continuous accumulations” and “conventional accumulations” to assist companies in disclosing segregated reserves based on these two types of accumulations. As noted elsewhere in this release, the final rules do not require disclosure based on the type of accumulation in which the reserves are found.¹⁵⁴ Therefore, there is no need to define these terms and we are not adopting the proposed definitions.

Similarly, we proposed a definition for the term “sedimentary basin” because it would have been part of our definition of the term “by geographic area.” As noted elsewhere in this release, we have substantially revised the definition of the term “by geographic area”¹⁵⁵ and the term “sedimentary basin” is no longer needed, so we are not adopting this proposed term and definition.

As noted above, one commenter recommended that we adopt a large glossary of terms and definitions that correspond with the PRMS definitions.¹⁵⁶ Rather than defining an extensive glossary of terms in our rules and attempting to constantly update those definitions, we advise companies to look to definitions that are commonly accepted

¹⁵³ See Rule 4-10(a)(3) [17 CFR 210.4-10(a)(3)].

¹⁵⁴ See Section III.B.3.c.

¹⁵⁵ See Section III. B.2.a.

¹⁵⁶ See letter from SPE.

within the oil and gas industry to the extent such definitions are not in, or inconsistent with, our rules.

K. Alphabetization of the Definitions Section of Rule 4-10

We are alphabetizing the definitional terms in Rule 4-10(a) because we are adding a significant number of defined terms to this section.

III. Revisions to Full Cost Accounting and Staff Accounting Bulletin

As we noted in Section II.B.2 of this release, commenters unanimously opposed our proposal to use different prices for disclosure and accounting purposes. We agree with those commenters and are revising our proposal to use a 12-month average price for accounting purposes. These revisions primarily will appear under the full cost accounting method described in Rule 4-10(c)¹⁵⁷ of Regulation S-X. The full cost accounting method permits certain oil and gas extraction costs to accumulate on a company's balance sheet subject to a limitation test or a "ceiling" as described in Rule 4-10(c)(3)(4). Like reserve disclosures, these capitalized costs and the related limitation test are not fair value based measurements. Rather the capitalized costs represent the accumulated historical acquisition, exploration and development costs (net of any previously recorded depletion, amortization or ceiling test write downs) incurred for oil and gas producing activities, limited to a standardized mathematical calculation (the full cost ceiling) adopted over 25 years ago. Costs that do not exceed the limitation are deferred and amortized over time. The limitation test calculation on capitalized costs is not designed or intended to represent a fair valuation of the related oil and gas assets.¹⁵⁸

¹⁵⁷ 17 CFR 210.4-10(c).

¹⁵⁸ While not intended to represent fair value, costs that are written down because they exceed the ceiling limitation are accounted for in the same manner as impairments recognized under

Similar to the single-day, year-end pricing used under the successful efforts method,¹⁵⁹ the application of the full cost method of accounting in Rule 4-10(c) has used “current prices,” interpreted as single-day, year-end prices, as the basis for calculating the limitation on costs that may be capitalized under the full cost method. In order to further the objective of providing comparable oil and gas reserve quantities, our final rule clarifies that the term “current prices” as used in Rule 4-10(c) is consistent with the 12-month average price as calculated in Rule 4-10(a)(22)(v).¹⁶⁰

However, since these calculations are not designed to result in a calculation of fair value and since the change to the full cost accounting method would effectively eliminate the anomalies caused by the single-day, year-end price currently used in the limitation test, the SEC staff will eliminate portions of Staff Accounting Bulletin (SAB) Topic 12:D.3.c that permit consideration of the impact of price increases subsequent to the period end on the ceiling limitation test.

The combination of adopting a 12-month average pricing mechanism and eliminating portions of SAB Topic 12:D.3.c could have the effect of requiring a company using the full cost accounting method to record a ceiling test write-down in income during periods of rising oil and gas prices. In that situation, it is possible that using a 12-month average price in the ceiling test calculation might result in a write-down that would not otherwise have been required had the full cost company been permitted to use

accounting generally. That is, once the asset is written down, it becomes the new historical cost basis and cannot be reinstated for subsequent increases in the ceiling. See Rule 4-10(c)(4)(i) of Regulation S-X [17 CFR 210.4-10(c)(4)(i)].

¹⁵⁹ The accounting guidance refers to our definition of proved reserves under existing Rule 4-10(a)(2), which currently uses a single-day, year-end price to establish reserves amounts.

¹⁶⁰ See Rule 4-10(c)(8) [17 CFR 210.4-10(c)(8)].

the single-day, year-end price. Conversely, it is also possible that in periods of declining oil and gas prices, the application of this rule could result in the deferral of ceiling test write-downs. In that situation, it is possible that using a 12-month average price in the ceiling limitation test calculation might not result in a write-down in situations where a write down would have otherwise been required had the full cost company been required to use a single-day, year-end price in its ceiling limitation test calculation.

Because the application of the ceiling limitation test is not a fair-value-based calculation but rather a limit on the amount of certain oil and gas related exploration costs that can be capitalized, portions of which would have resulted in write-downs in prior periods under other methods of accounting, we believe the benefits of using a single pricing mechanism justify the potential changes to the timing of those ceiling test write-downs or amortizations amounts. However, as discussed in Section V of this release, we believe that the company should discuss such situations, if material, particularly when pricing trends indicate the possibility of future write-downs, in Management's Discussion and Analysis and, where appropriate, the notes to the financial statements.

IV. Update and Codification of the Oil and Gas Disclosure Requirements in Regulation S-K

The Proposing Release proposed to update and codify Securities Act and Exchange Act Industry Guide 2: Disclosure of Oil and Gas Operations (Industry Guide 2).¹⁶¹ Industry Guide 2 currently sets forth most of the disclosures that an oil and gas company provides regarding its reserves, production, property, and operations. Regulation S-K references Industry Guide 2 in Instruction 8 to Item 102 (Description of

¹⁶¹ Exchange Act Industry Guide 2 merely references, and therefore is identical to, Securities Act Industry Guide 2.

Property), Item 801 (Securities Act Industry Guides), and Item 802 (Exchange Act Industry Guides). However, Industry Guide 2 itself does not appear in Regulation S-K or in the Code of Federal Regulations. The rules that we adopt today codify the contents of Industry Guide 2 in a new Subpart 1200 of Regulation S-K.

A. Revisions to Items 102, 801, and 802 of Regulation S-K

The instructions to Item 102 of Regulation S-K, as well as Items 801 and 802 of Regulation S-K, currently reference the industry guides. Because we are codifying the Industry Guide 2 disclosures in a new Subpart 1200 of Regulation S-K, we are revising the instructions to Item 102 to reflect this change.¹⁶² We also are eliminating the references in Items 801 and 802 to Industry Guide 2 because that industry guide will cease to exist upon effectiveness of the amendments we adopt today.¹⁶³

In addition, Instruction 5 to Item 102 of Regulation S-K currently prohibits the disclosure of reserves other than proved oil and gas reserves. Because we are adopting rules to permit disclosure of probable and possible oil and gas reserves, we are revising Instruction 5 to limit its applicability to extractive enterprises other than oil and gas producing activities, such as mining activities.¹⁶⁴ Similarly, Instruction 3 of Item 102, regarding production, reserves, locations, development and the nature of the company's interests, will no longer apply to oil and gas producing activities, so we also are limiting that instruction to mining activities.¹⁶⁵

¹⁶² See revised Instructions 4 and 8 to Item 102 [17 CFR 229.102].

¹⁶³ See revised Item 801 and 802 [17 CFR 229.801 and 802].

¹⁶⁴ See revised Instruction 5 to Item 102 [17 CFR 229.102]. Extractive enterprises include enterprises such as mining companies that extract resources from the ground.

¹⁶⁵ See revised Instruction 3 to Item 102 [17 CFR 229.102].

Finally, we are eliminating Instruction 4 to Item 102 regarding the ability of the Commission's staff to request supplemental information, including reserves reports. This instruction is duplicative of Securities Act Rule 418¹⁶⁶ and Exchange Act 12b-4,¹⁶⁷ regarding the staff's general ability to request supplemental information.

B. Proposed New Subpart 1200 to Regulation S-K Codifying Industry Guide 2 Regarding Disclosures by Companies Engaged in Oil and Gas Producing Activities

1. Overview

We are adding a new Subpart 1200 to Regulation S-K that codifies the disclosure requirements related to companies engaged in oil and gas producing activities. This new subpart largely includes the existing requirements of Industry Guide 2. However, we have revised these requirements to update them, provide better clarity with respect to the level of detail required in oil and gas disclosures, including the geographic areas by which disclosures need to be made, and provide formats for tabular presentation of these disclosures. In addition, Subpart 1200 contains the following new disclosure requirements, many of which have been requested by industry participants:

- Disclosure of reserves from non-traditional sources (e.g., bitumen, shale, coal) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves;

¹⁶⁶ 17 CFR 230.418.

¹⁶⁷ 17 CFR 240.12b-4.

- Disclosure of technologies used to establish additions to reserves estimates;
- Disclosure of a company's internal controls over reserves estimation and the qualifications of the business entity or individual preparing or auditing the reserves estimates; and
- Disclosure based on a new definition of the term "by geographic area."

We discuss each of these proposed new Items below.

2. Item 1201 (General instructions to oil and gas industry-specific disclosures)

We are adding new Item 1201 to Regulation S-K. This item sets forth the general instructions to Subpart 1200. The new item contains three paragraphs that perform the following tasks:

- Instruct companies for which oil and gas producing activities are material to provide the disclosures specified in Subpart 1200;¹⁶⁸
- Clarify that, although a company must present specified Subpart 1200 information in tabular form, the company may modify the format of the table for ease of presentation, to add additional information or to combine two or more required tables;
- State that the definitions in Rule 4-10(a) of Regulation S-X apply to Subpart 1200; and
- Define the term "by geographic area."

¹⁶⁸

This paragraph would maintain the existing exclusion in Industry Guide 2 for limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water.

a. Geographic area

We received significant comments regarding the proposed definition of the term “by geographic area.” We proposed to require disclosure by continent, country containing 15% of more of the company’s reserves, and sedimentary basin or field containing 10% or more of the company’s reserves. Several commenters were concerned that the proposed definition would add too much detail to the disclosures, particularly at the basin or field level.¹⁶⁹ They were concerned that this amount of detail would make disclosures too complex and incoherent.¹⁷⁰ They were particularly concerned with the extension of this standard to disclosures other than reserves, such as production, wells, and acreage.¹⁷¹ Commenters also believed that the disclosures, in particular by field, could cause competitive harm in future property sales transactions, unitization agreements, and other asset transfers.¹⁷²

Some commenters also believed that some of these disclosures may be prohibited by foreign governments.¹⁷³ One commenter noted that separate determination of field or basin reserves within a larger production sharing agreement may not be possible due to concession-wide cost sharing terms.¹⁷⁴ Eight commenters recommended that the determination of appropriate geographic disclosure should remain with management,

¹⁶⁹ See letters from Apache, CAPP, Devon, ExxonMobil, Imperial, Nexen, Repsol, Shell, and StatoilHydro.

¹⁷⁰ See letters from Apache, CAPP, ExxonMobil, Imperial, Nexen, and Repsol.

¹⁷¹ See letters from ExxonMobil, Imperial, and Total.

¹⁷² See letters from Apache, API, BHP, Canadian Natural, CAPP, Devon, EnCana, Eni, Newfield, Nexen, Petro-Canada, Shell, StatoilHydro, and Total.

¹⁷³ See letters from Apache, API, CAPP, Eni, Newfield, Petro-Canada, and Total.

¹⁷⁴ See letter from Apache.

consistent with Statement of Financial Accounting Standard No. 69 (SFAS 69).¹⁷⁵

However, two commenters indicated that a country-by-country breakdown would be adequate.¹⁷⁶

Four commenters supported the proposed percentage thresholds for geographic disclosure, stating that they would increase understanding of the total energy supply, leading to better decisions by policy makers.¹⁷⁷ One commenter supported the 15% threshold for countries.¹⁷⁸

As we noted in the Proposing Release, there have been differing interpretations among oil and gas companies as to the level of specificity required when a company is breaking out its reserves disclosures based on geographic area as required by Instruction 3 of Item 102 of Regulation S-K.¹⁷⁹ Some companies currently broadly organize their reserves only by hemisphere or continent. SFAS 69 requires reserves disclosure to be separately disclosed for the company's home country and foreign geographic areas. It defines "foreign geographic areas" as "individual countries or groups of countries as appropriate for meaningful disclosure in the circumstances." Since SFAS 69 was issued, the operations of oil and gas companies have become much more diversified globally. For many large U.S. oil and gas producers, the majority of reserves are now overseas, with material amounts in individual countries and even individual fields or basins.

¹⁷⁵ See letters from Apache, API, Canadian Natural, CAPP, Eni, ExxonMobil, Imperial, and Petro-Canada.

¹⁷⁶ See letters from ExxonMobil and Nexen.

¹⁷⁷ See letters from AAPG, CFA, Chesapeake, and E&Y.

¹⁷⁸ See letter from Shell.

¹⁷⁹ 17 CFR 229.102.

We think that greater specificity than simply disclosing reserves within “groups of countries” would benefit investors and, in certain cases, may be necessary to meet the requirements of Item 102 of Regulation S-K. Some countries in which many of these companies operate and may have significant reserves are subject to unique risks, such as political instability. However, we recognize that disclosure that is too detailed may detract from the overall disclosure. Thus, we have revised the definition of the term “by geographic area” to mean, as appropriate for meaningful disclosure under a company’s particular circumstances:

- (1) By individual country;
- (2) By groups of countries within a continent; or
- (3) By continent.¹⁸⁰

This definition is substantially the same as the definition currently provided in SFAS 69. However, as proposed, we are adopting specific percentage thresholds to the geographic breakdowns of reserves estimates and production. With respect to production, the final rules require disclosure of production in each country or field containing 15% or more of the company’s proved reserves unless prohibited by the country in which the reserves are located. We are raising the proposed 10% threshold for field disclosure of production to 15% to make the threshold consistent. However, rather than requiring disclosure based on a percentage of the amount of the company’s reserves of an individual product, as proposed, the final rules require disclosure based on a

¹⁸⁰

See Item 1201(d) [17 CFR 229.1201(d)].

percentage of a company's total global oil and gas proved reserves, based on barrels of oil equivalent.¹⁸¹

With respect to reserves estimates, the final rules require disclosure of reserves in countries containing more than 15% of the company's proved reserves. As with the production disclosure, this 15% threshold would be based on the company's total global oil and gas proved reserves, rather than on individual products, as proposed.¹⁸² A registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure of reserves in that country.

We are not adopting the requirement that we proposed to disclose reserves by sedimentary basin or field. We share commenters' concerns that there is potential for competitive harm from such disclosure in future property sales transactions, unitization agreements, and other asset transfers. Moreover, we recognize that there may be situations in which a particular field may encompass a significant portion of a company's reserves in a foreign country. To avoid compelling a company to provide, in effect, field disclosure, the rule does not require disclosure of reserves in a country containing 15% of the company's reserves if that country prohibits disclosure of reserves in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.¹⁸³ For example, if a company has 25% of its reserves in Country A and Country A's government prohibits disclosure of reserves by field within Country A, if

¹⁸¹ See Item 1204(a) [17 CFR 229.1204(a)].

¹⁸² See Item 1202(a)(2) [17 CFR 229.1202(a)(2)].

¹⁸³ See Instruction 4 to Item 1202(a)(2).

almost all of that company's reserves in Country A are located in a single field, the company would not be required to specify the amount of its reserves located in Country A.

b. Tabular disclosure

We proposed to require much of the reserves disclosures and other disclosures in Industry Guide 2 to be presented in tabular format. Two commenters encouraged using a standardized table for reserves disclosure.¹⁸⁴ Another believed that companies should be able to reorganize, supplement, or combine tables for better presentation of the company's strategy.¹⁸⁵ However, two commenters believed that the rules should not propose a specified tabular format in general.¹⁸⁶ These commenters believed that companies should have the flexibility to present data in a format that is most relevant and meaningful to investors, whether it is tabular or narrative.¹⁸⁷ We continue to believe that in certain circumstances, the required disclosures lend themselves to a tabular disclosure format. We believe that standardizing such tables will improve the readability and comparability of disclosures among companies. However, in response to comments received, we have made several revisions to the individual disclosure items, including whether the disclosure item must be presented in tabular format. We discuss each below.

3. Item 1202 (Disclosure of reserves)

Existing Instruction 3 to Item 102 of Regulation S-K requires disclosure of an extractive enterprise's proved reserves. With respect to oil and gas producing companies,

¹⁸⁴ See letters from Devon and Petrobras.

