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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 October 2006, 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.

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

CYNTHIA A. GLASSMAN, COMMISSIONER

PAUL S. ATKINS, COMMISSIONER

ROEL C. CAMPOS, COMMISSIONER

ANNETTE NAZARETH, COMMISSIONER

2 Documents

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54564 / October 3, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2491 / October 3, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12450

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In the Matter of

MARK P. ABIDE, CPA

Respondent.

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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 Mark P. Abide ("Abide" or "Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.<sup>1</sup>

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<sup>1</sup> 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.

Document 1 of 2

## 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. Abide, age 44, was a certified public accountant licensed to practice in the State of Texas from March 1993 through February 28, 2006, when he did not renew his license. He served as Director of Property Accounting at WorldCom, Inc. ("WorldCom") from January 2000 until he left the company in March 2003.

2. WorldCom was at all relevant times a Georgia corporation with principal offices in Clinton, Mississippi. It provided a broad range of communications services to both U.S. and non-U.S. based businesses and consumers. At all relevant times, WorldCom'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 System.

3. On July 27, 2006, the Commission filed a complaint against Abide in Securities and Exchange Commission v. Mark P. Abide, (06 CV 5660 (JSR)). On September 27, 2006, the United States District Court for the Southern District Court of New York entered an order permanently enjoining Abide, by consent, from future violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, and 13b2-1 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder. Abide was also ordered to pay \$57,947.22 in disgorgement of ill-gotten gains from his sales of WorldCom stock while participating in the fraud, and \$12,912.20 in prejudgment interest; and a \$57,947.22 civil money penalty.

4. The Commission's complaint alleged, among other things, the following: at the direction of WorldCom senior management, Abide and other WorldCom employees caused WorldCom to materially overstate its earnings in contravention of generally accepted accounting principles (GAAP) from the first quarter of 2001 through the first quarter of 2002. During this time, Abide altered previously prepared quarterly reports, which were routinely provided to WorldCom's auditors and personnel responsible for preparing WorldCom's SEC filings, to include improperly capitalized line costs. Abide also made, and directed others to

make, false accounting entries into WorldCom's depreciable asset accounts to conceal improperly capitalized line cost expenses from WorldCom's independent auditors and the investing public. Abide knew, or was reckless in not knowing, that these capitalized line cost entries were made without supporting documentation, were not in conformity with GAAP, were not disclosed to the investing public, and were designed to allow WorldCom to appear to meet Wall Street analysts' quarterly earnings estimates. As a result of Abide's and the other employee's actions, WorldCom understated expenses and overstated pre-tax earnings by approximately \$3.6 billion. Abide further improperly benefited from his knowledge of and participation in the ongoing fraud, when he sold 99% of the WorldCom stock he held in his 401(k) account at the end of January 2002 and the beginning of February 2002, just months before the fraud became public. Abide used the \$57,947.22 of losses avoided to diversify and therefore safeguard his 401(k) holdings.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Abide'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;

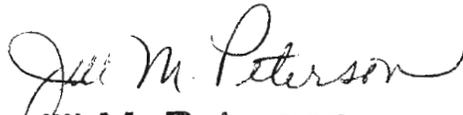
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(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.

Nancy M. Morris  
Secretary

  
By: **Jill M. Peterson**  
**Assistant Secretary**

Chairman Cux  
Not Participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54661 / October 27, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2499 / October 27, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12462

<p style="margin: 0;"><b>In the Matter of</b></p> <p style="margin: 0;"><b>MARTIN J. MERRITT, CPA,</b></p> <p style="margin: 0;"><b>Respondent.</b></p>	<p>⋮</p>	<p><b>ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS</b></p>
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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 Martin J. Merritt ("Respondent" or "Merritt") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.<sup>1</sup>

<sup>1</sup> 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. Merritt, age 43, is and has been a certified public accountant licensed to practice in the State of Massachusetts. He served as Controller of RenaissanceRe Holdings Ltd. ("RenRe") from at least 2000 until March 2005, and was a Vice President of RenRe from 2000 through 2002 and a Senior Vice President of RenRe from 2003 through March 2005. From March 2005 through approximately November 1, 2005, he was RenRe's Senior Vice President of Finance.

2. RenRe was, at all relevant times, a Bermuda corporation with its principal place of business in Bermuda. RenRe was a reinsurance company specializing largely in property catastrophe reinsurance. At all relevant times, RenRe's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the New York Stock Exchange.

3. On September 27, 2006, the Commission filed a complaint against Merritt in SEC v. Stanard, et al. (Civil Action No. 06 cv 7736 (GEL)). On October 6, 2006, the court entered an order permanently enjoining Merritt, 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, 13b2-1, and 13b2-2 thereunder; and from aiding and abetting violations of Sections 13(a) and 13(b)(2) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, and 13b2-1 thereunder. The Commission deferred resolution of any civil penalties and disgorgement against Merritt.

4. The Commission's complaint alleged, among other things, that Merritt participated in a fraudulent scheme which resulted in RenRe filing materially false and misleading financial statements in the company's annual report on Form 10-K for the fiscal years ended December 31, 2001 and December 31, 2002, and in the company's quarterly reports on Form 10-Q for the first and third quarters of 2001 and the third quarter of 2002. The complaint alleged that Merritt participated in a sham reinsurance transaction whose sole purpose was to smooth and defer \$26 million of RenRe's earnings from 2001 to 2002 and 2003. The complaint also alleged that Merritt engaged in improper accounting for the transaction in a departure from generally accepted

accounting principles ("GAAP"). In addition, the complaint alleged that Merritt made material misrepresentations and omissions about the transaction to RenRe's independent auditors.

**IV.**

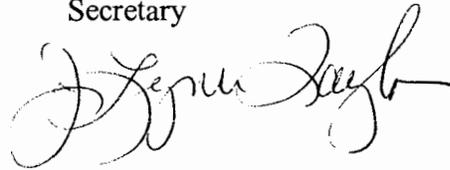
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Merritt's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

Merritt is suspended from appearing or practicing before the Commission as an accountant.

By the Commission.

Nancy M. Morris  
Secretary

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

By: J. Lynn Taylor  
Assistant Secretary

## 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 October 2006, 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.

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

ROEL C. CAMPOS, COMMISSIONER

ANNETTE NAZARETH, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

24 Documents

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54557 / October 2, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12449

In the Matter of

Global Express Securities, Inc.,

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE  
PROCEEDING 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 Global Express Securities, Inc. ("Respondent").

**II.**

In anticipation of the institution of this proceeding, Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding 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, the subject matter of this proceeding, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceeding 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. Respondent is a Florida corporation headquartered in Las Vegas, Nevada. It offered and sold investments in Global Express Real Estate Investment Fund I, LLC (the "Fund")

*Document 1 of 24*

and did not offer or sell any other securities. Respondent has been registered with the Commission as a broker-dealer since 1996.