¹⁸⁵ See letter from Petro-Canada.

¹⁸⁶ See letters from Apache and ExxonMobil.

¹⁸⁷ See letters from Apache and ExxonMobil.

we are replacing this Instruction by adding a new Item 1202 to Regulation S-K that contains a similar disclosure requirement regarding a company's proved reserves.¹⁸⁸

However, new Item 1202 expands on the requirements of Item 102 by specifically permitting the disclosure of probable and possible reserves and permitting the disclosure of reserves from non-traditional sources. In addition, because we are no longer distinguishing between types of accumulations, the item contains only one table with separate columns for different final products, specifically, oil, gas, synthetic oil, synthetic gas, and other natural resources sold by the company.

a. Oil and gas reserves tables

New Item 1202 requires disclosure, in the aggregate and by geographic area, of reserves estimates using prices and costs under existing economic conditions, for each product type, in the following categories:

- Proved developed reserves;
- Proved undeveloped reserves;
- Total proved reserves;
- Probable developed reserves (optional);
- Probable undeveloped reserves (optional);
- Possible developed reserves (optional); and
- Possible undeveloped reserves (optional).

A form of this table is set forth below:

¹⁸⁸ See Item 1202 [17 CFR 229.1202].

**Summary of Oil and Gas Reserves as of Fiscal-Year End
Based on Average Fiscal-Year Prices**

	Reserves				
	Oil	Natural Gas	Synthetic Oil	Synthetic Gas	Product A
Reserves category	(mbbls)	(mmcf)	(mbbls)	(mmcf)	(measure)
PROVED					
Developed					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
Undeveloped					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
TOTAL PROVED					
PROBABLE					
Developed					
Undeveloped					
POSSIBLE					
Developed					
Undeveloped					

i. Disclosure by final product sold

The table requires disclosure by final product sold by the company, specifically, oil, gas, synthetic oil, synthetic gas, or other natural resource. Thus, if the company processes a natural resource that it has extracted, such as bitumen, into synthetic oil or gas prior to selling the product, it may include such reserves under the synthetic oil or gas columns. As noted below, we have revised the proposal that would have required disclosure by type of accumulation. In addition, in response to commenters, we have revised the definition of “oil and gas producing activities” so that a company can use the price of that synthetic oil or gas to determine the economic producibility of the reserves

because the economics of the processing activity are relevant to the determination of whether to extract the underlying resource.¹⁸⁹

However, if a company extracts a resource other than oil or gas, such as bitumen, and sells the product without processing it into synthetic oil or gas, it must disclose reserves of that other natural resource. Although that company's extractive activities would be considered an oil and gas producing activity under the definition of that term, such a company would not benefit from the economics of processing of that resource because the price that determines whether such a company extracts the resource is the price of the unprocessed resource and therefore the company may not establish reserves estimates based on the price of the upgraded product. Similarly, if the company does not itself extract the natural resource, but purchases the natural resource for processing or is paid to process the natural resource, it may not claim reserves either of the resource or of the processed product.

ii. Aggregation

As proposed, the reserves to be reported in these tables would be aggregations (to the company total level) of reserves determined for individual wells, reservoirs, properties, fields, or projects. Regardless of whether the reserves were determined using deterministic or probabilistic methods, the reported reserves should be simple arithmetic sums of all estimates at the well, reservoir, property, field, or project level within each reserves category. Eight commenters agreed that aggregation should not be permitted beyond the field, property or project level, consistent with PRMS.¹⁹⁰

¹⁸⁹ See Section II.C.2 of this release.

¹⁹⁰ See letters from Devon, Evolution, ExxonMobil, Ryder Scott, Shell, SPE, Talisman, and Wagner.

iii. Optional disclosure of probable and possible reserves

A company may, but is not required to, disclose probable or possible reserves in these tables. If a company discloses probable or possible reserves, it must provide the same level of geographic detail as it must with respect to proved reserves and must state whether the reserves are developed or undeveloped. In addition, Item 1202 requires the company to disclose the relative uncertainty associated with these classifications of reserves estimations. By permitting disclosure of all three of these classifications of reserves, our objective is to enable companies to provide investors with more insight into the potential reserves base that managements of companies may use as their basis for decisions to invest in resource development.

Most commenters addressing this issue supported permitting the disclosure of probable and possible reserves in filed documents.¹⁹¹ They believed that such disclosure would provide a more complete picture of a company's full portfolio of opportunities.¹⁹² One commenter noted that this information often is already available on company websites and in press releases.¹⁹³ However, several commenters supporting the proposal cautioned that there could be significant variability among disclosures.¹⁹⁴

Other commenters expressed concern about disclosure of unproved reserves, but conceded that voluntary disclosure would be acceptable.¹⁹⁵ These commenters were

¹⁹¹ See letters from CFA, Chesapeake, Deloitte, EnCana, Evolution, McMoRan, Newfield, Petrobras, Petro-Canada, Questar, Ryder Scott, Sasol, Ryder Scott, Shell, SPE, Three Senators, Wagner, and Zakaib.

¹⁹² See letters from CFA, Evolution, Petro-Canada, Ryder Scott, and Wagner.

¹⁹³ See letter from Evolution.

¹⁹⁴ See letter from EnCana.

¹⁹⁵ See letters from API, ExxonMobil, Imperial, Repsol, and Total.

concerned that such disclosure may confuse investors and expose companies to increased litigation because of the inherent uncertainty associated with probable and possible reserves.¹⁹⁶ They noted that various technologies may be used to support these estimates.¹⁹⁷

Several commenters opposed permitting disclosure of probable and possible reserves in Commission filings for similar reasons.¹⁹⁸ Again, they were concerned that the inherent uncertainty associated with such reserves estimates may lead to investor confusion and misunderstanding.¹⁹⁹ They believed that the broad range of technologies and methods used by companies to support these estimates would lead to inconsistent disclosure among companies.²⁰⁰

We note that numerous oil and gas companies already disclose unproved reserves on their Web sites and in press releases. This practice does not appear to have created confusion in the market. However, we understand commenters' concerns that probable and possible reserves estimates are less certain than proved reserves estimates and so may increase litigation risk. By making these disclosures voluntary, a company could exercise its own discretion as to whether to provide the market with this disclosure.

Some commenters were concerned that voluntary disclosure by some companies may raise confusion as to why other companies do not disclose these classifications of

¹⁹⁶ See letters from API, ExxonMobil, Imperial, and Repsol.

¹⁹⁷ See letters from API, ExxonMobil, and Imperial.

¹⁹⁸ See letters from Apache, Devon, Energen, Eni, and Southwestern.

¹⁹⁹ See letters from Apache, Devon, Eni, and Southwestern.

²⁰⁰ See letters from Devon, Eni, and Southwestern.

reserves.²⁰¹ One commenter was concerned that voluntary disclosure may increase market pressure on all companies to disclose probable and possible reserves estimates.²⁰² Considering the fact that many companies already make these disclosures public, we do not believe that this is an adequate reason for prohibiting from filings disclosure that may be helpful to investors.

iv. Resources not considered reserves

Because we are permitting disclosure of probable and possible reserves, we are revising existing Instruction 5 to Item 102 of Regulation S-K to continue to prohibit disclosure of estimates of oil or gas resources other than reserves, and any estimated values of such resources, in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law.²⁰³ Five commenters recommended that the rules permit disclosure of all categories of resources, including those that do not qualify as reserves.²⁰⁴ One commenter believed that the prohibition against disclosing all resources deprives public markets of significant information without meaningfully enhancing investor protection and ultimately may harm the efficiency and development of U.S. markets and U.S. companies raising capital.²⁰⁵ That commenter also thought such a restriction could also encourage companies to form outside of the U.S.²⁰⁶ Another commenter believed that the

²⁰¹ See letters from Apache and Total.

²⁰² See letter from Eni.

²⁰³ See Instruction 5 to Item 102 [17 CFR 229.102].

²⁰⁴ See letters from Davis Polk, Petro-Canada, Shearman & Sterling, SPE, and Zakaib.

²⁰⁵ See letter from Shearman & Sterling.

²⁰⁶ Id.

uncertainty of resource estimates is best communicated by reporting the full range of estimates.²⁰⁷ In addition, another commenter believed that clear disclosure would allay concerns about investor misunderstanding of estimates of resources that do not qualify as reserves.²⁰⁸ That commenter noted that excluding resources that are not reserves is inconsistent with international standards and the fact that these resources are disclosed in the U.S. on websites and in press releases.²⁰⁹ We continue to be concerned that such resources are too speculative and may lead investors to incorrect conclusions. Therefore, we are adopting the proposal to prohibit disclosure of resources other than reserves.

However, consistent with existing Instruction 5, a company may continue to disclose such estimates of non-reserves resources in a Commission filing related to an acquisition, merger, or consolidation if the company previously provided those estimates to a person that is offering to acquire, merge, or consolidate with the company or otherwise to acquire the company's securities.²¹⁰ Several commenters recommended that the Commission maintain this exception so that the company's shareholders would not be at an informational disadvantage compared to the counterparty when assessing a merger.²¹¹ We agree with these commenters and have retained the exception in the revised Instruction 5 adopted today.

²⁰⁷ See letter from SPE.

²⁰⁸ See letter from Davis Polk.

²⁰⁹ See letter from Davis Polk.

²¹⁰ Id.

²¹¹ See letters from Devon, ExxonMobil, Shell, and Total.

b. Optional reserves sensitivity analysis table

The rules that we are adopting require a company to determine whether its oil or gas resources are economically producible based on a 12-month average price. We also proposed, and are adopting, an optional reserves sensitivity table. This table would permit companies to disclose additional information to investors, such as the sensitivity that oil and gas reserves have to price fluctuations. If a company chooses to provide such disclosure, it may choose the different scenario or scenarios, if any, that it wishes to disclose in the table, provided that it also discloses the price and cost schedules and assumptions on which the alternate reserves estimates are based.

Twelve commenters supported permitting such sensitivity analyses.²¹² Some believed that this would provide investors with a better view of management's analysis of future prices.²¹³ One recommended providing a set price change of 10% for the sensitivity analysis.²¹⁴ Two other commenters believed that different circumstances may require different types of sensitivity analyses, both with respect to the range of prices used and the format of the presentation.²¹⁵ We agree that the appropriate range for a sensitivity analysis may vary depending on the situation, and therefore, as proposed, we are not specifying a range of prices to be used.

²¹² See letters from Canadian Natural, CAPP, CFA, Chesapeake, Deloitte, Devon, Evolution, ExxonMobil, McMoRan, Nexen, Petro-Canada, and Total.

²¹³ See letters from Chesapeake, Deloitte, and McMoRan.

²¹⁴ See letter from CFA.

²¹⁵ See letters from Evolution and Total.

However, five commenters specifically opposed requiring such an analysis.²¹⁶ They believed that such a requirement would cause confusion and harm comparability.²¹⁷ Three commenters opposed such a sensitivity analysis because using different prices could mislead investors.²¹⁸ We are adopting this table, as proposed, as a voluntary disclosure rather than a requirement. However, as proposed, the table would require disclosure of the assumptions behind varying estimates. We believe this disclosure will mitigate any investor confusion.

In addition, we remind companies that Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations)²¹⁹ requires discussion of known trends and uncertainties, which may include changes to prices and costs. A form of this optional reserves sensitivity analysis table is set forth below.

**Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario**

Price Case	Proved Reserves			Probable Reserves			Possible Reserves		
	Oil	Gas	Product A	Oil	Gas	Product A	Oil	Gas	Product A
	Mbbls	mmcf	measure	mbbls	mmcf	measure	mbbls	mmcf	measure
Scenario 1									
Scenario 2									

c. Separate disclosure of conventional and continuous accumulations

Under the proposal, new Item 1202 would have required companies to disclose reserves from conventional accumulations separately from reserves in continuous

²¹⁶ See letters from Canadian Natural, CAPP, Devon, EnCana, and ExxonMobil.

²¹⁷ See letters from EnCana and Ryder Scott.

²¹⁸ See letters from Apache, Petrobras, and Wagner.

²¹⁹ See Item 303 of Regulation S-K [17 CFR 229.303].

accumulations. Nine commenters recommended disclosure based on the final product.²²⁰ These commenters opposed segregating disclosure based on the type of accumulation that is involved.²²¹ They believed that such disclosure would be too complex and detailed and of little use to investors.²²² In addition, seven commenters pointed out that separation may be impossible because some fields contain both conventional and continuous accumulations.²²³ This would make allocation of costs arbitrary.²²⁴ However, four commenters supported the definitions and separate disclosure by type of accumulation.²²⁵ One commenter believed that such disclosure would allow investors to assess the impact of unconventional sources on reserves.²²⁶

Although we agree conceptually that the focus of reserves disclosure should be on the final product, we also recognize that the production of oil and gas from varying sources can have significantly different economics. Extraction of oil and gas from continuous accumulations can be much more labor and resource intensive than extraction of oil and gas from traditional wells. They often require greater ongoing efforts and expense after the initial extraction equipment is in place, making such operations more sensitive to price fluctuations.

²²⁰ See letters from Apache, API, Canadian Natural, CAPP, EnCana, ExxonMobil, Imperial, Petro-Canada, and Total.

²²¹ See letters from Apache, API, CAPP, Chesapeake, Devon, ExxonMobil, Imperial, Repsol, and Shell.

²²² See letters from Apache, API, BP, CAPP, Chesapeake, Chevron, Devon, E&Y, EnCana, ExxonMobil, Imperial, Petro-Canada, Repsol, and Southwestern.

²²³ See letters from BP, Canadian Natural, CAPP, EnCana, Petro-Canada, Ryder Scott, and Talisman.

²²⁴ See letters from EnCana and Ryder Scott.

²²⁵ See letters from Davis Polk, EIA, Petrobras, and Wagner.

²²⁶ See letter from Wagner.

We agree with the commenters that disclosure based on the end product sold would provide a more effective basis for distinguishing reserves that disclosure based on the type of accumulation in which the reserves are held. Therefore, we have revised the disclosure to be based on the end product that is sold by the company.²²⁷ However, with respect to the end product, new Item 1202 makes a distinction between oil and gas, on the one hand, and synthetic oil and gas, on the other. Synthetic products require processing of the raw resource material, either while it is still in the ground ("in situ") or after it is extracted, before it can be used as refinery feedstock or as natural gas. Such processes currently include bitumen upgrading as well as coal liquefaction and gasification. However, resources from some continuous accumulations, such as coalbed methane, do not require such processing and therefore are not associated with the same level of ongoing costs once a well has been drilled because the in-ground resource is already oil or gas (in the case of coalbed methane, the in-ground resource is methane, trapped in a coalbed). Thus, coalbed methane would not be considered a synthetic product.

d. Preparation of reserves estimates or reserves audits

In the Proposing Release, we proposed to require a company to disclose whether or not the technical person²²⁸ primarily responsible for preparing the reserves estimate possessed certain specified qualifications and was subject to a list of controls for maintaining objectivity. Most commenters addressing the issue opposed this proposed

²²⁷ See Item 1202 [17 CFR 229.1202].

²²⁸ With regard to the objectivity of a technical person, the "person" could be an individual or an entity, as appropriate. However, with regard to the qualifications of a person, the disclosure would relate to the individual who is primarily responsible for the technical aspects of the reserves estimation or audit. Thus, this individual is not necessarily the individual generally overseeing the estimation or audit, but the individual who is primarily responsible for the actual calculations and estimation or audit.

requirement.²²⁹ However, many of these commenters appeared to believe that the disclosure requirement would pertain to every person involved with the estimation process.²³⁰ If adopted, they noted that such disclosure would be voluminous, adding unnecessary complexity to disclosures.²³¹ Four commenters suggested that we clarify that the disclosure is limited to the chief technical person who oversees the company's overall reserves estimation process,²³² which was the intent of the proposal. Five commenters supported this disclosure because it helps users understand the objectivity and quality of reserves estimates.²³³

It was our intent to limit the disclosure to the technical person primarily responsible for overseeing the reserves estimates. However, there may have been confusion with respect to this point based on a footnote which stated that we sought disclosure about the person who "is primarily responsible for the actual calculations and estimation or audit." By that term, we did not intend to include any person making "actual calculations." We recognize that, ultimately, the reserves estimates are overseen by top management, which may or may not have reserves estimation expertise. The focus of the final rule is the primary technical person responsible for overseeing the preparation of the reserves estimation process. We have revised the language in the rule to clarify this point.²³⁴

²²⁹ See letters from Apache, API, Chevron, Energen, Eni, ExxonMobil, Newfield, Nexen, PEMEX, Petro-Canada, Ryder Scott, Shell, and Total.