2. On August 3, 2006, a final judgment was entered by consent against Respondent permanently enjoining it from future violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Global Express Real Estate Investment Fund I, LLC, et al, Civil Action Number 2:03-cv-1514 in the United States District Court for the District of Nevada.

3. The Commission's complaint alleged that from late 2001 through December of 2003, Respondent, through its principals, offered and sold interests in the Fund through fraudulent misrepresentations and omissions of material fact. The complaint also alleged that Respondent did not conduct an independent investigation regarding its representations about the Fund to investors and blindly relied upon the information contained in the Fund's offering materials and provided by the Fund's manager. The complaint also alleged that contrary to Respondent's representations to investors, however, the Fund did not generate sufficient interest income to pay monthly distributions and, instead, operated as a Ponzi-like investment scheme. The complaint also alleged that from March 1, 2003, through September 30, 2003, alone, the Fund paid returns to investors totaling approximately \$2.3 million even though the Fund had only received approximately \$154,000 in interest income from its investments and other assets. The complaint also alleged that the Fund financed investors' monthly returns with cash from new investors as well as with capital contributions from the Fund's manager and proceeds from the sale of non-cash assets held by the Fund. The complaint also alleged that none of this was disclosed to 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's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(4) of the Exchange Act, that the registration of Respondent as a broker and dealer be, and hereby is, revoked.

By the Commission.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
**Assistant Secretary**

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**  
**October 5, 2006**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12451**

**In the Matter of**

**New Yorker Marketing Corp.,  
Pretory USA, Inc. (n/k/a Sunrise  
Petroleum Resources, Inc.), and  
U. S. Digital Communications, Inc.,**

**Respondents.**

**ORDER INSTITUTING  
ADMINISTRATIVE PROCEEDINGS AND  
NOTICE OF HEARING 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 public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENTS**

1. New Yorker Marketing Corp. ("New Yorker Marketing") (CIK No. 934008) is an inactive Delaware corporation located in the Bronx, New York with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). New Yorker Marketing is delinquent in its periodic filings with the Commission, having not filed a periodic report since a Form 10-QSB was filed for the period ended September 30, 1999, which reported a net loss of \$2,294,987 for the prior nine months. The current CFO of respondent Pretory USA, Inc. was Secretary and a consultant to the predecessor of New Yorker Marketing and was identified in New Yorker Marketing's May 14, 1999 Form 12b-25 Notification of Late Filing as the person to contact in regard to the late filing.

*Document 2 of 24*

2. Pretory USA, Inc. ("Pretory USA") (n/k/a Sunrise Petroleum Resources, Inc.) (CIK No. 1048693) is a dissolved Nevada corporation located in Suffield, Connecticut with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Pretory USA is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed an amended Form 10-SB on February 18, 2000. In August 2006, the company changed its name in the Pink Sheets to Mach Five Marketing Corp., but did not enter that name in the Commission records, as required by Commission rules. In September 2006, the company changed its name in the Pink Sheets to Sunrise Petroleum Resources, Inc., and changed its state of incorporation to the State of Washington, but did not enter that name in the Commission records, as required by Commission rules. As of September 19, 2006, the company's common stock (symbol "SRSP") was quoted on the Pink Sheets, had nine market makers and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

3. U.S. Digital Communications, Inc. ("U.S. Digital") (CIK No. 1020292) is a revoked Nevada corporation located in Chevy Chase, Maryland with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). U.S. Digital is delinquent in its periodic filings with the Commission, having not filed any periodic reports since a Form 10-QSB was filed for the period ended September 30, 1999, which reported a net loss of \$9,546,372 for the prior nine months. U.S. Digital filed an 8-K report on June 14, 2000 indicating that operations had ceased and that it no longer had any employees, officers or directors. The current CEO of respondent Pretory USA was the President and CEO of U.S. Digital. As of September 25, 2006, the company's stock (symbol "USDI") was traded on the over-the-counter markets.

#### B. DELINQUENT PERIODIC FILINGS

4. The Respondents or their predecessors are or were affiliated with officers of Pretory USA. All of the Respondents are more than six years delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance at their most recent address shown in their most recent filing with the Commission, or did not receive the letters because of their failure to keep an updated address on file with the Commission, as required by Commission rules.

5. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

6. As a result of their failure to file required periodic filings, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

### III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II of this Order are true, and to afford the Respondents an opportunity to establish any defenses to such allegations; and

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months or to revoke the registrations of each class of securities registered pursuant to Exchange Act Section 12 of the Respondents identified in Section II.

### IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened 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 HEREBY FURTHER ORDERED that each Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If a 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 it 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 or registered mail, or by any other means permitted by the Commission's Rules of Practice.

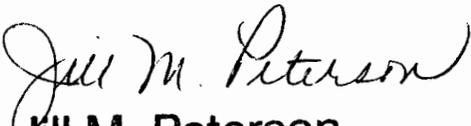
IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

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.

Nancy M. Morris  
Secretary

Attachment

  
By: **Jill M. Peterson**  
**Assistant Secretary**

Appendix 1

**Chart of Delinquent Filings**

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<b>New Yorker Marketing Corp.</b>	<i>10-KSB</i>	12/31/99	03/30/00	Not filed	78
	<i>10-QSB</i>	03/31/00	05/15/00	Not filed	76
	<i>10-QSB</i>	06/30/00	08/14/00	Not filed	73
	<i>10-QSB</i>	09/30/00	11/14/00	Not filed	70
	<i>10-KSB</i>	12/31/00	04/02/01	Not filed	65
	<i>10-QSB</i>	03/31/01	05/15/01	Not filed	64
	<i>10-QSB</i>	06/30/01	08/14/01	Not filed	61
	<i>10-QSB</i>	09/30/01	11/14/01	Not filed	58
	<i>10-KSB</i>	12/31/01	04/01/02	Not filed	53
	<i>10-QSB</i>	03/31/02	05/15/02	Not filed	52
	<i>10-QSB</i>	06/30/02	08/14/02	Not filed	49
	<i>10-QSB</i>	09/30/02	11/14/02	Not filed	46
	<i>10-KSB</i>	12/31/02	03/31/03	Not filed	42
	<i>10-QSB</i>	03/31/03	05/15/03	Not filed	40
	<i>10-QSB</i>	06/30/03	08/14/03	Not filed	37
	<i>10-QSB</i>	09/30/03	11/14/03	Not filed	34
	<i>10-KSB</i>	12/31/03	03/30/04	Not filed	30
	<i>10-QSB</i>	03/31/04	05/17/04	Not filed	28
	<i>10-QSB</i>	06/30/04	08/16/04	Not filed	25
	<i>10-QSB</i>	09/30/04	11/15/04	Not filed	22
	<i>10-KSB</i>	12/31/04	03/31/05	Not filed	18
	<i>10-QSB</i>	03/31/05	05/16/05	Not filed	16
	<i>10-QSB</i>	06/30/05	08/15/05	Not filed	13
	<i>10-QSB</i>	09/30/05	11/14/05	Not filed	10
	<i>10-KSB</i>	12/31/05	03/31/06	Not filed	6
	<i>10-QSB</i>	03/31/06	05/15/06	Not filed	4
	<i>10-QSB</i>	06/30/06	08/14/06	Not filed	1
<b>Total Filings Delinquent</b>		<b>27</b>			