²³⁰ See letters from Apache, API, ExxonMobil, Newfield, Nexen, PEMEX, Ryder Scott, and Total.

²³¹ See letters from Apache, API, ExxonMobil, Newfield, Nexen, PEMEX, Repsol, and Total.

²³² See letters from API, ExxonMobil, PEMEX, and Petro-Canada.

²³³ See letters from CFA, Devon, EnCana, Southwestern, and Wagner.

²³⁴ See Item 1202(a)(7) [17 CFR 229.1202(a)(7)].

Two commenters noted that it was inconsistent to require such precise disclosure about reserves experts, but not other experts.²³⁵ One of those commenters recommended that the rule require expert language, including clear disclosure of which portion of the reserves estimate the third party is expertising and filed consents.²³⁶ The concept of an expert under the Securities Act is different from the disclosures that we seek regarding the qualifications and objectivity of persons responsible for the preparation or audit of oil and gas reserves. Under the Securities Act, disclosure must be made when the company represents that disclosure is based on the authority of an expert. Although the Securities Act concept of experts will continue to be relevant when the reserves disclosures are in, or incorporated into, a Securities Act filing and the company represents that disclosure is based on the authority of an expert, the new rules requiring disclosure about the reserves preparer or auditor in a company's Exchange Act reports are intended to help investors determine whether reserves estimates, which are highly technical, have been prepared by a qualified, objective person, regardless of whether that person is an employee of the company.

However, we agree with commenters that a prescribed list of qualifications and objectivity requirements may be too rigid for all situations. With respect to technical qualifications, several commenters noted that licensing requirements can vary greatly among jurisdictions.²³⁷ Commenters also believed that disclosure of a person's objectivity was unnecessary because management is required to install appropriate

²³⁵ See letters from API and Deloitte.

²³⁶ See letter from Deloitte.

²³⁷ See letters from AAPG, API, Chevron, Eni, Petro-Canada, Questar, and SPE.

internal controls to ensure the reliability of reserves estimates.²³⁸ In fact, some commenters recommended that we limit the disclosure to a description of a company's internal controls, including the company's technical assessment routine, management and board review and approval processes, the internal audit process, the extent to which the company uses external parties to estimate or audit reserves estimates, and a summary description of the qualifications of the company's typical reserves estimators.²³⁹ We are following these commenters' recommendations and adopting a rule that requires a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process and disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit if the company discloses that such a reserves audit has been performed, regardless of whether the technical person is an employee or an outside third party.²⁴⁰

We did not propose, but sought comment on, whether the rules should require a company to retain an independent third party to prepare, or conduct a reserves audit of, the company's reserves estimates. Most commenters urged the Commission not to adopt such a requirement.²⁴¹ They believed that a company's internal staff, particularly at larger companies, is generally in a better position to prepare those estimates²⁴² and that there is a potential lack of qualified third party engineers and other professionals

²³⁸ See letters from API, Chevron, Energen, ExxonMobil, Newfield, Nexen, Petrobras, Ryder Scott, Shell, StatoilHydro, and Total.

²³⁹ See letters from ExxonMobil, Nexen, Shell, and StatoilHydro.

²⁴⁰ See Item 1202(a)(7) [17 CFR 229.1202(a)(7)].

²⁴¹ See letters from API, BHP, BP, CFA, CNOOC, Denbury, Devon, Eni, Energy Literacy, ExxonMobil, Imperial, R. Jones, D. McBride, Newfield, Nexen, Petro-Canada, Ross, D. Ryder, Sasol, Shell, Talisman, Total, and W. van de Vijver.

²⁴² See letters from API, Denbury, ExxonMobil, Imperial, Nexen, Shell, and Talisman.

available to conduct the increased work that would result from such a requirement.²⁴³

We agree with these commenters and are not adopting a requirement that an independent third party prepare, or conduct a reserves audit of, the company's reserves estimates.

e. Reserve audits and the contents of third-party reports

In the Proposing Release, we proposed that, if a company represents that its estimates of reserves are prepared or audited by a third party, the company must file a report of the third party as an exhibit to the relevant registration statement or report. Two commenters believed that a company description of the third party's report would be sufficient because the reports can contain sensitive information.²⁴⁴ However, another commenter was concerned that not filing the report may lead to mischaracterizations by the company.²⁴⁵ This commenter supported the filing of a report by the third party reserves estimator or auditor, but believed that the Commission should determine the contents of such a report.²⁴⁶ Two commenters supported the filing of the report "letter" as an exhibit, but not the full reserves report because it may contain proprietary information.²⁴⁷

As proposed, we are adopting a new rule to require that if the company represents that a third party prepared the reserves estimate or conducted a reserves audit of the reserves estimates, the company must file a report of the third party as an exhibit to the

²⁴³ See letters from AAPG, API, BP, Devon, ExxonMobil, Imperial, D. McBride, Newfield, D. Ryder, and Sasol.

²⁴⁴ See letters from Evolution and Petro-Canada.

²⁴⁵ See letter from Wagner.

²⁴⁶ See letter from Wagner.

²⁴⁷ See letters from Devon and Ryder Scott.

relevant registration statement or report.²⁴⁸ These reports need not be the full “reserves report,” which is often very detailed and voluminous. Rather, these reports could be shorter form reports that summarize the scope of work performed by, and conclusions of, the third party. These reports must include the following disclosure, based on the Society of Petroleum Evaluation Engineers’s audit report guidelines:

- The purpose for which the report is being prepared and for whom it is prepared;
- The effective date of the report and the date on which the report was completed;
- The proportion of the company’s total reserves covered by the report and the geographic area in which the covered reserves are located;
- The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of company’s total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- A discussion of primary economic assumptions;
- A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- A discussion regarding the inherent risks and uncertainties of reserves estimates;

²⁴⁸ See Item 1202(a)(8) [17 CFR 229.1202(a)(8)].

- A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report; and
- The signature of the third party.

In addition, if the report is related to a reserves audit, it must contain a brief summary of the third party's conclusions with respect to the reserves estimates. Finally, if the disclosures are made in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to the filing.

In the Proposing Release, we proposed to define the term "reserves audit" as "the process of reviewing certain of the pertinent facts interpreted and assumptions made that have resulted in an estimate of reserves prepared by others and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities. In order to disclose that a 'reserves audit' has been conducted, the report resulting from this review must represent an examination of at least 80% of the portion of the registrant's reserves covered by the reserves audit." We are substantively adopting the first sentence of this definition as proposed.

However, in response to comments received, we are not adopting the proposed second sentence of the definition of the term "reserves audit." Two commenters supported the proposed 80% threshold regarding the proportion of reserves that a reserves auditor must review in order for the company to characterize that auditor's work as a

"reserves audit."²⁴⁹ Another commenter believed that the 80% threshold was appropriate for preparing reserves estimates.²⁵⁰ But three commenters believed that an audit should simply disclose the percentage that was audited.²⁵¹ One of these noted that it has its reserves audit performed on a rolling basis.²⁵² We believe that disclosure of the work done in the required third-party report makes a bright-line percentage test unnecessary. If a company conducts its reserves audit on a rolling basis, it is appropriate for its shareholders to be aware of that fact. Therefore, we are not adopting the proposed 80% threshold. We believe that disclosure of the scope of the review will enable investors to assess the significance to attribute to a reserves audit.

f. Process reviews

In the Proposing Release, we solicited comment regarding whether we should permit a company to disclose that it has hired a third party to perform a process review under the Society of Petroleum Engineers' (SPE's) reserves auditing standards.²⁵³ Those standards define a process review as an investigation by a person who is qualified by experience and training equivalent to that of a reserves auditor to address the adequacy and effectiveness of an entity's internal processes and controls relative to reserves estimation. However, those standards also note that a process review should not include an opinion relative to the reasonableness of the reserves quantities and should be limited to the processes and control system reviewed. The SPE's standards state that, although

²⁴⁹ See letters from Evolution and Wagner.

²⁵⁰ See letter from Ryder Scott.

²⁵¹ See letters from Devon, Ryder Scott, and Talisman.

²⁵² See letter from Talisman.

²⁵³ See SPE Reserves Auditing Standards.

such reviews may provide value to the entity, an external or internal process review is not of sufficient rigor to establish appropriate classifications and quantities of reserves and should not be represented to the public as being equivalent to a reserves audit.

Five commenters believed that internal process reviews are helpful in promoting accuracy and effectiveness, so companies should be permitted to disclose them.²⁵⁴

However, one commenter was concerned that, although a process review can be helpful for a company, disclosure may give investors a false sense of security.²⁵⁵ Two commenters suggested that, if a company discloses that it performed a process review, it should clearly disclose what a process review is.²⁵⁶

We agree that a process review can be helpful to the company and ultimately to investors. However, we also agree that if a company discloses that it has hired a third party to perform a process review, it must clearly disclose the details surrounding that process review. As such, the new rules treat a process review similar to a reserves audit. If the company discloses that it has hired a third party to conduct a process review, it must file a report of the third party as an exhibit to the relevant registration statement or report and, if the disclosures are made in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to the filing.²⁵⁷

²⁵⁴ See letters from Devon, ExxonMobil, Petro-Canada, Ryder Scott, and Shell.

²⁵⁵ See letter from Wagner.

²⁵⁶ See letters from Devon and Petro-Canada.

²⁵⁷ See Item 1202(a)(8) [17 CFR 229.1202(a)(8)].

4. Item 1203 (Proved undeveloped reserves)

We proposed requiring tabular disclosure of the aging of proved undeveloped reserves (PUDs). Proposed Item 1203 would have required an oil and gas company to prepare a table showing, for each of the last five fiscal years and by product type, proved reserves estimated using current prices and costs in the following categories:

- Proved undeveloped reserves converted to proved developed reserves during the year; and
- Net investment required to convert proved undeveloped reserves to proved developed reserves during the year.²⁵⁸

Numerous commenters were concerned that the proposed five-year table would be too complex for investors to understand.²⁵⁹ They expressed concern that the proposed table may mislead investors by not clearly attributing costs to the year in which the corresponding PUDs are converted because much of the costs may have been spent in previous years.²⁶⁰ In addition, commenters noted that maintenance of such data would be costly²⁶¹ and that companies currently do not always capture this type of information because management does not use it to run the business.²⁶²

Eight commenters suggested an alternative of disclosing (1) the quantity of undeveloped reserves if material, (2) the progress in converting PUDs, and (3) any

²⁵⁸ See Item 1204 [17 CFR 229.1204].

²⁵⁹ See letters from API, BP, Canadian Natural, CAPP, Chevron, Eni, Equitable, ExxonMobil, Nexen, Petrobras, Repsol, Shell, and Wagner.

²⁶⁰ See letters from API, ExxonMobil, Petrobras, Ryder Scott, Total, and Wagner.

²⁶¹ See letters from API, Canadian Natural, CAPP, Chevron, Eni, Equitable, ExxonMobil, Nexen, Petrobras, Southwestern, and Wagner.

²⁶² See letter from Apache.

material changes in the current year.²⁶³ Three U.S. Senators recommended requiring disclosure of development plans in addition to the table.²⁶⁴ They believed that requiring reporting of investments and planned investments in oil and gas development would provide investors with certainty about companies' intentions to develop the federal lands that they have at their disposal.²⁶⁵ However, three commenters opposed disclosure of a company's plans to drill and expected capital expenditures because disclosing their business plan may cause competitive harm and might expose them to litigation if results differ from their plan.²⁶⁶ Six commenters supported the proposed table.²⁶⁷

We recognize the concern that the PUD table that we proposed may be confusing to investors because it would not attribute capital expenditures to the corresponding reserves as they are developed. As an alternative to the proposed table, we are adopting rules that require a company to disclose the following in narrative form:

- The total quantity of PUDs at year end;
- Any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves;
- Investments and progress made during the year to convert PUDs to proved developed oil and gas reserves; and

²⁶³ See letters from API, Canadian Natural, Chevron, ExxonMobil, Newfield, Nexen, Petrobras, and Ryder Scott.

²⁶⁴ See letter from Three Senators.

²⁶⁵ See letter from Three Senators.

²⁶⁶ See letters from Chesapeake, Devon, and Newfield.

²⁶⁷ See letters from Chesapeake, Deloitte, Devon, Three Senators, Talisman, and Wagner.

- An explanation of the reasons why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after disclosure as PUDs.²⁶⁸

These disclosures would have been required under the proposal, but much of it would have been presented in tabular format. We believe that a narrative approach to these disclosures will provide companies with a better vehicle to explain the status of their PUDs and their track record for developing such reserves. Rather than requiring forward-looking information about a company's plans to develop reserves that may lead to exaggeration of a company's capability to actually convert such reserves, we believe that disclosure of a company's verifiable, established track record of converting such reserves, including its ability to obtain financing for such activities, would be a better indication of the likelihood of that company's success in developing reserves in the future. Specific required disclosure regarding a company's failure to develop material concentrations of PUDs for five or more years should address commenters' concerns that the company may have no intention to develop such reserves.

5. Item 1204 (Oil and gas production)

We proposed to codify the Industry Guide 2 disclosure regarding oil and gas production as Item 1204 of Regulation S-K, in tabular form and with greater detail. One commenter did not believe that separating production, sales price and production costs based on whether they were related oil wells or gas wells would be valuable to investors.²⁶⁹ It believed that companies do not use this information to manage their

²⁶⁸ See Item 1203 [17 CFR 229.1203].

²⁶⁹ See letter from Apache.

business and do not maintain systems to capture this information on that basis, so tracking such data would require costly changes to their systems.²⁷⁰ Two commenters also believed that it would not be possible to separate production cost by product because many units extract different products.²⁷¹ One commenter also recommended that production not be segregated by type of accumulation.²⁷²

We have decided not to adopt Item 1204 as proposed. Rather, we are codifying the existing Industry Guide 2 disclosure item with several revisions. Consistent with the Industry Guide 2 disclosure item, the Item 1204, as adopted, requires disclosure, for each of the prior three fiscal years, of production, by final product sold, of oil, gas, and other products. In addition, for the same time period, the company must disclose, by geographical area:

- The average sales price (including transfers) per unit of oil, gas and other products produced; and
- The average production cost, not including ad valorem and severance taxes, per unit of production.

However, unlike the Industry Guide disclosure item, this disclosure must be made by geographical area and for each country and field containing 15% or more of the registrant's proved reserves, expressed on an oil-equivalent-barrels basis.

Similarly, we are codifying the instructions to the Industry Guide 2 item. One commenter recommended that we maintain some of the existing instructions from the

²⁷⁰ See letter from Apache.

²⁷¹ See letters from Total and ExxonMobil.

²⁷² See letter from ExxonMobil.

Industry Guide.²⁷³ The first instruction codified from the Industry Guide clarifies that net production should include only production that is owned by the registrant and produced to its interest, less royalties and production due others. However, in special situations (e.g., foreign production), net production before any royalties may be provided, if more appropriate. If "net before royalty" production figures are furnished, the change from the usage of "net production" should be noted.

The second instruction, which is also from the Industry Guide, states that production of natural gas should include only marketable production of natural gas on an "as sold" basis. Production will include dry, residue, and wet gas, depending on whether liquids have been extracted before the registrant transfers title. Flared gas, injected gas, and gas consumed in operations should be omitted. Recovered gas-lift gas and reproduced gas should not be included until sold. Synthetic gas, when marketed as such, should be included in natural gas sales.

We are adding a third instruction that was not in the Industry Guide. This instruction states that, if any product, such as bitumen, is sold or custody is transferred prior to conversion to synthetic oil or gas, the product's production, transfer prices, and production costs should be disclosed separately from all other products. This instruction is necessary because the existing Industry Guide 2 disclosure requirement only required separate disclosure based on whether the end product was oil or gas. This instruction merely clarifies that disclosures under this item must be based on the end product, which may not be oil or gas because the amendments will permit the disclosure of reserves of other end products, such as bitumen.

²⁷³

See letter from ExxonMobil.

The fourth instruction codified from the Industry Guide states that the transfer price of oil and gas (natural and synthetic) produced should be determined in accordance with SFAS 69. And the fifth instruction codified from the Industry Guide clarifies that the average production cost per unit of production should be computed using production costs disclosed pursuant to SFAS 69. Units of production should be expressed in common units of production with oil, gas, and other products converted to a common unit of measure on the basis used in computing amortization. This instruction also adds products from unconventional sources to the existing disclosure Item in Industry Guide 2.