**Pretory USA, Inc.**

<i>10-KSB</i>	12/31/99	3/30/00	Not filed	78
<i>10-QSB</i>	03/31/00	05/15/00	Not filed	76
<i>10-QSB</i>	06/30/00	08/14/00	Not filed	73
<i>10-QSB</i>	09/30/00	11/14/00	Not filed	70
<i>10-KSB</i>	12/31/00	04/02/01	Not filed	65
<i>10-QSB</i>	03/31/01	05/15/01	Not filed	64

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<b>Pretory USA, Inc.</b>					
	10-QSB	06/30/01	08/14/01	Not filed	61
	10-QSB	09/30/01	11/14/01	Not filed	58
	10-KSB	12/31/01	04/01/02	Not filed	53
	10-QSB	03/31/02	05/15/02	Not filed	52
	10-QSB	06/30/02	08/14/02	Not filed	49
	10-QSB	09/30/02	11/14/02	Not filed	46
	10-KSB	12/31/02	03/31/03	Not filed	42
	10-QSB	03/31/03	05/15/03	Not filed	40
	10-QSB	06/30/03	08/14/03	Not filed	37
	10-QSB	09/30/03	11/14/03	Not filed	34
	10-KSB	12/31/03	03/30/04	Not filed	30
	10-QSB	03/31/04	05/17/04	Not filed	28
	10-QSB	06/30/04	08/16/04	Not filed	25
	10-QSB	09/30/04	11/15/04	Not filed	22
	10-KSB	12/31/04	03/31/05	Not filed	18
	10-QSB	03/31/05	05/16/05	Not filed	16
	10-QSB	06/30/05	08/15/05	Not filed	13
	10-QSB	09/30/05	11/14/05	Not filed	10
	10-KSB	12/31/05	03/31/06	Not filed	6
	10-QSB	03/31/06	05/15/06	Not filed	4
	10-QSB	06/30/06	08/14/06	Not filed	1

Total Filings Delinquent 27

**U.S. Digital Communications, Inc.**

10-K	12/31/99	03/30/00	Not filed	78
10-Q	03/31/00	05/15/00	Not filed	76
10-Q	06/30/00	08/14/00	Not filed	73
10-Q	09/30/00	11/14/00	Not filed	70
10-K	12/31/00	04/02/01	Not filed	65
10-Q	03/31/01	05/15/01	Not filed	64
10-Q	06/30/01	08/14/01	Not filed	61
10-Q	09/30/01	11/14/01	Not filed	58
10-K	12/31/01	04/01/02	Not filed	53
10-Q	03/31/02	05/15/02	Not filed	52
10-Q	06/30/02	08/14/02	Not filed	49
10-Q	09/30/02	11/14/02	Not filed	46
10-K	12/31/02	03/31/03	Not filed	42
10-Q	03/31/03	05/15/03	Not filed	40
10-Q	06/30/03	08/14/03	Not filed	37
10-Q	09/30/03	11/14/03	Not filed	34

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)	
U.S. Digital Communications, Inc.	10-K	12/31/03	03/30/04	Not filed	30	
	10-Q	03/31/04	05/17/04	Not filed	28	
	10-Q	06/30/04	08/16/04	Not filed	25	
	10-Q	09/30/04	11/15/04	Not filed	22	
	10-K	12/31/04	03/31/05	Not filed	18	
	10-Q	03/31/05	05/16/05	Not filed	16	
	10-Q	06/30/05	08/15/05	Not filed	13	
	10-Q	09/30/05	11/14/05	Not filed	10	
	10-K	12/31/05	03/31/06	Not filed	6	
	10-Q	03/31/06	05/15/06	Not filed	4	
	10-Q	06/30/06	08/14/06	Not filed	1	
	Total Filings Delinquent					27

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

OCT 05 2006

In the Matter of

Pretory USA, Inc.  
(n/k/a Sunrise Petroleum Resources, Inc.)

File No. 500-1

**ORDER OF SUSPENSION OF  
TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Pretory USA, Inc. (n/k/a Sunrise Petroleum Resources, Inc.) because it has not filed any periodic reports since it filed an amended Form 10-SB on February 18, 2000.

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 above-listed company is suspended for the period from 9:30 a.m. EDT on October 5, 2006, through 11:59 p.m. EDT on October 18, 2006.

By the Commission.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
**Assistant Secretary**

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**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 240**

**[Release No. 34-54575; File No. S7-16-06]**

**RIN 3235-AJ72**

**Amendments to Rule 15c3-1 and Rule 17a-11 Applicable to Broker-Dealers also Registered as Futures Commission Merchants**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission is proposing for comment amendments to conform provisions of its net capital rule to changes to the net capital rule of the Commodity Futures Trading Commission. The proposed amendments would apply to broker-dealers also registered as futures commission merchants with the Commodity Futures Trading Commission. The Securities and Exchange Commission also is proposing to amend certain rules related to subordinated debt agreements to conform those rules to the Commodity Futures Trading Commission's amended net capital rules. Finally, the Securities and Exchange Commission is proposing to amend its early warning provisions to require that it be notified if a broker-dealer also registered as a futures commission merchant must warn the Commodity Futures Trading Commission or a designated self-regulatory organization that its adjusted net capital has fallen below specified levels.

**DATES:** Comments should be received on or before [insert date 30 days after publication in the federal register].

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic comments:

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- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-16-06 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 Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-16-06. 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 also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. 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:** Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Assistant Director, at (202) 551-5521; or Bonnie L. Gauch, Special Counsel, at (202) 551-5524, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

## I. INTRODUCTION

The Securities and Exchange Commission (“Commission”) is proposing to amend its financial responsibility rules for broker-dealers registered with the Commodity Futures Trading Commission (“CFTC”) under the Commodity Exchange Act (“CEA”) as futures commission merchants (“FCMs”). The Commission’s net capital rule, Rule 15c3-1,<sup>1</sup> imposes minimum financial (net capital) requirements on broker-dealers. The CFTC’s adjusted net capital rule, Rule 1.17,<sup>2</sup> similarly imposes minimum financial requirements on FCMs. Under Rule 15c3-1(a)(1)(iii), a broker-dealer/FCM must maintain net capital of no less than the greater of its requirements under the applicable provisions of Rule 15c3-1 or four percent of the funds that must be segregated under the CEA and its rules. The requirement to maintain at least four percent of segregated funds was intended to conform Rule 15c3-1 to the CFTC’s Rule 1.17.<sup>3</sup>

In 2004, the CFTC amended Rule 1.17 and adopted certain new net capital requirements applicable to FCMs.<sup>4</sup> Before adoption of the amended capital requirements, Rule 1.17(a)(1)(i)(A)-(D) required an FCM to maintain minimum adjusted net capital equal to, or in excess of, the greatest of the following: (1) \$250,000; (2) four percent of an amount that equals the total of funds required to be segregated for customer trading on U.S. commodity markets under section 4d(a)(2) of the CEA and the funds required to be secured for customer trading on foreign commodity markets under Rule 30.7 to the CEA, less the market value of options purchased by customers for which the full premiums

<sup>1</sup> 17 CFR 240.15c3-1. Section 15(c)(3) of the Securities Exchange Act of 1934 (the “Exchange Act”) authorizes the Commission to impose, by regulation, minimum financial requirements on broker-dealers (15 U.S.C. 78o(c)(3)).