6. Item 1205 (Drilling and other exploratory and development activities)

We proposed to codify the Industry Guide 2 disclosure item regarding drilling activities as Item 1205 of Regulation S-K, in tabular form, with several revisions to that Industry Guide 2 disclosure item, including applying a new definition of the term “geographic area” and adding two categories of wells:

- Extension wells; and
- Suspended wells.

Three commenters believed that the disclosures required under this proposed Item would become too detailed.²⁷⁴ One of these commenters also believed that the number of wells being drilled does not provide an accurate picture of a company’s drilling activities because of the increased usage of horizontal wells.²⁷⁵

²⁷⁴ See letters from Apache, ExxonMobil, and Total.

²⁷⁵ See letter from ExxonMobil.

Some commenters also did not believe that creating new categories for extension wells and suspended wells would be meaningful.²⁷⁶ They noted the burden of the added detail would exceed the value of the information to investors.²⁷⁷ One pointed out that determining whether a well constitutes an extension well would be difficult because of multipurpose drilling.²⁷⁸

After considering the above comments, we have decided not to adopt all of the proposed revisions to the existing Industry Guide 2 disclosure. We recognize that, for some companies that use advanced drilling techniques, the proposed disclosure may not be a good indicator of the extent of their exploratory and development activities, although we believe that this disclosure is still important for many companies. Therefore, we have decided to codify the existing disclosures found in Industry Guide 2 related to drilling activities without revision and to not require tabular disclosure.²⁷⁹ However, as proposed, we are adding a new provision to this Item that requires companies to discuss their exploratory and development activities regarding oil and gas resources that are extracted by mining techniques because we are now including such resources under the definition of “oil and gas producing activities.”

7. Item 1206 (Present activities)

Item 1206 codifies existing Item 7 of Industry Guide 2, which calls for disclosure of present activities, including the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed,

²⁷⁶ See letters from Apache, API, and Imperial.

²⁷⁷ See letters from Apache and Southwestern.

²⁷⁸ See letter from Total.

²⁷⁹ See Item 1205 [17 CFR 229.1205].

pressure maintenance operations, and any other related activities of material importance.²⁸⁰ We are adopting Item 1206 substantially as proposed.

8. Item 1207 (Delivery commitments)

Item 1207 codifies existing Item 8 of Industry Guide 2, which calls for disclosure of arrangements under which the company is required to deliver specified amounts of oil or gas and how the company intends to meet such commitments.²⁸¹ We are not adopting any substantive changes to the disclosure currently called for by Item 8 of Industry Guide 2. However, we are restructuring and rewording the disclosure item to make it easier to understand, including separating embedded lists into separate subparagraphs and making general plain English revisions. As proposed, these revisions are not intended to change the substance of the disclosures.

9. Item 1208 (Oil and gas properties, wells, operations, and acreage)

We proposed to codify disclosure about oil and gas properties, wells, operations, and acreage as Item 1208 of Regulation S-K, in tabular form, as well as make several revisions to the existing disclosures, including applying a new definition of the term “geographic area” and adding language that better illustrates the types of properties and the types of disclosures for those properties, including the following:

- Identification and description generally of the company’s material properties, plants, facilities, and installations;
- Identification of the geographic area in which they are located;
- Indication of whether they are located onshore or offshore; and

²⁸⁰ See Item 1206 [17 CFR 229.1206].

²⁸¹ See Item 1207 [17 CFR 229.1207].

- Description of any statutory or other mandatory relinquishments, surrenders, back-ins, or changes in ownership.

Six commenters believed that it is not necessary to enhance this section from Industry Guide 2 because the requirements are already covered by Item 102 of Regulation S-K.²⁸² Commenters were particularly concerned with the segmentation of this disclosure by product, by type of accumulation, and by geographic location.²⁸³ They believed that this level of detail would not be helpful to investors and would impose added costs on companies because they currently do not collect this detailed information.²⁸⁴ Moreover, seven commenters thought that the well count disclosure is no longer meaningful because of technologies such as horizontal drilling.²⁸⁵ They thought that, in light of these new technologies, well count disclosure could be misleading.²⁸⁶

As with the case of drilling activities, we agree that the proposed added detail could make the disclosures too cumbersome. In addition, such disclosure may be of less importance to many companies because of new drilling technology. Therefore, we are merely codifying the existing Industry Guide 2 disclosure, without revision.²⁸⁷

V. Guidance for Management's Discussion and Analysis for Companies Engaged in Oil and Gas Producing Activities

We proposed to add a new Item 1209, which would have specified topics that a company should address either as part of its Management's Discussion and Analysis of

²⁸² See letters from API, Chevron, ExxonMobil, Imperial, Shell, and Total.

²⁸³ See letters from Apache, ExxonMobil, Shell, and Total.

²⁸⁴ See letters from Apache, ExxonMobil, and Petro-Canada.

²⁸⁵ See letters from API, BP, Chevron, ExxonMobil, Imperial, StatoilHydro, and Total.

²⁸⁶ See letters from API and Imperial.

²⁸⁷ See Item 1208 [17 CFR 229.1208].

Financial Condition and Results of Operations (MD&A) or in a separate section.²⁸⁸ Four commenters were concerned that, although the proposed Item was intended to provide more guidance regarding the disclosures required, it would effectively require companies to address all of the issues listed in the Item.²⁸⁹ One recommended that, instead of a detailed list, the requirement should clarify that companies should address “material changes due to technology, prices, concession conditions, commercial terms, known trends, demands, commitments, uncertainties and any events that are reasonably likely to have a material effect on reserves estimates and financial condition.”²⁹⁰ Similarly, another commenter recommended that the Commission clarify that the Item is limited to material impacts.²⁹¹

We are not adopting the proposed Item as part of Regulation S-K because it is intended to be guidance, rather than a specific disclosure Item. We agree that, if companies were to discuss every issue provided in the list, the disclosure would be too long and detailed to be of much use to most investors. Important issues could be hidden amid unnecessary detail. However, we believe that added guidance would be beneficial to companies regarding the issues that the Commission’s staff commented upon in its review of the MD&A section of filings made by oil and gas companies.

To begin, a fundamental premise of MD&A is that the information provided should be related to issues that are material to a company. Although we discuss a list of topics that a company might need to discuss, a company need only discuss a topic if it

²⁸⁸ See Item 303 of Regulation S-K [17 CFR 229.303].

²⁸⁹ See letters from Chevron, ExxonMobil, Petrobras, and Shell.

²⁹⁰ See letter from Repsol.

²⁹¹ See letter from Total.

constitutes, involves, or indicates known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company. These topics include:

- Changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to:
 - Changes in prices;
 - Technical revisions; and
 - Changes in the status of any concessions held (such as terminations, renewals, or changes in provisions);
- Technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates, including any material additions or increases to reserves estimates that are the result of any of the final rules adopted in this release;
- Prices and costs, including the impact on depreciation, depletion and amortization as well as the full cost ceiling test;
- Performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;
- Performance of any mining-type activities for the production of hydrocarbons;

- The company's recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;
- The minimum remaining terms of leases and concessions;
- Material changes to any line item in the tables described in Items 1202 through 1208 of Regulation S-K;
- Potential effects of different forms of rights to resources, such as production sharing contracts, on operations; and
- Geopolitical risks that apply to material concentrations of reserves.

The MD&A is typically presented in a self-contained section of the registration statement or report. However, the disclosure requirements that comprise new Subpart 1200 of Regulation S-K will cause a substantial amount of an oil and gas company's disclosure to appear in tabular format, providing an outline of much of a company's operations. Because the tables will present many of the types of changes that management often discusses in its MD&A, we believe it may be more helpful to investors to locate such discussion close to the tables themselves. Thus, to the extent that any discussion or analysis of known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company is directly relevant to a particular disclosure required by Subpart 1200, the company may include that discussion or analysis with the relevant table, with appropriate cross-references, rather than including it in its general MD&A section.

VI. Conforming Changes to Form 20-F

Form 20-F is the form on which foreign private issuers file their annual reports and Exchange Act registration statements. Currently, Form 20-F contains instructions that are similar to those in Item 102 of Regulation S-K. However, rather than referring to Industry Guide 2 for disclosures regarding oil and gas producing activities, Form 20-F contains its own "Appendix A to Item 4.D—Oil and Gas" (Appendix A) that provides guidance for oil and gas disclosures for foreign private issuers.²⁹² Appendix A is significantly shorter, and provides far less guidance regarding disclosures, than Subpart 1200 or Industry Guide 2. We proposed to revise Form 20-F to eliminate the reference to Appendix A, and rather refer to Subpart 1200, which would expand the disclosures required by foreign private issuers.

Six commenters supported harmonizing the Form 20-F disclosures with Regulation S-K.²⁹³ One noted that the proposal would make disclosure more consistent and comparable among oil companies.²⁹⁴ It believed the proposal would put all oil companies on a level playing field.²⁹⁵

However, one commenter recommended that the Commission exempt companies reporting under International Financial Reporting Standards (IFRS).²⁹⁶ It also recommended that instead of applying the proposed Subpart 1200 to foreign private issuers, the Commission should revise Appendix A to Form 20-F itself, making

²⁹² See Appendix A to Item 4.D—Oil and Gas of Form 20-F [17 CFR 249.220f].

²⁹³ See letters from CAQ, Deloitte, ExxonMobil, KPMG, PWC, and Shell.

²⁹⁴ See letter from ExxonMobil.

²⁹⁵ See letter from ExxonMobil.

²⁹⁶ See letter from Total.

appropriate limitations for foreign private issuers, such as eliminating the disclosure of wells and acreage.²⁹⁷ Another commenter was concerned because the proposals may hinder, rather than facilitate, transition to the use of IFRS.²⁹⁸

We continue to believe that Subpart 1200 would be appropriate disclosure for all public companies engaged in oil and gas producing activities, including foreign private issuers. The added guidance in Subpart 1200 should promote more consistent and comparable disclosures among oil and gas companies. It is our understanding that many of the larger foreign private issuers already provide disclosure in their filings with the Commission comparable to the disclosure provided by domestic companies. Thus, we are revising Form 20-F to incorporate Subpart 1200 with respect to oil and gas disclosures and delete Appendix A to Item 4.D in that form. We recognize that this requirement may require a foreign private issuer to prepare two different reserves estimates if the rules in their home jurisdiction require a different pricing standard than the 12-month average that we adopt in this release. However, we believe the same conflict would have existed under our previous rule to the extent our pricing method differed from the home jurisdiction's method.

Appendix A currently allows a foreign private issuer to exclude required disclosures about reserves and agreements if its home country prohibits the disclosures. Two commenters suggested that the rule continue to provide an exception for disclosures about reserves and agreements that are prohibited by foreign laws.²⁹⁹ However, another

²⁹⁷ See letter from Total.

²⁹⁸ See letter from Ross.

²⁹⁹ See letters from Shell and Total.

commenter believed that a company taking advantage of such an exception should be required to disclose the country, the citation of the relevant law or regulation, and the fact that the disclosed estimates do not include amounts from the named country.³⁰⁰ We are not revising this provision. Rather, because these considerations still apply to such foreign private issuers, we are moving that provision from Appendix A and adopting it as Instruction 2 to Item 4 of Form 20-F, as proposed.³⁰¹

One commenter recommended clarifying that the new disclosures would not apply to foreign private issuers under the Multi-Jurisdictional Disclosure System (MJDS) using Form 40-F that comply with NI 51-101 in Canada because those rules already are broadly consistent with PRMS.³⁰² We agree with this commenter and believe that such issuers need not provide disclosures beyond those required in Canada.

VII. Impact of Amendments on Accounting Literature

A. Consistency with FASB and IASB Rules

Numerous commenters recommended that the SEC generally coordinate its efforts with the IASB and FASB to create a cohesive whole and not adopt competing models.³⁰³ We have begun, and will continue, to work with both of these organizations to ensure a smooth transition to the new reporting rules.

B. Change in Accounting Principle or Estimate

In the Proposing Release, we expressed our view that the change from using single-day year-end price to an average price should be treated as a change in accounting

³⁰⁰ See letter from ExxonMobil.

³⁰¹ Id.

³⁰² See letter from Deloitte.

³⁰³ See letters from CAQ, CFA, Eni, Grant Thornton, KPMG, and PWC.

principle, or a change in the method of applying an accounting principle, that is inseparable from a change in accounting estimate. Therefore, this change would be considered a change in accounting estimate pursuant to Statement of Financial Accounting Standard No. 154 "Accounting Changes and Error Corrections" (SFAS 154) and would be accounted for prospectively.

Commenters believed that the change would be best described as:

- A change in accounting estimate;³⁰⁴
- A change in accounting principle that is inseparable from a change in accounting estimate; or³⁰⁵
- A change in accounting estimate effected by a change in accounting principle.³⁰⁶

We believe that any accounting change resulting from the changes in definitions and required pricing assumptions in Rule 4-10, should be treated as a change in accounting principle that is inseparable from a change in accounting estimate, which does not require retroactive revision. We note that pursuant to AU 420.13, such a change requires recognition in the independent auditor's report through the addition of an explanatory paragraph.

All commenters on the issue agreed that adoption of the rules should not require retroactive revision of past reserves estimates.³⁰⁷ Some believed retroactive revision of

³⁰⁴ See letters from CAQ, Canadian Natural, CAPP, Deloitte, Devon, KPMG, Petrobras, PWC, Repsol, Shell, and StatoilHydro.

³⁰⁵ See letter from Deloitte.

³⁰⁶ See letter from Petro-Canada.

³⁰⁷ See letters from Apache, CAQ, Canadian Natural, CAPP, Deloitte, Devon, Evolution, ExxonMobil, Petrobras, Petro-Canada, PWC, Repsol, Shell, StatoilHydro, and Total.

reserves estimates would be very burdensome or impossible because such data was not maintained.³⁰⁸ We agree with those commenters and believe that no retroactive revisions will be necessary.

Three commenters recommended that the FASB revise Statement of Financial Accounting Standard No. 19 (SFAS 19) to include unconventional resources currently accounted for as mining activities and also provide guidance that no retroactive revisions would be required in that scenario.³⁰⁹ We will continue to work with the FASB on this issue.

C. Differing Capitalization Thresholds Between Mining Activities and Oil and Gas Producing Activities

As noted elsewhere in this release, extraction of products such as bitumen now will be considered oil and gas producing activities, and not mining activities. Under current U.S. accounting guidance, costs associated with proven plus probable mining reserves may be capitalized for operations extracting products through mining methods, like bitumen. Under the new rules, bitumen extraction and operations that produce oil or gas through mining methods are included under oil and gas accounting rules, which only permit capitalization of costs associated with proved reserves.³¹⁰ Moreover, the mining guidelines do not provide specified percentages for establishing levels of certainty for proven or probable reserves for mining activities. It is possible that these differences could result in changing reserves estimates for these resources during the transition to the new rules.

³⁰⁸ See letters from Canadian Natural, Deloitte, Evolution, Petrobras, and Shell.

³⁰⁹ See letters from CAQ, Petrobras, and PWC.

³¹⁰ See Rule 4-10(c) of Regulation S-X [17 CFR 210.4-10(c)].

One commenter believed that the industry would need guidance regarding how to transition operations that are disclosed and accounted for as mining operations to oil and gas disclosure and accounting.³¹¹ It noted that this issue would be relevant not only coincident with the new rules, but could be relevant to future events, such as a coal mining company that in subsequent years changes its operations to in situ coal gasification.³¹² That commenter believed that, without guidance, the change from mining treatment to oil and gas treatment could be considered a change in accounting principle which requires retroactive revision.³¹³ We acknowledge this commenter's concerns. With respect to resources formerly considered mining activities, we view the change from mining treatment to oil and gas treatment as a change in accounting principle that is inseparable from a change in accounting estimate, which does not require retroactive revision.

VIII. Application of Interactive Data Format to Oil and Gas Disclosures

In the Proposing Release, we sought comment on the desirability of rules that would permit, or require, oil and gas companies to present the tabular disclosures in Subpart 1200 in interactive data format in addition to the currently required format. Most commenters addressing the topic supported the use of XBRL for oil and gas disclosures.³¹⁴ They believed using interactive data would be very helpful to investors and analysts.³¹⁵

³¹¹ See letter from KPMG.

³¹² See letter from KPMG.

³¹³ See letter from KPMG.

³¹⁴ See letters from Audit Policy, CFA, Deloitte, Devon, E&Y, ExxonMobil, PWC, Shell, Standard Advantage, StatoilHydro, and Zakaib.

³¹⁵ See letters from CFA, Devon, E&Y, StatoilHydro, and Zakaib.

However, they also recommended that the Commission wait until a well-developed taxonomy exists.³¹⁶ Some recommended that the Commission implement it in stages, initially with a voluntary program.³¹⁷ One commenter recommended that the SEC work with other groups like SPE, IASB, and the United Nations to ensure tags ultimately become the industry standard.³¹⁸

We agree that much of the disclosures regarding oil and gas companies would be conducive to interactive data. We intend to continue to work on developing a taxonomy for such disclosure. Once a well-developed taxonomy is created, we will address this issue further. We are not, however, adopting interactive data requirements in this release. We will continue to consider whether to require interactive oil and gas disclosure filings in the future and, if so, when such filings should be required based on the development status of an oil and gas disclosure taxonomy.

IX. Implementation Date

A. Mandatory Compliance

We proposed to require companies to begin complying with the disclosure requirements for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. A company may not apply the new rules to disclosures in quarterly reports prior to the first annual report in which the revised disclosures are required.

³¹⁶ See letters from Audit Policy, Deloitte, Devon, E&Y, ExxonMobil, PWC, Shell, StatoilHydro, and Zakaib.

³¹⁷ See letters from Audit Policy, Devon, E&Y, PWC, StatoilHydro, and Zakaib.

³¹⁸ See letter from Zakaib.

Fifteen commenters agreed that a delayed compliance date would be helpful in allowing companies to familiarize themselves with the new disclosure requirements before having to comply with them.³¹⁹ Four commenters supported the proposed January 1, 2010 compliance date of Securities Act filings and Exchange Act filings related to fiscal periods ending on or after December 31, 2009.³²⁰ However, one conditioned this approval upon the adoption of the rules before December 31, 2008.³²¹ Another suggested one year after adoption of the rules.³²²

Four commenters believed that the proposed compliance date would be too soon.³²³ One recommended a compliance date of December 31, 2010 to enable companies to make necessary changes in IT systems and data processing.³²⁴ Another noted the magnitude of the proposed changes, length of time to design, program and implement system changes, and the goal of getting the best possible disclosure.³²⁵ One commenter suggested delaying implementation for two years after adoption.³²⁶

We continue to believe that the proposed compliance dates are appropriate. However, as we discuss our revisions with the FASB and IASB, we will consider whether to delay the compliance date further.

³¹⁹ See letters from Apache, Chevron, Davis Polk, Deloitte, ExxonMobil, KPMG, Newfield, Petrobras, Petro-Canada, PWC, Ryder Scott, Shell, Southwestern, Talisman, and Total.

³²⁰ See letters from Davis Polk, ExxonMobil, Shell, and StatoilHydro.

³²¹ See letter from ExxonMobil.

³²² See letter from Talisman.

³²³ See letters from Apache, Petrobras, PWC, and Total.

³²⁴ See letter from Petrobras.

³²⁵ See letter from Apache.

³²⁶ See letter from Devon.

B. Voluntary Early Compliance

Seven commenters recommended that early compliance not be permitted to maintain consistency and comparability of disclosure among issuers, which could be misleading or confusing to investors.³²⁷ However, one commenter believed that the Commission should permit early adoption of the new rules because companies with different fiscal year ends are not comparable anyway.³²⁸ One commenter suggested that the Commission permit companies to provide the new disclosures supplementally.³²⁹ We agree that voluntary compliance may make disclosures incomparable. Therefore, companies may not elect to follow the new disclosure rules prior to the effective date.

X. Paperwork Reduction Act

A. Background

Our new rules and amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").³³⁰ We submitted the new rules and amendments to the Office of Management and Budget (OMB) for review in accordance with the PRA.³³¹ OMB has approved the revisions. The titles for these collections of information are:

- (1) "Regulation S-K" (OMB Control No. 3235-0071);³³²

³²⁷ See letters from Davis Polk, Devon, ExxonMobil, Petrobras, Ryder Scott, Shell, and Wagner.

³²⁸ See letter from Evolution.

³²⁹ See letter from Davis Polk.

³³⁰ 44 U.S.C. 3501 *et seq.*

³³¹ 44 U.S.C. 3507(d) and 5 CFR 1320.11.

³³² The paperwork burden from Regulation S-K and the Industry Guides is imposed through the forms that are subject to the disclosures in Regulation S-K and the Industry Guides and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience, we estimate the burdens imposed by each of Regulation S-K and the Industry Guides to be a total of one hour.

- (2) "Industry Guides" (OMB Control No. 3235-0069);
- (3) "Regulation S-X" (OMB Control No. 3235-0009);
- (4) "Form S-1" (OMB Control No. 3235-0065);
- (5) "Form S-4" (OMB Control No. 3235-0324);
- (6) "Form F-1" (OMB Control No. 3235-0258);
- (7) "Form F-4" (OMB Control No. 3235-0325);
- (8) "Form 10" (OMB Control No. 3235-0064);
- (9) "Form 10-K" (OMB Control No. 3235-0063); and
- (10) "Form 20-F" (OMB Control No. 3235-0063).

We adopted all of the existing regulations and forms pursuant to the Securities Act and the Exchange Act. These regulations and forms set forth the disclosure requirements for annual reports³³³ and registration statements that are prepared by issuers to provide investors with the information they need to make informed investment decisions in registered offerings and in secondary market transactions. The industry guides supplement the existing regulations and forms and provide guidance with respect to industry-specific disclosures.

Our amendments to these existing forms are intended to modernize and update our reserves definitions to better reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's

³³³ The pertinent annual reports are those on Forms 10-K and 20-F.

reserves, as well as providing information regarding a company's internal controls over reserves estimation and the qualifications of person preparing reserves estimates or conducting reserves audits. The new rules and amendments also are intended to codify, modernize, and centralize the disclosure items for oil and gas companies in Regulation S-K. Finally, the new rules and amendments are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the new rules and amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Many, but not all, of the information collection requirements related to annual reports and registration statements will be mandatory. There is no mandatory retention period for the information disclosed, and the information will be publicly available on the EDGAR filing system.

B. Summary of Information Collections

The new rules and amendments increase existing disclosure burdens for annual reports on Forms 10-K³³⁴ and 20-F and registration statements on Forms 10, 20-F, S-1,

³³⁴ The disclosure requirements regarding oil and gas properties and activities are in Form 10-K as well as the annual report to security holders required pursuant to Rule 14a-3(b) [17 CFR 240.14a-3(b)]. Form 10-K permits the incorporation by reference of information from the Rule 14a-3(b) annual report to security holders to satisfy the Form 10-K disclosure requirements. The analysis that follows assumes that companies would either provide the proposed disclosure in a

S-4, F-1, and F-4 by creating the following new disclosure requirements, many of which were requested by industry participants:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

Form 10-K or incorporate the required disclosure into the Form 10-K by reference to the Rule 14a-3(b) annual report to security holders if the company is subject to the proxy rules. This approach takes into account the burden from the proposed disclosure requirements that are included in both Form 10-K and Regulation 14A or 14C.

In addition, the amendments harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, foreign private issuers must disclose the information required by Items 1205 through 1208 of Regulation S-K regarding drilling activities, present activities, delivery commitments, wells, and acreage, which previously were not specified in Appendix A to Form 20-F. These disclosure items codify the substantive disclosures called for by Items 4 through 8 of Industry Guide 2, although much of this disclosure may have been disclosed by some companies under the more general discussions of business and property on that form.

C. Revisions to PRA Burden Estimates

For purposes of the PRA, we estimated, in the Proposing Release, the total annual increase in the paperwork burden for all affected companies to comply with our proposed collection of information requirements to be approximately 7,472 hours of in-house company personnel time and to be approximately \$1,659,000 for the services of outside professionals.³³⁵ These estimates included the time and the cost of preparing and reviewing disclosure and filing documents. Our methodologies for deriving the above estimates are discussed below.

Our estimates represented the burden for all oil and gas companies that file annual reports or registration statements with the Commission. Based on filings received during the Commission's last fiscal year, we estimate that 241 oil and gas companies file annual reports and 67 oil and gas companies file registration statements. Most of the

³³⁵ For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest thousand.

information called for by the new disclosure requirements, including the optional disclosure items, is readily available to oil and gas companies and includes information that is regularly used in their internal management systems. These disclosures include:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

We estimated that, on average, each company would incur a burden of 35 hours to prepare these disclosures in an annual report or registration statement.

The amendments also apply several disclosure items to foreign private issuers that previously did not apply to them. As noted above, many of these disclosure items, such as drilling activities, wells and acreage, require the issuer to provide more specificity about its business and property. Foreign private issuers that do not currently provide such specificity would incur an added burden to present such disclosures in their filings. In the Proposing Release, we estimated that this burden would be 20 hours per foreign private issuer.

We received few comments regarding our estimates. Several large oil companies, and an industry organization that primarily represents large oil companies, believed that the estimates were too low. They believed that the new rules and amendments would increase their burden by 10,000 to 15,000 hours per year. However, these commenters included the initial cost to change their internal systems to provide the new required disclosures in their estimates. Based on conversations with these commenters, the staff understands that they believed that the ongoing burden would be approximately one third of that estimate. For purposes of its Paperwork Reduction Act estimate, the staff considers the ongoing annual burden and spreads the initial transitional burden of compliance with new rules and regulations over a three year period.

In addition, these commenters indicated that the two most significant burdens that stemmed from the proposed use of different prices for disclosure and accounting purposes and the increased detail in disclosures that would result from the proposed definition of the term "geographic area" and the proposed disclosure by type of accumulation. It should be noted that these commenters have significant reserves spread worldwide. Some of these large companies have as much as 10,000 times the amount of

reserves of the median oil and gas company. These large companies likely would be more significantly impacted by the level of detailed disclosure that the proposals would have required compared to the vast majority of oil and gas companies in our reporting system, which do not have such extensive global operations. Therefore, we do not believe that the estimate provided by those large oil and gas companies necessarily would be applicable to most oil and gas companies. However, in response to the concerns that they expressed, the final rules do not require the use of different prices for disclosure and full cost accounting purposes. We also intend to continue to work with the FASB to align the accounting standards with that pricing mechanism. In addition, we have significantly reduced the level of detailed geographic and product disclosure that the rules require. Finally, we are providing for a substantial transition period to allow companies to adjust their systems to comply with the new rules. We believe that these changes will help to mitigate the increased burden of the new rules.

We do, however, believe that our initial burden estimates may have been too low. We are therefore adjusting our burden estimate to reflect an additional increase of 100 hours per company per year. In addition, we are increasing our burden estimate for foreign private issuers by an additional 150 hours per company per year. Consistent with current Office of Management and Budget estimates and recent Commission rulemakings, we estimate that 25% of the burden of preparation of registration statements on Forms S-1, S-4, F-1, F-4, 10, and 20-F is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average

cost of \$400 per hour.³³⁶ We estimate that 75% of the burden of preparation of annual reports on Form 10-K or Form 20-F is carried by the company internally and that 25% of the burden is carried by outside professionals retained by the company at an average cost of \$400 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. The following tables summarize the additional changes to the PRA estimates:

Table 1: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Exchange Act Periodic Reports

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	75% Issuer	25% Professional	\$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*\$400
10-K ³³⁷	206	100	20,600	15,450	5,150	2,060,000
20-F	35	150	5,250	3,938	1,312	525,000
Total	241		25,850	19,388	6,462	2,585,000

Table 2: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Securities Act Registration Statements and Exchange Act Registration Statements

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	25% Issuer	75% Professional	\$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*\$400
10	5	100	500	125	375	150,000
20-F	2	150	300	75	225	90,000
S-1	38	100	3,800	950	2,850	1,140,000
S-4	17	100	1,700	425	1,275	510,000
F-1	2	150	300	75	225	90,000
F-4	3	150	450	112.5	337.5	135,000
Total	67		7,050	1762.5	5,287.5	2,115,000

D. Request for Comment

We request comment in order to evaluate the accuracy of our estimates of the burden of the revised information collections. Any member of the public may direct to us

³³⁶ In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of \$400 as the average cost of outside professionals that assist issuers in preparing disclosures and conducting registered offerings.

³³⁷ The burden estimates for Form 10-K assume that the requirements are satisfied by either including information directly in the annual reports or incorporating the information by reference from the Rule 14a-3(b) annual report to security holders.

any comments concerning the accuracy of these burden estimates. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington DC 20503, and should send a copy of the comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-15-08. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-15-08, and be submitted to the Securities and Exchange Commission, Records Management Branch, 100 F Street NE, Washington, DC 20549-1126. Because OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if OMB receives them within 30 days of publication.

XI. Cost-Benefit Analysis

A. Background

We are adopting revisions to the oil and gas reserves disclosure regime of Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934 and Industry Guide 2. The revisions are intended to modernize and update oil and gas disclosure. The oil and gas industry has experienced significant changes since the Commission initially adopted its current rules and disclosure regime between 1978 and 1982, including advancements in technology and changes in the types of projects in which oil and gas companies invest. The revisions also are intended to

provide investors with improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability.

B. Description of New Rules and Amendments

Currently, Industry Guide 2 specifies many of the disclosure guidelines for oil and gas companies. The Industry Guide calls for disclosure relating to reserves, production, property, and operations in addition to that which is required by Regulation S-K.

Generally, the new rules and amendments codify and update the existing Industry Guide 2 disclosures in a new Subpart 1200 of Regulation S-K, clarify the level of detail required to be disclosed, and require reserves disclosure in a tabular presentation. The changes relate primarily to disclosure of the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen, shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;

- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

The new rules and amendments also make revisions and additions to the definitions section of Rule 4-10 of Regulation S-X. These revisions update and extend reserves definitions to reflect changes in the oil and gas industry and new technologies.

In particular, the new and revised definitions:

- Expand the definition of "oil and gas producing activities" to include the extraction of hydrocarbons from oil sands, shale, coalbeds, or other natural resources and activities undertaken with a view to such extraction;
- Add a definition of "reasonable certainty" to provide better guidance regarding the meaning of that term;
- Add a definition of "reliable technology" to permit the use of new technologies to establish proved reserves;
- Define probable and possible reserves estimates; and
- Add definitions to explain new terms used in the revised definitions.

In addition, the amendments harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, the amendments to Form 20-F will

require foreign private issuers to disclose the information required by Items 1205 through 1208 of Regulation S-K regarding drilling activities, present activities, delivery commitments, wells, and acreage, which are not currently specified under Appendix A to Form 20-F, although much of this disclosure is often disclosed by companies under the more general discussions of business and property on that form.

C. Benefits

We expect that the new rules and amendments will increase transparency in disclosure by oil and gas companies by providing improved reporting standards. The revisions to the definitions should align our disclosure rules with the realities of the modern oil and gas markets. For example, we believe that the inclusion of bitumen and other resources from continuous accumulations as oil and gas producing activities is consistent with company practice to treat these operations as part of, rather than separate from, their traditional oil and gas producing activities. Similarly, the expansion of permissible technologies for determining certainty levels of reserves recognizes that companies now take advantage of these technological advances to make business decisions. We expect these new rules and amendments to improve disclosure by aligning the required disclosure more closely with the way companies conduct their business.

Allowing companies to disclose probable and possible reserves is designed to improve investors' understanding of a company's unproved reserves. For those companies that already disclose such reserves on their Web sites, the new rules and amendments permit them to unify such disclosures into a single, filed document. Disclosure of these categories of reserves beyond proved reserves may foster better company valuations by investors, creditors, and analysts, thus improving capital

allocation and reducing investment risk. Because some of the disclosure items are optional, the amount of increased transparency will depend on the extent to which companies elect to provide the additional disclosures permitted under the new rules. If companies elect not to provide the optional disclosure, then the benefits from increased transparency would be limited to the extent that the new rules improve the transparency of proved reserves disclosure.

By permitting increased disclosure and promoting more consistency and comparability among disclosures, the new rules and amendments provide a mechanism for oil and gas companies to seek more favorable financing terms through more disclosure and increased transparency. Investors may be able to request such additional disclosure in Commission filings during negotiations regarding bond and debt covenants. Thus, we expect that, as a result of competing factors in the marketplace, the new rules and amendments will result in increased transparency, either because companies elect to voluntarily provide increased disclosure, or because investors may discount companies that do not do so. We believe that the benefits and costs of disclosing unproved reserves ultimately will be determined by market conditions, rather than regulatory requirements.

We expect that permitting companies to disclose probable and possible reserves will increase market transparency, provide investors with more reserves information, and allow for more accurate production forecasts. By relating standards used in deterministic methods to comparable percentage thresholds used in probabilistic methods for establishing a given level of certainty, the new rules and amendments should result in increased standardization in reporting practices which would promote comparability of reserves across companies. The new rules would define the term "reliable technology" to

permit oil and gas companies to prepare their reserves estimates using new types of technology that companies are not permitted to use under the current rules. This new definition also is designed to encompass new technologies as they are developed in the future, thereby providing investors and the market with a more comprehensive understanding of a company's estimated reserves.