<sup>2</sup> 17 CFR 1.17.

<sup>3</sup> See Exchange Act Release No. 15898 (Jun. 5, 1979), 44 FR 24884 (Jun. 15, 1979).

<sup>4</sup> The new rules became effective on September 30, 2004. See 69 FR 49784 (Aug. 12, 2004).

have been paid (“segregated funds”); (3) the amount of adjusted net capital required by a registered futures association; or (4) for broker-dealer/FCMs, the amount of net capital required under Rule 15c3-1(a).

CFTC Rule 1.17(a)(1)(i)(B), as amended, eliminates the four percent of segregated funds provision. Instead, the amended rule requires an FCM to maintain adjusted net capital equal to a specified percentage of the margin required to be collected under exchange or clearing organization rules. Under amended CFTC Rule 1.17(a)(1)(i)(B), an FCM must maintain adjusted net capital equal to the following: (1) eight percent of the total risk margin requirement<sup>5</sup> for positions carried by the FCM in customer accounts;<sup>6</sup> plus (2) four percent of the total risk margin requirement for positions carried by the FCM in noncustomer accounts.<sup>7</sup>

The CFTC intended changes to Rule 1.17 to address material limitations on the segregated funds method of computing net capital.<sup>8</sup> For example, the segregated funds method did not reflect fully the extent to which an FCM was exposed to commodity positions carried for both customers and noncustomers. The segregated funds method did not include “funds held by an FCM on behalf of foreign-domiciled customers trading on foreign commodity markets, nor [did] it include funds held by an FCM on behalf of noncustomers trading on either U.S. or foreign futures and options markets.”<sup>9</sup> This method also did not include “letters of credit deposited as margin or reflect the additional

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<sup>5</sup> CFTC Rule 1.17(b)(8) defines “risk margin” (17 CFR 1.17(b)(8)).

<sup>6</sup> CFTC Rule 1.17(b)(7) defines “customer account” (17 CFR 1.17(b)(7)).

<sup>7</sup> CFTC Rule 1.17(b)(4) defines “noncustomer account” (17 CFR 1.17(b)(4)).

<sup>8</sup> See 68 FR 40835, 40837 (July 9, 2003).

<sup>9</sup> Id.

risks posed by open positions in customer accounts that liquidate to a deficit.”<sup>10</sup> Finally, the segregated funds method of calculating net capital “subjects an FCM to a higher requirement in situations where the FCM requires additional margin from customers or carries free credit balances for its customers, despite the risk reducing effect of holding higher levels of customer funds.”<sup>11</sup> The CFTC amended Rule 1.17 to address these concerns and conform its net capital requirement to the net capital requirements implemented by the National Futures Association (“NFA”), two exchanges, and a clearing organization.

The Commission is proposing to amend Rule 15c3-1 to reflect the amendments to CFTC Rule 1.17, and is also proposing to amend paragraph (c) of Rule 17a-11,<sup>12</sup> which generally requires a broker-dealer to notify the Commission and its designated examining authority (“DEA”) if it fails to maintain certain levels of net capital.

## **II. PROPOSED AMENDMENTS**

### **A. Amendments to Rule 15c3-1**

#### **1. Amendments to Rule 15c3-1(a)(1)(iii)**

The Commission is proposing to amend Rule 15c3-1(a)(1)(iii) to conform to amended CFTC Rule 1.17. The proposed amendments to Rule 15c3-1(a)(1)(iii) would require a broker-dealer/FCM to maintain net capital of not less than the greater of the following: (1) its requirement under paragraph (a)(1)(i) or (ii) of Rule 15c3-1; or (2) eight percent of the total risk margin requirement for positions carried by the FCM in customer

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<sup>10</sup> Id.

<sup>11</sup> Id.

<sup>12</sup> 17 CFR 240.17a-11(c).

accounts plus four percent of the total risk margin requirement for positions carried by the FCM in noncustomer accounts (“risk margin-based capital requirement”).

## **2. Amendments to Rule 15c3-1(e)(2)(ii)**

The Commission also is proposing to amend Rule 15c3-1(e)(2)(ii) to conform it to CFTC Rule 1.17(e)(1)(ii). Rule 15c3-1(e)(2)(ii) prohibits a broker-dealer/FCM from withdrawing equity capital if the withdrawal would cause the broker-dealer/FCM’s net capital to fall below, among other standards, a specified percentage of its minimum net capital dollar amount or a specified level of aggregate indebtedness, or its “net capital would be less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder” after the withdrawal. The Commission is proposing to replace the seven percent of segregated funds requirement with the amended CFTC Rule 1.17(e)(1)(ii) requirement of 120 percent of the risk margin-based capital requirement.

## **B. Amendments to Appendix D to Rule 15c3-1**

The Commission also is proposing to amend certain provisions of Appendix D to Rule 15c3-1 (“Rule 15c3-1d”),<sup>13</sup> which contains minimum and non-exclusive requirements for satisfactory broker-dealer subordination agreements. Specifically, the Commission is proposing to amend paragraphs (b)(6)(iii), (b)(7), (b)(8)(i)(A), (b)(10)(ii)(B), (c)(2), (c)(5)(i)(B), (c)(5)(ii)(A), and (c)(7) of Rule 15c3-1d, which relate to repayment and prepayment of subordinated debt. Both Rule 15c3-1 and CFTC Rule 1.17 prohibit a broker-dealer or an FCM, respectively, from repaying or prepaying

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<sup>13</sup> 17 CFR 240.15c3-1d.

subordinated debt if the payments would cause the broker-dealer's or FCM's net capital to fall below certain thresholds.

**1. Amendments to Rule 15c3-1d(b)(6)(iii)**

The Commission is proposing to replace the segregated funds requirement of Rule 15c3-1d(b)(6)(iii) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(2)(vi)(C)(2). Rule 15c3-1d(b)(6)(iii) permits a subordinated lender to reduce the unpaid principal amount of a secured demand note pledged to a broker-dealer with the consent of the broker-dealer and its DEA. The reduction, however, may not cause the broker-dealer's aggregate indebtedness to exceed a specified level of net capital or its net capital to fall below a specified level of aggregate debit items or, if the broker-dealer also is registered as an FCM, its net capital to fall below seven percent of the funds that must be segregated under the CEA and its rules, if that segregated amount is greater. The proposed amendment to Rule 15c3-1d(b)(6)(iii) would conform to amended CFTC Rule 1.17(h)(2)(vi)(C)(2) and replace the seven percent of segregated funds requirement with 120 percent of the risk margin-based capital requirement.