We expect that replacing the Industry Guide with new Regulation S-K items will provide greater certainty because the disclosure requirements would be in rules established by the Commission. In addition, we believe that disclosure of reserves concentrated in particular countries should provide better information to investors regarding the geopolitical risk to which some companies may be exposed. Overall, we believe that the amendments, as a whole, will provide investors with more information that management uses to make business decisions in the oil and gas industry.

1. Average price and first of the month price

The revision to change the price used to calculate reserves from a year-end single-day price to an historical average price over the company's most recently ended fiscal year is expected to reduce the effects of seasonality. In particular, many commenters suggested the use of a 12-month average price to mitigate the risk of a year-end price affected by short-term price volatility such that it does not reflect the true nature of a company investment, planning, and performance. Our Office of Economic Analysis studied the publicly-available pricing data and found evidence of year-end price volatility. The historical volatility of year-end prices is between 16% and 41% higher than the volatility of annual average prices depending on the grade and geography of oil or gas prices considered. This difference demonstrates variability in oil and gas prices,

likely due to seasonal demands, that does not reflect long term fundamental values, but that cannot be immediately corrected due to the costs of transportation and speed of delivery. Given this variability, it is likely that a 12-month average price will yield better reserves estimates—that reflect management planning and investment to the extent that they discount the short-term component of oil and gas prices—than a year-end spot price.

Many of the commenters to the Proposing Release supported the use of an historical price, even though this approach may be less useful in determining the fair value of a company's reserves compared to a futures market price. We believe investors are concerned not only about the quantity of a company's reserves, but also about the profitability of those reserves. We also recognize that some reserves will be of more value than others due to extraction and transportation costs. As a result, since the new rules and amendments require the use of a single price to estimate reserves and since that price may not be as informative of value as a futures price, the new rules and amendments also gives companies the option of providing a sensitivity analysis and reporting reserves based on additional price estimates.

If companies elect to provide a sensitivity analysis, we expect this to benefit investors by allowing them to formulate better projections of company prospects that are more consistent with management's planning price and prices higher and lower that may reasonably be achieved. In particular, it allows companies the flexibility to communicate how their reserves would change under alternative economic conditions, including those that they may believe better reflect their future prospects. We expect that companies would be more likely to adopt a sensitivity analysis approach if investors and other market participants determine that this information would reduce investment risk, or if

companies believe such disclosure will reduce the cost of capital formation. The new rules and amendments should result in increased price stability in determining whether reserves are economically producible. This should mitigate seasonal effects, resulting in reserves estimates that more closely reflect those used by management in planning and investment decisions. We expect this to allow for more accurate company assessments and improve projections of company prospects.

In addition to an average annual price, many of the commenters suggested that the price be computed on the first day of the month. Two reasons were given. First, beginning month prices would allow an additional month of preparation time in calculating reserves for financial reporting. Second, some commenters suggested that month-end, and in particular year-end, prices were subject to additional short-term volatility because many oil and gas financial contracts expire on those days, resulting in higher than normal trading activity. While the staff of the Office of Economic Analysis did not find systematic evidence of increased volatility around month-end or year-end oil and gas prices relative to other days in the month, we agree that additional preparation time is beneficial because reserves estimations require significant time and resources. An additional month would help reduce errors that might otherwise result from the financial reporting time constraints.

Finally, we believe that revising the full cost accounting method to use the same pricing mechanism as the reserves disclosure requirements should provide consistency between the disclosure and accounting presentations. The use of a single pricing method should also minimize the incremental burden placed on companies as a result of the rule changes because they would not be required to prepare two separate estimates.

2. Probable and possible reserves

We anticipate that disclosure of probable and possible reserves, if companies elect to do so, will allow investors, creditors, and other users to better assess a company's reserves. In addition, the tabular format for disclosing probable and possible reserves should reduce investor search costs by making it easier to locate reserves disclosures and facilitating comparability among oil and gas companies.

While we recognize that many companies already communicate with investors about their unproved and other reserves through alternative means, such as company Web sites or press releases, some commenters remarked that an objective comparison among companies is difficult because different companies have defined such reserves classifications differently. We believe that permitting disclosure of this information in Commission filings will provide a more consistent means of comparison because disclosure in our filings must comply with our definitions. Although our new rules make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit because of the relative uncertainty of those estimates, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers. Regardless, since the disclosure decision is voluntary, it should occur only to the extent that companies find that the benefits justify the costs of doing so.

We believe that permitting the disclosure of probable and possible reserves will benefit smaller companies, in particular. Larger issuers tend to already have large amounts of proved reserves. The new rules and amendments permit smaller companies, who often participate in a significant amount of exploratory activity, to better disclose their business prospects. Consequently, we anticipate that the new rules and amendments could lead to efficiencies in capital formation, as more information will be available regarding the prospects of smaller issuers.

3. Reserves estimate preparers and reserves auditors

We believe that investors would benefit from a greater level of assurance with respect to the reliability of reserve estimates, particularly if companies are allowed to disclose unproved reserves because unproved reserves are inherently less certain than proved reserves. We proposed disclosure requirements relating to whether the person primarily responsible for preparing reserves estimates or conducting a reserves audit, if the company represents that it has enlisted a third party to conduct a reserves audit, met a specified list of qualifications based on the Society of Petroleum Engineers's reserves audit guidelines. However, commenters expressed concern that many of these qualifications such as membership in professional societies were not standardized worldwide. Without control over those standards, the disclosures would not be comparable. We agree with those commenters and, as suggested, have adopted a more principles-based disclosure requirement. Under the adopted rules, a company must disclose its internal controls over reserves estimations and disclose the qualifications of the primary technical person in charge of overseeing the reserves estimations or reserves audit. We believe that disclosure of the individual qualifications, rather than simple

acknowledgement of meeting certain criteria, which may differ within countries, will provide investors with better information to compare companies and the qualifications of persons in charge of the reserves estimations and reserves audits, which should enable more accurate assessments of the quality of audit reports. We believe that disclosure of a company's internal controls over reserves estimates will allow investors to assess whether a company has implemented appropriate controls without dictating to companies specified criteria for establishing those controls.

Although we do not expect all companies to undertake a third-party reserves audit because our rules do not require such a reserves audit, third party participation in the estimation of reserves should add credibility to a company's public disclosure. The opinion of an objective, qualified person on the reserves estimates is designed to increase the reliability of these estimates and investor confidence.

4. Development of proved undeveloped reserves

The new rules and amendments also require disclosure of a company's progress in developing undeveloped reserves and the reasons why any PUDs have remained undeveloped for five years or more. We believe that such disclosure supplements our amendments that ease the requirements for recognizing PUDs and thereby should increase the amount of PUDs disclosed in filings, even though the properties representing such proved reserves have not yet been developed and therefore do not provide the company with cash flow. We believe that the disclosure requirements will increase the accountability of companies that disclose reserves for extended periods of time without adequate justification for their failure to develop those reserves.

5. Disclosure guidance

The release also provides guidance about the type of information that companies should consider disclosing in Management's Discussion and Analysis, and allows companies to include this information with the relevant tables. Providing the additional guidance should assist companies in preparing their disclosure, improving the quality and consistency of this disclosure. Locating this discussion with the tables themselves should benefit investors by simplifying the presentation of disclosure, and providing insight into the information disclosed in the tables.

6. Updating of definitions related to oil and gas activities

The new rules and amendments also update the definition of the term "oil and gas producing activities" as well as updating or creating new definitions for other terms related to such activities, including "proved oil and gas reserves" and "reasonable certainty." We believe that updating these definitions will help companies disclose oil and gas operations in the same way that companies manage and assess those operations. This includes resources extracted from nontraditional sources that companies consider oil and gas activities, which previously were excluded them from the definition of "oil and gas producing activities." In addition, adding definitions for terms like "reasonable certainty" (which currently is in the definition of "proved oil and gas reserves," but not defined) will provide companies with added guidance and assist them in providing consistent disclosures between companies.

7. Harmonizing foreign private issuer disclosure

We believe that the harmonization of foreign private issuer disclosure will help make disclosures of foreign private issuers more comparable with domestic companies.

The oil and gas industry has changed significantly since the rules were adopted. Today, many companies have interests that span the globe. In addition, many of these projects are joint ventures between foreign private issuers and domestic companies. Having differing levels of disclosure for companies that may be participating in the same projects harms comparability between investment choices. The harmonization of foreign private issuer disclosure is intended to promote comparability among all oil companies.

D. Costs

We expect that the new rules and amendments will result in initial and ongoing costs to oil and gas companies. These burdens will vary significantly among companies. Based on disclosures in company filings, the largest oil and gas companies can have as much as 10,000 times the reserves of the median reporting oil and gas company. As would be expected, companies that have more reserves and larger operations will have a correspondingly larger amount of information that they must disclose and, therefore, the burden of complying with our disclosure requirements would be greater for larger companies.

Although we are adding a new subpart to Regulation S-K to set forth the disclosure requirements that are unique to oil and gas companies, the subpart, for the most part, codifies the substantive disclosure called for by Industry Guide 2. The disclosure requirements have been updated and clarified, and require the disclosure to be presented in a tabular format, where appropriate. Although many companies already present this information in tabular form, for companies that do not, this requirement could impose a burden on companies as they transition from a narrative to tabular disclosure format. We expect, however, that any increased preparation costs would be

highest in the first year after adoption, but would decline in subsequent years as companies adjust to the new format. We think this burden is justified because tabular disclosure will increase comparability and facilitate understanding and analysis by investors.

1. Probable and possible reserves

Allowing disclosure of probable and possible reserves could create an increased risk of litigation because these categories of reserves estimates are less certain than proved reserves. Companies may choose not to disclose such reserves, in part, because of the risk of incurring litigation costs to defend their disclosures due to the increased uncertainty of these categories. Disclosure of probable and possible reserves may also result in revealing competitive information because it might reveal a company's business strategy, such as the geographic location and nature of its exploration and discoveries. For example, if geographical detail can be inferred from estimates of unproved reserves, this might reveal information about the value of a company's assets to competitors and could put the producer at a competitive disadvantage. We have reduced the level of geographical detail to reduce the burden on companies, while still providing sufficient information to investors regarding concentrations of risk, including political risk.

We expect companies will incur costs in preparing the additional disclosures such as calculating and aggregating the reserve projections in a prescribed format. However, if probable and possible categories of reserves have different extraction cost structures and they are not disclosed separately from proved reserves, this could result in increased uncertainty in an investor's assessment of a company's prospects.

Companies also expressed concern that mandatory disclosure of probable and possible reserves could expose them to increased litigation risk. We believe that making these disclosures voluntary mitigates these concerns. Companies unwilling to bear the added risk can simply opt not to provide this disclosure.

2. Reserves estimate preparers and reserves auditors

If a company chooses to use a third party to prepare or audit reserve estimates, it will incur costs to hire these outside consultants. The new rules and amendments do not require companies to hire such a person. If enough companies that currently do not use such consultants begin to hire them, we believe that industry wages could potentially increase due to increased demand for reserves calculating specialists unless that demand is compensated by an increase in the supply of such persons. If wages increased, then all companies, not just those employing third party consultants, would incur added costs.

Large companies may be less likely to hire third parties because they tend to have staff to make reserves estimates. However, if such large companies chose to hire third-party consultants, third parties would expend significantly more effort on such projects than for smaller companies because larger companies have more properties to evaluate. Thus, we expect third-party fees, and the time required to conduct such projects, would scale upwards with the quantity of company reserves.

Disclosure of unproved reserves without third-party certification may present a risk with respect to smaller oil and gas producers because smaller companies are likely to have less in-house expertise and ability to accurately estimate such reserves than larger companies. However, we understand that the vast majority of smaller oil and gas companies already hire third parties to estimate their reserves or certify their estimates.

3. Consistency with IASB

Some commenters remarked that the International Accounting Standards Board is currently preparing a set of guidelines for oil and gas extractive activities, including definitions of oil and gas reserves, and recommended that the Commission align its regulations with those guidelines. We intend to monitor this initiative and work with the IASB, but our new rules may differ from the guidelines ultimately established by the International Accounting Standards Board. This could make it more difficult for investors to compare foreign and domestic companies.

4. Change in pricing mechanism

We do not anticipate significant costs with the change in pricing mechanisms for establish reserves. Companies simply will apply a different price scenario to determine the economic producibility of reserves. It is possible that the use of a 12-month average price may reduce the cost of disclosure because it should reduce the volatility of reserves estimates and therefore reduce the need to make significant adjustments to those estimates on a yearly basis due to daily price swings.

5. Disclosure of PUD development

The required disclosure of a company's progress in developing PUDs will increase the cost of reporting. However, we believe that companies regularly track their progress in this arena. Until a company develops a property, it cannot begin to realize the cash flows from production and the actual sale of products. Thus, the development of reserves is of utmost importance to an oil and gas company's business.

6. Increased geographic disclosure

The requirements to provide increased geographic disclosure of reserves and production, in certain circumstances, may increase the amount of disclosure that a company must present. However, because the threshold that we are adopting in the release is 15% of the company's total reserves, a company would be required to disclose, at most, reserves and production in six countries. Considering the relatively large proportion of reserves that must exist in a country before a company is required to provide country-level disclosure, we believe that such information is readily available to companies. As noted in the body of this release, we have attempted to draft this provision to minimize any competitive harm that such disclosure may cause a company.

7. Harmonizing foreign private issuer disclosure

The harmonization of foreign private issuer disclosure regarding oil and gas activities may increase the burden on foreign private issuers. However, it is our understanding that the large foreign private issuers already voluntarily provide disclosure comparable to the level required from domestic companies. Much of the added new disclosure relates to the day-to-day business and properties of these companies, including drilling activities, number of wells and acreage. This is information that is central to the activities of oil and gas companies, and therefore is readily known to these companies. We believe that applying Subpart 1200 to these companies could prompt more detailed disclosure regarding these activities, which would cause these companies to incur some cost. The provision permitting foreign private issuers to omit disclosures if prohibited from making those disclosures by their home jurisdiction could mitigate some of these costs.

XII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Securities Act Section 2(b)³³⁸ and Section 3(f) of the Exchange Act³³⁹ require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act³⁴⁰ requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We expect the new rules and amendments to increase efficiency and enhance capital formation, and thereby benefit investors, by providing the market with better information based on updated technology as well as increased information covering a broader range of reserves classifications held by a company and reserves found in non-traditional sources of oil and gas. Such increased and improved information should permit investors to better assess a company's prospects. In particular, the existing prohibitions against disclosing reserves other than proved reserves, using modern technology to determine the certainty level of reserves, and including resources from non-traditional sources can lead to incomplete disclosures about a company's actual

³³⁸ 15 U.S.C. 77b(b).

³³⁹ 15 U.S.C. 78c(f).

³⁴⁰ 15 U.S.C. 78w(a)(2).

resources and prospects. The new rules and amendments are designed to better align the disclosure requirements with the way companies make business decisions.

We believe that permitting the disclosure of probable and possible reserves will benefit smaller companies, in particular. Larger issuers tend to already have large amounts of proved reserves. The new rules and amendments permit smaller companies, who often participate in a significant amount of exploratory activity, to better disclose their business prospects. Consequently, we anticipate that the new rules and amendments could lead to efficiencies in capital formation, as more information will be available regarding the prospects of smaller issuers.

The effects of the new rules and amendments on competition are difficult to predict, but it is possible that permitting public issuers to disclose probable and possible reserves will lead to a reallocation of capital, as companies that previously could show few proved reserves will be able to disclose a broader range of its business prospects, making it easier for these issuers to raise capital and compete with companies that have large proved reserves. Although our new rules make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit because of the relative uncertainty associated with such reserves, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers.

XIII. Final Regulatory Flexibility Analysis

We have prepared this Final Regulatory Flexibility Analysis in accordance with Section 603 of the Regulatory Flexibility Act.³⁴¹ This analysis relates to the modernization of the oil and gas disclosure requirements. An Initial Regulatory Flexibility Analysis (IRFA) was prepared in accordance with the Regulatory Flexibility Act in conjunction with the Proposing Release. The Proposing Release included, and solicited comment on, the IRFA.

A. Reasons for, and Objectives of, the New Rules and Amendments

The Commission adopted the current disclosure regime for oil and gas producing companies in 1978 and 1982, respectively. Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital. On December 12, 2007, the Commission published a Concept Release on possible revisions to the disclosure requirements relating to oil and gas reserves.³⁴² Prior to our issuance of the Concept Release, many industry participants had expressed concern that our disclosure rules are no longer in alignment with current industry practices and therefore have limited usefulness to the market and investors.

Our new rules and amendments to these existing forms are intended to modernize and update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing

³⁴¹ 5 U.S.C. 603.

³⁴² See Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's reserves, as well as providing information regarding the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit, and the qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates. The amendments also harmonize our full cost accounting rules with the changes that we are adopting with respect to disclosure of oil and gas reserves. The new rules and amendments also are intended to codify, modernize and centralize the disclosure items for oil and gas companies into Regulation S-K. Finally, the new rules and amendments are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the new rules and amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

B. Significant Issues Raised by Commenters

We did not receive comments specifically addressing the impact of the proposed rules and amendments on small entities. However, several of the comments related to burdens that would be placed on all companies affected by the proposals. In particular, commenters believed that the proposal to require the use of different prices for disclosure and accounting purposes would impose a significant burden on all oil and gas companies. We have considered those comments and are adopting amendments to our disclosure

rules and the full cost accounting method that will require the use of a single price for both purposes. Similarly, commenters were concerned that certain aspects of the proposal, such as the new definition of geographic area and disclosure by accumulation type would increase the detail in the disclosures significantly. We agree with those commenters and have significantly reduced the level of detail required in the disclosure requirements.

C. Small Entities Subject to the New Rules and Amendments

The new rules and amendments affect small entities that are engaged in oil and gas producing activities, the securities of which are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. The new rules and amendments also would affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn. Securities Act Rule 157³⁴³ and Exchange Act Rule 0-10(a)³⁴⁴ define an issuer to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year. The new rules and amendments affect small entities that are operating companies and engage in oil and gas producing activities. Based on filings in 2007, we estimate that there are approximately 28 oil and gas companies that may be considered small entities.

³⁴³ 17 CFR 230.157.

³⁴⁴ 17 CFR 240.0-10(a).

D. Reporting, Recordkeeping, and Other Compliance Requirements

The new rules and amendments to Regulation S-K expand some existing disclosures, and eliminate others. In particular, the new disclosure requirements, many of which were requested by industry participants, include the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen and shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for 5 years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish reserves in a company's initial filing with the Commission and in filings which include material additions to reserves estimates;
- Disclosure of the company's internal controls over reserves estimates and the qualifications the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

There would be no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

E. Agency Action to Minimize Effect on Small Entities

We considered different compliance standards for the small entities that will be affected by the new rules and amendments. In the Proposing Release, we solicited comment regarding the possibility of different standards for small entities. We did not receive comment on this particular issue. However, we believe that such differences would be inconsistent with the purposes of the rules.

The new rules and amendments are designed to modernize the disclosure requirements for oil and gas companies. As such, we believe all oil and gas companies will benefit from the modernization of the rules. Under the new rules and amendments, all companies will be allowed to use modern technologies to establish reserves and include operations in unconventional resources in their oil and gas reserves estimates. Adopting differing standards for disclosure for small entities would significantly reduce the comparability between companies. However, the new rules and amendments do permit companies to disclose probable and possible reserves. We believe the removal of the prohibition against such reserves will enable companies to disclose a broader view of their prospects. We believe this will particularly benefit smaller oil and gas companies that may have significant unproved reserves in their portfolio. Such disclosure may assist smaller companies in raising capital for development projects in those properties.

XIV. Update to Codification of Financial Reporting Policies

The Commission amends the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) [47 FR 21028] as follows:

1. By removing the seven introductory paragraphs before Section 406.01, the last sentence of Section 406.01.c.vi., the first paragraph of Section 406.01.d, the introductory paragraph of Section 406.02.d, and removing and reserving Sections 406.01.a., 406.02.a, 406.02.b., 406.02.d.iii., and 406.02.e.

2. By revising Section 406.01B to read as follows:

The rules in Rule 4-10(b) specify that the application of successful efforts shall comply with SFAS 19. In 2008, the Commission published amendments to the definitions in Rule 4-10(a) that may not align completely with SFAS 19's existing terminology and application. Further, paragraph 7 of SFAS 25 states: "For purposes of applying this Statement and Statement 19, the definition of proved reserves, proved developed reserves, and proved undeveloped reserves shall be the definitions adopted by the SEC for its reporting purposes that are in effect on the date(s) as of which the reserve disclosures are to be made. Previous reported quantities shall not be revised retroactively if the SEC definitions are changed." In any case, the Commission expects the practical application of SFAS 19 will remain unchanged other than incorporating the effects of the new definitions.

3. By removing the first three sentences of Section 406.02.c. and in the fourth sentence replacing the phrase "this sort of information" with "information to assess the impact of oil and gas producing activities on near term cash flows and liquidity".

4. By adding a new Section 406.03 entitled "Transition" and including the text of the 3rd paragraph of Section VII.B and the last sentence of the 2nd paragraph of Section VII.C of this release.

5. By adding a new Section 406.04 entitled "MD&A Guidance" and including the text beginning with the last sentence of the 2nd paragraph of Section V of this release through the end of that Section.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register or Code of Federal Regulations. For more information on the Codification of Financial Reporting Policies, contact the Commission's Public Reference Room at 202-551-5850.

XV. Statutory Basis and Text of Amendments

We are adopting the amendments pursuant to Sections 3(b), 6, 7, 10 and 19(a) of the Securities Act and Sections 12, 13, 14(a), 15(d), and 23(a) of the Exchange Act, as amended.

TEXT OF AMENDMENTS

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 211, 229 and 249

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

**PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR
FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES
EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF
1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT
OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Amend § 210.4-10 by:

a. Redesignating the subparagraphs in paragraph (a) as follows:

Old paragraph number	New paragraph number
(a)(1)	(a)(16)
(a)(2)	(a)(22)
(a)(5)	(a)(23)
(a)(6)	(a)(32)
(a)(7)	(a)(21)
(a)(8)	(a)(15)
(a)(9)	(a)(27)
(a)(10)	(a)(13)
(a)(11)	(a)(9)
(a)(12)	(a)(29)
(a)(13)	(a)(30)
(a)(14)	(a)(1)
(a)(15)	(a)(12)
(a)(16)	(a)(7)
(a)(17)	(a)(20)

b. Removing paragraphs (a)(3) and (a)(4);

c. Adding new paragraphs (a)(2), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (a)(10), (a)(11), (a)(14), (a)(17), (a)(18), (a)(19), (a)(24), (a)(25), (a)(26), (a)(28), (a)(31), and (c)(8);

d. Revising newly redesignated paragraphs (a)(13), (a)(16), (a)(22), and (a)(30); and

e. Removing the authority citations following the section.

The additions and revisions read as follows:

§ 210.4-10 Financial accounting and reporting for oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975.

* * * * *

(a) Definitions. * * *

* * * * *

(2) Analogous reservoir. Analogous reservoirs, as used in resources assessments, have similar rock and fluid properties, reservoir conditions (depth, temperature, and pressure) and drive mechanisms, but are typically at a more advanced stage of development than the reservoir of interest and thus may provide concepts to assist in the interpretation of more limited data and estimation of recovery. When used to support proved reserves, an "analogous reservoir" refers to a reservoir that shares the following characteristics with the reservoir of interest:

- (i) Same geological formation (but not necessarily in pressure communication with the reservoir of interest);
- (ii) Same environment of deposition;
- (iii) Similar geological structure; and
- (iv) Same drive mechanism.

Instruction to paragraph (a)(2): Reservoir properties must, in the aggregate, be no more favorable in the analog than in the reservoir of interest.

(3) Bitumen. Bitumen, sometimes referred to as natural bitumen, is petroleum in a solid or semi-solid state in natural deposits with a viscosity greater than 10,000 centipoise measured at original temperature in the deposit and atmospheric pressure, on a

gas free basis. In its natural state it usually contains sulfur, metals, and other non-hydrocarbons.

(4) Condensate. Condensate is a mixture of hydrocarbons that exists in the gaseous phase at original reservoir temperature and pressure, but that, when produced, is in the liquid phase at surface pressure and temperature.

(5) Deterministic estimate. The method of estimating reserves or resources is called deterministic when a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation is used in the reserves estimation procedure.

(6) Developed oil and gas reserves. Developed oil and gas reserves are reserves of any category that can be expected to be recovered:

(i) Through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and

(ii) Through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well.

* * * * *

(8) Development project. A development project is the means by which petroleum resources are brought to the status of economically producible. As examples, the development of a single reservoir or field, an incremental development in a producing field, or the integrated development of a group of several fields and associated facilities with a common ownership may constitute a development project.

* * * * *

(10) Economically producible. The term economically producible, as it relates to a resource, means a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation. The value of the products that generate revenue shall be determined at the terminal point of oil and gas producing activities as defined in paragraph (a)(16) of this section.

(11) Estimated ultimate recovery (EUR). Estimated ultimate recovery is the sum of reserves remaining as of a given date and cumulative production as of that date.

* * * * *

(13) Exploratory well. An exploratory well is a well drilled to find a new field or to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir. Generally, an exploratory well is any well that is not a development well, an extension well, a service well, or a stratigraphic test well as those items are defined in this section.

(14) Extension well. An extension well is a well drilled to extend the limits of a known reservoir.

* * * * *

(16) Oil and gas producing activities. (i) Oil and gas producing activities include:

(A) The search for crude oil, including condensate and natural gas liquids, or natural gas ("oil and gas") in their natural states and original locations;

(B) The acquisition of property rights or properties for the purpose of further exploration or for the purpose of removing the oil or gas from such properties;

(C) The construction, drilling, and production activities necessary to retrieve oil and gas from their natural reservoirs, including the acquisition, construction, installation, and maintenance of field gathering and storage systems, such as:

- (1) Lifting the oil and gas to the surface; and
- (2) Gathering, treating, and field processing (as in the case of processing gas to extract liquid hydrocarbons); and

(D) Extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.

Instruction 1 to paragraph (a)(16)(i): The oil and gas production function shall be regarded as ending at a "terminal point", which is the outlet valve on the lease or field storage tank. If unusual physical or operational circumstances exist, it may be appropriate to regard the terminal point for the production function as:

- a. The first point at which oil, gas, or gas liquids, natural or synthetic, are delivered to a main pipeline, a common carrier, a refinery, or a marine terminal; and
- b. In the case of natural resources that are intended to be upgraded into synthetic oil or gas, if those natural resources are delivered to a purchaser prior to upgrading, the first point at which the natural resources are delivered to a main pipeline, a common carrier, a refinery, a marine terminal, or a facility which upgrades such natural resources into synthetic oil or gas.

Instruction 2 to paragraph (a)(16)(i): For purposes of this paragraph (a)(16), the term saleable hydrocarbons means hydrocarbons that are saleable in the state in which the hydrocarbons are delivered.

(ii) Oil and gas producing activities do not include:

(A) Transporting, refining, or marketing oil and gas;

(B) Processing of produced oil, gas or natural resources that can be upgraded into synthetic oil or gas by a registrant that does not have the legal right to produce or a revenue interest in such production;

(C) Activities relating to the production of natural resources other than oil, gas, or natural resources from which synthetic oil and gas can be extracted; or

(D) Production of geothermal steam.

(17) Possible reserves. Possible reserves are those additional reserves that are less certain to be recovered than probable reserves.

(i) When deterministic methods are used, the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves. When probabilistic methods are used, there should be at least a 10% probability that the total quantities ultimately recovered will equal or exceed the proved plus probable plus possible reserves estimates.

(ii) Possible reserves may be assigned to areas of a reservoir adjacent to probable reserves where data control and interpretations of available data are progressively less certain. Frequently, this will be in areas where geoscience and engineering data are unable to define clearly the area and vertical limits of commercial production from the reservoir by a defined project.

(iii) Possible reserves also include incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than the recovery quantities assumed for probable reserves.

(iv) The proved plus probable and proved plus probable plus possible reserves estimates must be based on reasonable alternative technical and commercial interpretations within the reservoir or subject project that are clearly documented, including comparisons to results in successful similar projects.

(v) Possible reserves may be assigned where geoscience and engineering data identify directly adjacent portions of a reservoir within the same accumulation that may be separated from proved areas by faults with displacement less than formation thickness or other geological discontinuities and that have not been penetrated by a wellbore, and the registrant believes that such adjacent portions are in communication with the known (proved) reservoir. Possible reserves may be assigned to areas that are structurally higher or lower than the proved area if these areas are in communication with the proved reservoir.

(vi) Pursuant to paragraph (a)(22)(iii) of this section, where direct observation has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves should be assigned in the structurally higher portions of the reservoir above the HKO only if the higher contact can be established with reasonable certainty through reliable technology. Portions of the reservoir that do not meet this reasonable certainty criterion may be assigned as probable and possible oil or gas based on reservoir fluid properties and pressure gradient interpretations.

(18) Probable reserves. Probable reserves are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered.

(i) When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.

(ii) Probable reserves may be assigned to areas of a reservoir adjacent to proved reserves where data control or interpretations of available data are less certain, even if the interpreted reservoir continuity of structure or productivity does not meet the reasonable certainty criterion. Probable reserves may be assigned to areas that are structurally higher than the proved area if these areas are in communication with the proved reservoir.

(iii) Probable reserves estimates also include potential incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than assumed for proved reserves.

(iv) See also guidelines in paragraphs (a)(17)(iv) and (a)(17)(vi) of this section.

(19). Probabilistic estimate. The method of estimation of reserves or resources is called probabilistic when the full range of values that could reasonably occur for each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.

* * * * *

(22) Proved oil and gas reserves. Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time.

(i) The area of the reservoir considered as proved includes:

(A) The area identified by drilling and limited by fluid contacts, if any, and

(B) Adjacent undrilled portions of the reservoir that can, with reasonable certainty, be judged to be continuous with it and to contain economically producible oil or gas on the basis of available geoscience and engineering data.

(ii) In the absence of data on fluid contacts, proved quantities in a reservoir are limited by the lowest known hydrocarbons (LKH) as seen in a well penetration unless geoscience, engineering, or performance data and reliable technology establishes a lower contact with reasonable certainty.

(iii) Where direct observation from well penetrations has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves may be assigned in the structurally higher portions of the reservoir only if

geoscience, engineering, or performance data and reliable technology establish the higher contact with reasonable certainty.

(iv) Reserves which can be produced economically through application of improved recovery techniques (including, but not limited to, fluid injection) are included in the proved classification when:

(A) Successful testing by a pilot project in an area of the reservoir with properties no more favorable than in the reservoir as a whole, the operation of an installed program in the reservoir or an analogous reservoir, or other evidence using reliable technology establishes the reasonable certainty of the engineering analysis on which the project or program was based; and

(B) The project has been approved for development by all necessary parties and entities, including governmental entities.

(v) Existing economic conditions include prices and costs at which economic producibility from a reservoir is to be determined. The price shall be the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.

* * * * *

(24) Reasonable certainty. If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate. A high degree of

confidence exists if the quantity is much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease.

(25) Reliable technology. Reliable technology is a grouping of one or more technologies (including computational methods) that has been field tested and has been demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in an analogous formation.

(26) Reserves. Reserves are estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.

Note to paragraph (a)(26): Reserves should not be assigned to adjacent reservoirs isolated by major, potentially sealing, faults until those reservoirs are penetrated and evaluated as economically producible. Reserves should not be assigned to areas that are clearly separated from a known accumulation by a non-productive reservoir (i.e., absence of reservoir, structurally low reservoir, or negative test results). Such areas may contain prospective resources (i.e., potentially recoverable resources from undiscovered accumulations).

* * * * *

(28) Resources. Resources are quantities of oil and gas estimated to exist in naturally occurring accumulations. A portion of the resources may be estimated to be recoverable, and another portion may be considered to be unrecoverable. Resources include both discovered and undiscovered accumulations.

* * * * *

(30) Stratigraphic test well. A stratigraphic test well is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. Such wells customarily are drilled without the intent of being completed for hydrocarbon production. The classification also includes tests identified as core tests and all types of expendable holes related to hydrocarbon exploration. Stratigraphic tests are classified as "exploratory type" if not drilled in a known area or "development type" if drilled in a known area.

(31) Undeveloped oil and gas reserves. Undeveloped oil and gas reserves are reserves of any category that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

(i) Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances.

(ii) Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time.

(iii) Under no circumstances shall estimates for undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir, as defined in paragraph (a)(2) of this section, or by other evidence using reliable technology establishing reasonable certainty.

* * * * *

(c) * * *

(8) For purposes of this paragraph (c), the term "current price" shall mean the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.