**2. Amendments to Rule 15c3-1d(b)(7)**

The Commission is proposing to replace the segregated funds requirement of Rule 15c3-1d(b)(7) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(2)(vii)(A)(2). Rule 15c3-1d(b)(7) permits a broker-dealer to prepay subordinated debt if the prepayment occurs at least one year after the effective date of the subordination agreement and the broker-dealer meets certain other requirements. A broker-dealer/FCM may not prepay subordinated debt, however, if the

prepayment would cause its aggregated indebtedness to exceed a specified level of net capital or its net capital to fall below a specified percentage of the minimum net capital dollar amount, fall below a specified level of aggregate debit items or, if the broker-dealer also is registered as an FCM, its net capital to fall below seven percent of the funds that must be segregated under the CEA and its rules, if that amount is greater. The proposed amendment to Rule 15c3-1d(b)(7) would conform to amended CFTC Rule 1.17(h)(2)(vii)(A)(2) and replace the seven percent of segregated funds requirement with 120 percent of the risk margin-based capital requirement.

### **3. Amendments to Rule 15c3-1d(b)(8)(i)(A)**

The Commission is proposing to replace the segregated funds requirement of Rule 15c3-1d(b)(8)(i)(A) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(2)(viii)(A)(2). Rule 15c3-1d(b)(8)(i)(A) requires a broker-dealer/FCM to suspend repayment of subordinated debt if the repayment would cause its aggregated indebtedness to exceed a specified level of net capital or its net capital to fall below a specified level of aggregate debit items or, if the broker-dealer also is registered as an FCM, its net capital to fall below six percent of the funds required to be segregated under the CEA and its rules, if that amount is greater. The proposed amendment to Rule 15c3-1 d(b)(8)(i)(A) would conform to amended CFTC Rule 1.17(h)(2)(viii)(A)(2) and replace the six percent of segregated funds requirement with 120 percent of the risk margin-based capital requirement.

### **4. Amendments to Rule 15c3-1d(b)(10)(ii)(B)**

The Commission also is proposing to replace the segregated funds requirement of Rule 15c3-1d(b)(10)(ii)(B) to reflect the CFTC's risk margin-based capital requirements.

Rule 15c3-1d(b)(10)(ii)(B) limits the events of default that may accelerate a broker-dealer/FCM's obligation to repay subordinated debt. Those events of default occur if a broker-dealer/FCM's aggregate indebtedness exceeds 1500 percent of its net capital, its net capital computed under Rule 15c3-1(a)(1)(ii) is less than two percent of aggregate debit items as computed under Rule 15c3-3a, or its net capital is less than four percent of the funds required to be segregated under the CEA and its rules, if that amount is greater. The proposed amendment to Rule 15c3-1(b)(10)(ii)(B) would replace the four percent of segregated funds requirement with the risk margin-based capital requirements of proposed Rule 15c3-1(a)(1)(iii).

#### **5. Amendments to Rule 15c3-1d(c)(2)**

Furthermore, the Commission is proposing to replace the segregated funds requirement of Rule 15c3-1d(c)(2) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(3)(ii)(B). Rule 15c3-1d(c)(2) requires a broker-dealer/FCM to notify its DEA if repayment of its subordinated debt would cause its aggregate indebtedness to exceed 1200 percent of its net capital; its net capital to be less than 120 percent of the minimum dollar amount required by Rule 15c3-1; less than five percent of aggregate debit items computed in accordance with Rule 15c3-3a; or its net capital to be less than six percent of the funds required to be segregated under the CEA and its rules, if that amount is greater. The proposed amendment to Rule 15c3-1d(c)(2) would conform to amended CFTC Rule 1.17(h)(3)(ii)(B) and replace the six percent of segregated funds requirement with 120 percent of the risk margin-based capital requirement.

**6. Amendments to Rule 15c3-1d(c)(5)(i)(B)**

The Commission also is proposing to replace the segregated funds requirement of Rule 15c3-1d(c)(5)(i)(B) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(3)(v)(B). Rule 15c3-1d(5)(i)(B) permits a broker-dealer to enter into temporary subordination agreements (terms of no more than 45 days), subject to specified conditions, so that the broker-dealer may engage in securities underwriting and other extraordinary activities. A broker-dealer/FCM operating under Rule 15c3-1(a)(1)(ii) may not enter into a temporary subordination agreement, however, if its net capital is less than five percent of its aggregate debit items computed under Rule 15c3-3a or seven percent of the funds required to be segregated under the CEA or its rules, if that amount is greater. The proposed amendment to Rule 15c3-1d(c)(5)(i)(B) would conform to amended CFTC Rule 1.17(h)(3)(v)(B) and replace the seven percent of segregated funds requirement with 120 percent of the risk margin-based capital requirement.

**7. Amendments to Rule 15c3-1d(c)(5)(ii)(A)**

Finally, the Commission is proposing to replace the segregated funds requirement of Rule 15c3-1d(c)(5)(ii)(A) with a risk margin-based capital requirement to conform it to the CFTC's amended Rule 1.17(h)(2)(vii)(B)(2). Rule 15c3-1d(c)(5)(ii)(A) permits a broker-dealer to enter into a revolving subordinated loan agreement that provides for prepayment within less than one year. A broker-dealer/FCM may not prepay subordinated debt, however, if, as a result of the prepayment, its aggregate indebtedness would exceed 900 percent of its net capital; its net capital would be less than 200 percent of the minimum dollar amount required under Rule 15c3-1; its net capital would be less

than six percent of aggregate debit items computed under Rule 15c3-3a (for broker-dealer operating under Rule 15c3-1(a)(1)(ii)); or its net capital would be less than ten percent of the funds required to be segregated under the CEA or its rules, if that amount is greater. The proposed amendment to Rule 15c3-1d(c)(5)(ii)(A) would conform to amended CFTC Rule 1.17(h)(2)(vii)(B)(2) and replace the ten percent of segregated funds requirement with 125 percent of the risk margin-based capital requirement.

**8. Applicability of amendments to Rule 15c3-1d to existing subordination agreements**

Under the proposed amendments to Rule 15c3-1d(c)(7), satisfactory subordination agreements that comply with Rule 15c3-1d, as in effect before adoption of these proposed amendments to that rule, would continue to be deemed satisfactory until their maturity date, if the agreements are not amended or renewed. However, all subordination agreements would be required to meet the requirements of amended Rule 15c3-1d within five years of adoption of these proposed amendments to that rule. Amendments to, or renewals of, subordination agreements would be required to comply with the proposed amendments to Rule 15c3-1d, as would any new subordination agreements. This proposed “grandfathering” provision is intended to allow broker-dealer/FCMs sufficient time to comply with the proposed amendments to subordinated debt rules in a manner that is not unduly burdensome on either the broker-dealer/FCMs or their DEAs, which must approve subordinated debt agreements under Appendix D.