* * * * *

PART 211—INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

3. Amend Part 211, subpart A, by adding "Modernization of Oil and Gas Reporting," Release No. FR-78 and the release date of December 31, 2008, to the list of interpretive releases.

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S-K

4. The authority citation for part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

5. Amend § 229.102 by revising the introductory text of Instruction 3 and Instructions 4, 5 and 8 to read as follows.

§ 229.102 (Item 102) Description of property.

* * * * *

Instructions to Item 102: * * *

3. In the case of an extractive enterprise, not involved in oil and gas producing activities, material information shall be given as to production, reserves, locations, development, and the nature of the registrant's interest. If individual properties are of major significance to an industry segment:

* * * * *

4. A registrant engaged in oil and gas producing activities shall provide the information required by Subpart 1200 of Regulation S-K.

5. In the case of extractive reserves other than oil and gas reserves, estimates other than proven or probable reserves (and any estimated values of such reserves) shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided,

however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant, or otherwise to acquire the registrant's securities, such estimates may be included in documents relating to such acquisition.

* * * * *

8. The attention of certain issuers engaged in oil and gas producing activities is directed to the information called for in Securities Act Industry Guide 4 (referred to in §229.801(d)).

* * * * *

6. Amend § 229.801 by removing and reserving paragraph (b) and removing the authority citation following the section.

7. Amend § 229.802 by removing and reserving paragraph (b) and removing the authority citation following the section.

8. Add Subpart 229.1200 to read as follows:

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

Sec.

229.1201 (Item 1201) General instructions to oil and gas industry-specific disclosures.

229.1202 (Item 1202) Disclosure of reserves.

229.1203 (Item 1203) Proved undeveloped reserves.

229.1204 (Item 1204) Oil and gas production, production prices and production costs.

229.1205 (Item 1205) Drilling and other exploratory and development activities.

229.1206 (Item 1206) Present activities.

229.1207 (Item 1207) Delivery commitments.

229.1208 (Item 1208) Oil and gas properties, wells, operations, and acreage.

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

§ 229.1201 (Item 1201) General instructions to oil and gas industry-specific disclosures.

(a) If oil and gas producing activities are material to the registrant's or its subsidiaries' business operations or financial position, the disclosure specified in this Subpart 229.1200 should be included under appropriate captions (with cross references, where applicable, to related information disclosed in financial statements). However, limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water, need not include such disclosure.

(b) To the extent that Items 1202 through 1208 (§§ 229.1202 – 229.1208) call for disclosures in tabular format, as specified in the particular Item, a registrant may modify such format for ease of presentation, to add information or to combine two or more required tables.

(c) The definitions in Rule 4–10(a) of Regulation S-X (17 CFR 210.4-10(a)) shall apply for purposes of this Subpart 229.1200.

(d) For purposes of this Subpart 229.1200, the term by geographic area means, as appropriate for meaningful disclosure in the circumstances:

- (1) By individual country;
- (2) By groups of countries within a continent; or
- (3) By continent.

§ 229.1202 (Item 1202) Disclosure of reserves.

(a) Summary of oil and gas reserves at fiscal year end. (1) Provide the information specified in paragraph (a)(2) of this Item in tabular format as provided below:

**Summary of Oil and Gas Reserves as of Fiscal-Year End
Based on Average Fiscal-Year Prices**

	Reserves				
	Oil	Natural Gas	Synthetic Oil	Synthetic Gas	Product A
Reserves category	(mbbls)	(mmcf)	(mbbls)	(mmcf)	(measure)
PROVED					
Developed					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
Undeveloped					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
TOTAL PROVED					
PROBABLE					
Developed					
Undeveloped					
POSSIBLE					
Developed					
Undeveloped					

(2) Disclose, in the aggregate and by geographic area and for each country containing 15% or more of the registrant's proved reserves, expressed on an oil-equivalent-barrels basis, reserves estimated using prices and costs under existing economic conditions, for the product types listed in paragraph (a)(4) of this Item, in the following categories:

(i) Proved developed reserves;

- (ii) Proved undeveloped reserves;
- (iii) Total proved reserves;
- (iv) Probable developed reserves (optional);
- (v) Probable undeveloped reserves (optional);
- (vi) Possible developed reserves (optional); and
- (vii) Possible undeveloped reserves (optional).

Instruction 1 to paragraph (a)(2): Disclose updated reserves tables as of the close of each fiscal year.

Instruction 2 to paragraph (a)(2): The registrant is permitted, but not required, to disclose probable or possible reserves pursuant to paragraphs (a)(2)(iv) through (a)(2)(vii) of this Item.

Instruction 3 to paragraph (a)(2): If the registrant discloses amounts of a product in barrels of oil equivalent, disclose the basis for such equivalency.

Instruction 4 to paragraph (a)(2): A registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure of reserves in that country. In addition, a registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.

(3) Reported total reserves shall be simple arithmetic sums of all estimates for individual properties or fields within each reserves category. When probabilistic methods

are used, reserves should not be aggregated probabilistically beyond the field or property level; instead, they should be aggregated by simple arithmetic summation.

(4) Disclose separately material reserves of the following product types:

(i) Oil;

(ii) Natural gas;

(iii) Synthetic oil;

(iv) Synthetic gas; and

(v) Sales products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and gas.

(5) If the registrant discloses probable or possible reserves, discuss the uncertainty related to such reserves estimates.

(6) If the registrant has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to its reserves estimates, the registrant shall provide a general discussion of the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. The particular properties do not need to be identified.

(7) Preparation of reserves estimates or reserves audit. Disclose and describe the internal controls the registrant uses in its reserves estimation effort. In addition, disclose the qualifications of the technical person primarily responsible for overseeing the preparation of the reserves estimates and, if the registrant represents that a third party conducted a reserves audit, disclose the qualifications of the technical person primarily responsible for overseeing such reserves audit.

(8) Third party reports. If the registrant represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review, the registrant shall file a report of the third party as an exhibit to the relevant registration statement or other Commission filing. If the report relates to the preparation of, or a reserves audit of, the registrant's reserves estimates, it must include the following disclosure, if applicable to the type of filing:

- (i) The purpose for which the report was prepared and for whom it was prepared;
- (ii) The effective date of the report and the date on which the report was completed;
- (iii) The proportion of the registrant's total reserves covered by the report and the geographic area in which the covered reserves are located;
- (iv) The assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- (v) A discussion of primary economic assumptions;
- (vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- (vii) A discussion regarding the inherent uncertainties of reserves estimates;
- (viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;

- (ix) A brief summary of the third party's conclusions with respect to the reserves estimates; and
- (x) The signature of the third party.
- (9) For purposes of this Item 1202, the term reserves audit means the process of reviewing certain of the pertinent facts interpreted and assumptions underlying a reserves estimate prepared by another party and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities.
- (b) Reserves sensitivity analysis (optional). (1) The registrant may, but is not required to, provide the information specified in paragraph (b)(2) of this Item in tabular format as provided below:

**Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario**

Price Case	Proved Reserves					Probable Reserves					Possible Reserves				
	Oil	Gas	Syn. Oil	Syn. Gas	Product A	Oil	Gas	Syn. Oil	Syn. Gas	Product A	Oil	Gas	Syn. Oil	Syn. Gas	Product A
	mbbls	mmcf	mbbls	mmcf	measure	mbbls	mmcf	mbbls	mmcf	measure	mbbls	mmcf	mbbls	mmcf	measure
Scenario 1															
Scenario 2															

- (2) The registrant may, but is not required to, disclose, in the aggregate, an estimate of reserves estimated for each product type based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts.
- (3) If the registrant provides disclosure under this paragraph (b), disclose the price and cost schedules and assumptions on which the disclosed values are based.

Instruction to Item 1202: Estimates of oil or gas resources other than reserves, and any estimated values of such resources, shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant or otherwise to acquire the registrant's securities, such estimate may be included in documents related to such acquisition.

§ 229.1203 (Item 1203) Proved undeveloped reserves.

- (a) Disclose the total quantity of proved undeveloped reserves at year end.
- (b) Disclose material changes in proved undeveloped reserves that occurred during the year, including proved undeveloped reserves converted into proved developed reserves.
- (c) Discuss investments and progress made during the year to convert proved undeveloped reserves to proved developed reserves, including, but not limited to, capital expenditures.
- (d) Explain the reasons why material amounts of proved undeveloped reserves in individual fields or countries remain undeveloped for five years or more after disclosure as proved undeveloped reserves.

§ 229.1204 (Item 1204) Oil and gas production, production prices and production costs.

- (a) For each of the last three fiscal years disclose production, by final product sold, of oil, gas, and other products. Disclosure shall be made by geographical area and for each country and field that contains 15% or more of the registrant's total proved

reserves expressed on an oil-equivalent-barrels basis unless prohibited by the country in which the reserves are located.

(b) For each of the last three fiscal years disclose, by geographical area:

(1) The average sales price (including transfers) per unit of oil, gas and other products produced; and

(2) The average production cost, not including ad valorem and severance taxes, per unit of production.

Instruction 1 to Item 1204: Generally, net production should include only production that is owned by the registrant and produced to its interest, less royalties and production due others. However, in special situations (e.g., foreign production) net production before any royalties may be provided, if more appropriate. If "net before royalty" production figures are furnished, the change from the usage of "net production" should be noted.

Instruction 2 to Item 1204: Production of natural gas should include only marketable production of natural gas on an "as sold" basis. Production will include dry, residue, and wet gas, depending on whether liquids have been extracted before the registrant transfers title. Flared gas, injected gas, and gas consumed in operations should be omitted. Recovered gas-lift gas and reproduced gas should not be included until sold. Synthetic gas, when marketed as such, should be included in natural gas sales.

Instruction 3 to Item 1204: If any product, such as bitumen, is sold or custody is transferred prior to conversion to synthetic oil or gas, the product's production, transfer prices, and production costs should be disclosed separately from all other products.

Instruction 4 to Item 1204: The transfer price of oil and gas (natural and synthetic) produced should be determined in accordance with SFAS 69.

Instruction 5 to Item 1204: The average production cost, not including ad valorem and severance taxes, per unit of production should be computed using production costs disclosed pursuant to SFAS 69. Units of production should be expressed in common units of production with oil, gas, and other products converted to a common unit of measure on the basis used in computing amortization.

§ 229.1205 (Item 1205) Drilling and other exploratory and development activities.

(a) For each of the last three fiscal years, by geographical area, disclose:

- (1) The number of net productive and dry exploratory wells drilled; and
- (2) The number of net productive and dry development wells drilled.

(b) Definitions. For purposes of this Item 1205, the following terms shall be defined as follows:

(1) A dry well is an exploratory, development, or extension well that proves to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.

(2) A productive well is an exploratory, development, or extension well that is not a dry well.

(3) Completion refers to installation of permanent equipment for production of oil or gas, or, in the case of a dry well, to reporting to the appropriate authority that the well has been abandoned.

(4) The number of wells drilled refers to the number of wells completed at any time during the fiscal year, regardless of when drilling was initiated.

(c) Disclose, by geographic area, for each of the last three years, any other exploratory or development activities conducted, including implementation of mining methods for purposes of oil and gas producing activities.

§ 229.1206 (Item 1206) Present activities.

(a) Disclose, by geographical area, the registrant's present activities, such as the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed, pressure maintenance operations, and any other related activities of material importance.

(b) Provide the description of present activities as of a date at the end of the most recent fiscal year or as close to the date that the registrant files the document as reasonably possible.

(c) Include only those wells in the process of being drilled at the "as of" date and express them in terms of both gross and net wells.

(d) Do not include wells that the registrant plans to drill, but has not commenced drilling unless there are factors that make such information material.

§ 229.1207 (Item 1207) Delivery commitments.

(a) If the registrant is committed to provide a fixed and determinable quantity of oil or gas in the near future under existing contracts or agreements, disclose material information concerning the estimated availability of oil and gas from any principal sources, including the following:

(1) The principal sources of oil and gas that the registrant will rely upon and the total amounts that the registrant expects to receive from each principal source and from all sources combined;

(2) The total quantities of oil and gas that are subject to delivery commitments; and

(3) The steps that the registrant has taken to ensure that available reserves and supplies are sufficient to meet such commitments for the next one to three years.

(b) Disclose the information required by this Item:

(1) In a form understandable to investors; and

(2) Based upon the facts and circumstances of the particular situation, including, but not limited to:

(i) Disclosure by geographic area;

(ii) Significant supplies dedicated or contracted to the registrant;

(iii) Any significant reserves or supplies subject to priorities or curtailments which may affect quantities delivered to certain classes of customers, such as customers receiving services under low priority and interruptible contracts;

(iv) Any priority allocations or price limitations imposed by Federal or State regulatory agencies, as well as other factors beyond the registrant's control that may affect the registrant's ability to meet its contractual obligations (the registrant need not provide detailed discussions of price regulation);

(v) Any other factors beyond the registrant's control, such as other parties having control over drilling new wells, competition for the acquisition of reserves and supplies, and the availability of foreign reserves and supplies, which may affect the registrant's ability to acquire additional reserves and supplies or to maintain or increase the availability of reserves and supplies; and

(vi) Any impact on the registrant's earnings and financing needs resulting from its inability to meet short-term or long-term contractual obligations. (See Items 303 and 1209 of Regulation S-K (§§ 229.303 and 229.1209).)

(c) If the registrant has been unable to meet any significant delivery commitments in the last three years, describe the circumstances concerning such events and their impact on the registrant.

(d) For purposes of this Item, available reserves are estimates of the amounts of oil and gas which the registrant can produce from current proved developed reserves using presently installed equipment under existing economic and operating conditions and an estimate of amounts that others can deliver to the registrant under long-term contracts or agreements on a per-day, per-month, or per-year basis.

§ 229.1208 (Item 1208) Oil and gas properties, wells, operations, and acreage.

(a) Disclose, as of a reasonably current date or as of the end of the fiscal year, the total gross and net productive wells, expressed separately for oil and gas (including synthetic oil and gas produced through wells) and the total gross and net developed acreage (i.e., acreage assignable to productive wells) by geographic area.

(b) Disclose, as of a reasonably current date or as of the end of the fiscal year, the amount of undeveloped acreage, both leases and concessions, if any, expressed in both gross and net acres by geographic area, together with an indication of acreage concentrations, and, if material, the minimum remaining terms of leases and concessions.

(c) Definitions. For purposes of this Item 1208, the following terms shall be defined as indicated:

(1) A gross well or acre is a well or acre in which the registrant owns a working interest. The number of gross wells is the total number of wells in which the registrant owns a working interest. Count one or more completions in the same bore hole as one well. In a footnote, disclose the number of wells with multiple completions. If one of the multiple completions in a well is an oil completion, classify the well as an oil well.

(2) A net well or acre is deemed to exist when the sum of fractional ownership working interests in gross wells or acres equals one. The number of net wells or acres is the sum of the fractional working interests owned in gross wells or acres expressed as whole numbers and fractions of whole numbers.

(3) Productive wells include producing wells and wells mechanically capable of production.

(4) Undeveloped acreage encompasses those leased acres on which wells have not been drilled or completed to a point that would permit the production of economic quantities of oil or gas regardless of whether such acreage contains proved reserves. Do not confuse undeveloped acreage with undrilled acreage held by production under the terms of the lease.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

9. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

10. Amend Form 20-F (referenced in §249.220f) by:

- a. Revising "Instruction to Item 4" and the introductory text and paragraph (b) of "Instructions to Item 4.D"; and
- b. Removing paragraph (c) of "Instructions to Item 4.D" and "Appendix A to Item 4.D—Oil and Gas."

The revisions read as follows:

[Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.]

FORM 20-F

* * * * *

Item 4. Information on the Company

* * * * *

Instructions to Item 4:

1. Furnish the information specified in any industry guide listed in Subpart 229.800 of Regulation S-K (§229.801 et seq. of this chapter) that applies to you.
2. If oil and gas operations are material to you or your subsidiaries' business operations or financial position, provide the information specified in Subpart 1200 of Regulation S-K (§229.1200 et seq. of this chapter).

* * * * *

Instruction to Item 4.D: In the case of an extractive enterprise, other than an oil and gas producing activity:

* * * * *

- (b) In documents that you file publicly with the Commission, do not disclose estimates of reserves unless the reserves are proven or probable and do not give estimated

values of those reserves, unless foreign law requires you to disclose the information. If these types of estimates have already been provided to any person that is offering to acquire you, however, you may include the estimates in documents relating to the acquisition.

* * * * *

Florence E. Harmon

By the Commission.

Florence E. Harmon
Acting Secretary

December 31, 2008