**C. Rationale for the Amendments to Rules 15c3-1 and 15c3-1d**

The Commission believes that the proposed amendments to Rules 15c3-1 and 15c3-1d are necessary and appropriate. First, compliance with both the current Commission and the amended CFTC rules could impose duplicative or conflicting

obligations on a broker-dealer/FCM because the rules may apply different standards. Under current Rule 15c3-1(a)(1)(iii) and amended CFTC Rule 1.17, a broker-dealer/FCM must maintain net capital equal to at least the greatest of its requirements under Rule 15c3-1(a)(1)(i) or (ii), four percent of the funds required to be segregated under the CEA and its applicable rules, or the risk margin-based capital requirement under amended CFTC Rule 1.17. That is, a broker-dealer/FCM must maintain net capital equal to at least the Commission minimum applicable to broker-dealers, the now-eliminated CFTC segregated funds minimum, or the new CFTC minimum applicable to FCMs. Section 15 of the Exchange Act requires the Commission to issue those rules, in consultation with the CFTC, that are necessary to avoid imposing duplicative or conflicting financial responsibility regulations on broker-dealer/FCMs.<sup>14</sup> The proposed amendments to Rules 15c3-1 and 15c3-1d are intended to avoid imposing potentially duplicative or conflicting regulations on broker-dealer/FCMs by eliminating the four percent of segregated funds requirement and replacing it with a risk margin-based capital requirement identical to that contained in amended CFTC Rule 1.17.

Second, the risk margin-based capital requirement applicable to FCMs should be an adequate substitute for the previous segregated funds standard. The risk margin-based requirement has been in place at futures exchanges for a number of years without significant problems.

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<sup>14</sup> Section 15 of the Exchange Act requires the Commission, in consultation with the CFTC, to:  
issue such rules, regulations, or orders as are necessary to avoid duplicative or conflicting regulations applicable to any broker or dealer registered with the Commission pursuant to section 15(b) (except paragraph (11) thereof), that is also registered with the Commodity Futures Trading Commission pursuant to section 4f(a) of the Commodity Exchange Act...with respect to application of...financial responsibility rules.

15 U.S.C. 78o(c)(3)(B).

Third, the proposed amendments to Rule 15c3-1 also are necessary to avoid potentially placing a broker-dealer/FCM at a competitive disadvantage with respect to entities registered solely as broker-dealers or FCMs. Sole registrants might be subject to lower regulatory costs than a combined broker-dealer/FCM, which could be required to maintain higher capital than either the broker-dealer or FCM net capital rules would require a sole registrant to maintain.

Fourth, the proposed amendments should provide the Commission with enhanced ability to monitor the financial position of broker-dealer/FCMs. The proposed amendments to Rule 15c3-1 would permit the Commission to oversee a broker-dealer/FCM for capital problems arising from the firm's futures business. A broker-dealer/FCM might be in a financial position in which its net capital otherwise is sufficient for the securities aspect of Rule 15c3-1, but is insufficient for purposes of the risk margin-based capital requirement for its futures business. Under the proposed amendments to Rule 15c3-1, a broker-dealer's failure to maintain sufficient risk margin-based capital, which is a violation of CFTC Rule 1.17, also would be a violation of the Commission's net capital rule. The Commission, therefore, could force the broker-dealer/FCM to take corrective action (or require it to cease conducting business), an ability the Commission would not have without the proposed amendments.

**D. Amendments to Rule 17a-11, Notification Provisions for Brokers and Dealers**

We are proposing to amend paragraph (c) of Rule 17a-11,<sup>15</sup> which generally requires a broker-dealer to notify the Commission and its DEA if it fails to maintain certain levels of net capital. Specifically, the Commission is proposing to amend

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<sup>15</sup> 17 CFR 240.17a-11(c).

paragraph (c) of Rule 17a-11 to redesignate existing paragraph (c)(4) as paragraph (c)(5); and add a new paragraph (c)(4).

Proposed new paragraph (c)(4) would require a broker-dealer/FCM to notify the Commission and its DEA under circumstances in which the CFTC's rules would require an FCM to provide notification to the CFTC that its adjusted net capital had fallen below a particular threshold. We are proposing these amendments to help protect customers from broker-dealer failures. Current Rule 17a-11 does not require a broker-dealer/FCM to notify the Commission if its adjusted net capital under the CFTC's net capital rule falls below specified requirements. The proposed notification requirement should provide an early warning to the Commission that a broker-dealer/FCM may be experiencing financial difficulties whatever the source and allow the Commission to take corrective action with respect to the firm, if necessary. The proposed amendments to Rule 17a-11 also are consistent with amended CFTC Rule 1.12(b)(2),<sup>16</sup> which requires an FCM to notify the CFTC and its designated self-regulatory organization if its adjusted net capital falls below 110% of its risk margin-based requirements under 1.17(a)(1)(i)(B).

### **III. REQUEST FOR COMMENTS**

We invite interested persons to submit written comments on all aspects of the proposed amendments. Further, we invite comment on other matters that might have an effect on the proposals contained in the release.

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<sup>16</sup> 17 CFR 1.12(b)(2).

#### IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed amendments to Rule 17a-11<sup>17</sup> contain “collection of information requirements” within the meaning of the Paperwork Reduction Act of 1995.<sup>18</sup> The Commission has submitted the proposed amendments to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission is revising the collection of information entitled, “Rule 17a-11 (17 CFR 240.17a-11) Notification Provision for Brokers and Dealers,” OMB Control Number 3235-0085. 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.

##### A. Collection of Information under these Amendments

As discussed, the Commission is proposing to amend Rule 17a-11 to provide the Commission with an early warning of a broker-dealer/FCM’s low capital level, which should help protect customers from broker-dealer failures. The proposed amendments to paragraph 17a-11(c)(4) would require a broker-dealer/FCM to notify the Commission and its DEA under circumstances in which the CFTC’s rules would require an FCM to provide notification that its adjusted net capital had fallen below a particular threshold.

##### B. Proposed Use of Information

The Commission would use the information collected under the proposed amendments to Rule 17a-11 to determine if a broker-dealer is in compliance with

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<sup>17</sup> There is no new collection of information imposed on broker-dealer/FCMs under the amendments to Rules 15c3-1 and 15c3-1d. The Commission’s and CFTC’s rules, both in previous form and as amended, require broker-dealer/FCMs to comply with the net capital rules of both agencies. Accordingly, the proposed amendments to Rules 15c3-1 and 15c3-1d do not impose any new requirements on broker-dealer/FCMs.

<sup>18</sup> 44 U.S.C. 3501 *et seq.*

financial responsibility rules. Specifically, the Commission would use the information to monitor whether broker-dealer/FCMs are complying with the net capital rule and relevant notification requirements.

### **C. Respondents**

The proposed amendments to Rule 17a-11 would apply only to broker-dealer/FCMs. As of July 31, 2006, there were approximately 67 broker-dealer/FCMs.<sup>19</sup> A broker-dealer/FCM would be required to notify the Commission and its DEA under circumstances in which the CFTC's rules would require an FCM to provide notification that its adjusted net capital had fallen below a particular threshold.

### **D. Total Annual Reporting and Recordkeeping Burden**

Under the proposed amendment to Rule 17a-11(c)(4), a broker-dealer/FCM would be required to notify the Commission and its DEA under circumstances in which the CFTC's rules would require an FCM to provide notification that its adjusted net capital had fallen below a particular threshold. The Commission staff estimates that 5 out of 67 broker-dealer/FCMs will file Rule 17a-11 notifications annually.<sup>20</sup> The staff further estimates that these broker-dealer/FCMs would spend annually approximately 1.25 hours (or .25 hours each x 5 broker-dealer/FCMs) send the notifications.<sup>21</sup>

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<sup>19</sup> Selected FCM Financial Data as of July 31, 2006, CFTC Division of Clearing and Intermediary Oversight.

<sup>20</sup> There were approximately 5,980 registered broker-dealers as of December 31, 2005. Approximately 450, or 7.5% (450/5,980), of those firms filed early warning notices under Rule 17a-11. The Commission, therefore, expects that 5 broker-dealer/FCMs (approximately 7.5% of 67 broker-dealer/FCMs) would file early warning notices annually under Rule 17a-11.

<sup>21</sup> A broker-dealer/FCM is already required to draft and send these notifications to the CFTC or DSROs pursuant to CFTC Rules. Consequently, the only additional cost relates to the additional time it would take the broker-dealer/FCM's staff to send the notification to the Commission and its DEA. The Staff estimates, based on its experience, that it would take an individual 15 minutes to send these additional notifications.

**E. Collection of Information is Mandatory**

The collection of information under the proposed amendments to Rule 17a-11 is mandatory if a broker-dealer/FCM's net capital falls below the Commission's or the CFTC's early warning thresholds.

**F. Confidentiality**

The collection of information under the proposed amendments to Rule 17a-11(c)(4) would be provided to the Commission and to a broker-dealer/FCM's DEA, but would not be subject to public availability.

**G. Record Retention Period**

Rule 17a-4(b)(4) requires a broker-dealer to preserve copies of all communications sent relating to its business as such for no less than three years, the first two years in an accessible place.

**H. Request for Comment**

Under 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;
- (ii) Evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information;
- (iii) Enhance the quality, utility, and clarity of the information to be collected; and
- (iv) Minimize the burden of the collection of information on those required to respond, including through the use of automated collection techniques or other forms of information technology.

Persons who desire to submit comments on the collection of information requirements should direct them to OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File No. S7-16-06. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the Federal Register; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. The Commission has submitted the proposed collections of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-16-06, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549.

## **V. COSTS AND BENEFITS OF THE PROPOSED AMENDMENTS**

### **A. Introduction**

As discussed, the Commission is proposing to amend Exchange Act Rules 15c3-1(a)(1)(iii) and (e)(2)(ii); 15c3-1d(b)(6)(iii), (b)(7), (b)(8)(i)(A), (b)(10)(ii)(B), (c)(2), (c)(5)(i)(B), (c)(5)(ii)(A), and (c)(7); and 17a-11(c)(3), (c)(4), and (c)(5). The CFTC amended Rules 1.17 and 1.12 to adopt certain new net capital requirements applicable to FCMs.<sup>22</sup> Broker-dealer/FCMs must comply with both the CFTC's and the Commission's net capital rules under Rule 15c3-1(a)(1)(iii). Accordingly, the Commission is amending

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<sup>22</sup> See *supra*, note 4.

Rules 15c3-1 and 15c3-1d to conform those rules to the CFTC's amendments. Finally, the Commission is amending Rule 17a-11 to provide itself with an early warning that a broker-dealer/FCM may be experiencing financial difficulties.

The Commission has identified below certain costs and benefits associated with its proposed amendments. We encourage commenters to discuss, analyze, and supply relevant data regarding any additional costs or benefits.

**B. Benefits**

We believe that the proposed amendments to Rules 15c3-1 and 15c3-1d will benefit both broker-dealer/FCMs and investors. As discussed, the Commission is proposing to amend Rule 15c3-1(a)(1)(iii) by eliminating the rule's segregated funds requirement and replacing it with the risk margin-based capital requirement. Rule 15c3-1(a)(1)(iii) requires a broker-dealer/FCM to maintain net capital of not less than the greater of its requirement under Rule 15c3-1 or four percent of the funds required to be segregated under the CEA and its rules. The four percent of segregated funds requirement was intended to conform Rule 15c3-1(a)(1)(iii) to Rule 1.17, the CFTC's adjusted net capital rule, and ensure that a broker-dealer/FCM complied with the net capital rules of both the CFTC and the Commission. Rule 1.17, as amended, eliminates the four percent of segregated funds requirement and replaces it with a new risk margin-based capital requirement. Proposed Rule 15c3-1(a)(1)(iii) would require a broker-dealer/FCM to maintain net capital of not less than the greater of its requirement under Rule 15c3-1 or a risk margin-based capital requirement identical to the one contained in CFTC Rule 1.17, as amended.

We also are proposing to amend Rule 15c3-1(e)(2)(ii) to conform it to the CFTC's new risk margin-based capital requirement. Rule 15c3-1(e)(2)(ii) prohibits a broker-dealer/FCM from withdrawing equity capital if the withdrawal would cause the broker-dealer/FCM's net capital to fall below, among other standards, a specified percentage of its minimum net capital dollar amount, a specified level of aggregate indebtedness, or a specified percentage of the funds required to be segregated under the CEA. CFTC Rule 1.17(e)(1)(ii), as amended, prohibits an FCM from withdrawing equity capital if the withdrawal would cause the FCM's adjusted net capital to fall below a specified percentage of risk margin-based capital, rather than a specified percentage of segregated funds. The proposed amendments would substitute the segregated funds requirement in Rule 15c3-1(e)(2)(ii) with a risk margin-based requirement calculated under Rule 15c3-1(a)(1)(iii).

Furthermore, the Commission is proposing amendments to various provisions of Rule 15c3-1d, which contains minimum and non-exclusive requirements for satisfactory subordination agreement involving broker-dealers. Repayment and prepayment of subordinated debt under Rule 15c3-1d generally is permissible only if the broker-dealer/FCM maintains net capital equal to at least a specified percentage of net capital calculated under Rule 15c3-1 and a specified percentage of segregated funds. Rather than permitting repayment or prepayment of subordinated debt if an FCM maintains a specified percentage of segregated funds, the CFTC's Rule 1.17, as amended, permits repayment or prepayment if the FCM maintains net capital equal to at least a specified percentage of its risk margin-based capital requirement. Accordingly, the Commission is proposing to amend Rule 15c3-1d by substituting the risk margin-based capital

requirement for the segregated funds requirement to avoid subjecting broker-dealer/FCMs to conflicting or duplicative regulation.

The Commission believes that the risk margin-based capital requirement is appropriate. Each of the amendments to Rules 15c3-1 and 15c3-1d substitutes the risk margin-based capital requirement for the segregated funds standard. The risk margin-based capital requirement should be an adequate substitute for the segregated funds standard based on its implementation and use by the futures exchanges and FCMs' comfort level with the requirement.

As noted, the Commission also believes that the amendments to Rules 15c3-1 and 15c3-1d would benefit both broker-dealer/FCMs and investors. First, the proposed amendments would prevent the imposition of potentially conflicting or duplicative regulation on a broker-dealer/FCM. Current Rule 15c3-1(a)(1)(iii) requires a broker-dealer/FCM to maintain net capital equal to the greater of its net capital requirement under Rule 15c3-1 or four percent of the funds required to be segregated under the CEA and its rules. The four percent of segregated funds requirement reflects the previous version of CFTC Rule 1.17 and has been substituted in current CFTC Rule 1.17 with the risk margin-based capital requirement. The proposed amendments would substitute the risk margin-based capital requirement for the segregated funds requirement in Rules 15c3-1 and 15c3-1d and, therefore, free a broker-dealer/FCM from complying with a capital requirement no longer applicable to FCMs that are sole registrants.

Second, the proposed amendments would help to avoid potentially placing a broker-dealer/FCM at a competitive disadvantage with respect to an entity registered solely as a broker-dealer or FCM. Neither a broker-dealer nor an FCM is subject to the

four percent of segregated funds requirement; a broker-dealer/FCM is subject to such a requirement unless the proposed amendments are adopted. Accordingly, the proposed amendments could free a broker-dealer/FCM from making three separate capital computations (one based on Rule 15c3-1(a)(1)(i) or (ii), one based on CFTC Rule 1.17, and one based on the four percent of segregated requirement under current Rule 15c3-1(a)(1)(iii)) and holding unnecessarily more net capital than its sole registrant competitors.

Third, the proposed amendments would enhance the Commission's ability to monitor the financial condition of a broker-dealer/FCM. Under the proposed amendments to Rule 15c3-1, a broker-dealer's failure to maintain sufficient risk margin-based capital, which is a violation of CFTC Rule 1.17, also would be a violation of the Commission's net capital rule. The Commission, therefore, could force the broker-dealer/FCM to take corrective action (or require it to cease conducting business), an ability the Commission would not have without the proposed amendments.

Finally, the proposed amendments to Rule 17a-11 would help protect customers from broker-dealer failures. Current Rule 17a-11 does not require a broker-dealer/FCM to notify the Commission if its adjusted net capital falls below specified requirements. The proposed amendments to Rule 17a-11 would require a broker-dealer/FCM to notify the Commission if its net capital falls below certain thresholds determined in accordance with Rule 15c3-1 or if the CFTC's rules would require it to notify the CFTC or a DSRO that its adjusted net capital had breached certain thresholds. This notification requirement should provide an early warning to the Commission that a broker-dealer/FCM may be experiencing financial difficulties.

### C. Costs

There would be no costs associated with the proposed amendments to Rules 15c3-1 and 15c3-1d. A broker-dealer/FCM already must comply with the net capital rules of both the Commission and the CFTC. Likewise, a broker-dealer/FCM already must comply with Rule 15c3-1d and comparable CFTC subordinated debt rules.

The proposed amendments would help ensure that broker-dealer/FCMs are not subject to inconsistent or duplicative regulation under Rules 15c3-1 and 15c3-1d by eliminating the four percent of segregated funds standard in those rules and replacing it with the risk margin-based capital requirement. With respect to 15c3-1d, the applicable thresholds no longer will be calculated based upon a segregated funds, but upon risk margin-based capital, which the broker-dealer/FCM already calculates under CFTC Rule 1.17.

As discussed, proposed Rule 17a-11(c)(4) would require a broker-dealer/FCM to notify the Commission and its DEA under circumstances in which the CFTC's rules would require an FCM to notify the CFTC or a DRSO that its adjusted net capital had fallen below a particular threshold. The cost of notification in these circumstances should be minimal because the broker-dealer/FCM already must notify the CFTC.<sup>23</sup> We estimate the annual cost of notification under Rule 17a-11(c)(4) would be \$331 (.25 hours x \$265 per hour for a financial reporting manager<sup>24</sup> x 5 broker-dealer/FCMs).<sup>25</sup>

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<sup>23</sup> See *supra*, note 21.

<sup>24</sup> A financial reporting manager is a person at a broker-dealer with responsibility for helping to ensure that the broker-dealer complies with its financial reporting requirements with respect to the Commission, other federal or state agencies and SROs.

<sup>25</sup> Security Industry Association's ("SIA") Report on Management & Professional Earnings in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The amount also reflects the average between New York City salaries and Non-New York City salaries. This is the latest report on financial industry salaries that is available from the SIA.

## VI. CONSIDERATION OF BURDEN ON COMPETITION, AND PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 3(f) of the Exchange Act<sup>26</sup> requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider if the action will promote efficiency, competition, and capital formation. Under section 23(a)(2) of the Exchange Act,<sup>27</sup> the Commission must consider the impact of its rulemaking on competition. It 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.

We preliminarily believe that the amendments to Rules 15c3-1, 15c3-1d, and 17a-11 would promote efficiency, competition, and capital formation. The amendments to Rules 15c3-1 and 15c3-1d should promote efficiency because they would help to ensure that broker-dealer/FCMs are not subject to net capital requirements beyond those that the Commission already imposes on broker-dealers and those that the CFTC already imposes on FCMs. That is, the amendments would not subject broker-dealer/FCMs to any new requirements and, consequently, would not impose any new costs. Furthermore, the proposed amendments to Rule 17a-11(c)(4) should promote efficiency because they would require a broker-dealer/FCM to notify the Commission that it has fallen below a specified percentage of its adjusted net capital requirement under CFTC rules, a notification that it already must provide to the CFTC. This notification should help the Commission address potential financial difficulties at a broker-dealer/FCM before a liquidation becomes necessary and, therefore, should help protect customers. Each of

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<sup>26</sup> 15 U.S.C. 78c(f).

<sup>27</sup> 15 U.S.C. 78w(a)(2).

these provisions also should help foster competition because they would allow firms to function jointly as broker-dealer/FCMs without imposing regulatory requirements beyond those already applicable to broker-dealers and FCMs individually.

We preliminarily believe that the proposed amendments to Rules 15c3-1, 15c3-1d and 17a-11 would promote capital formation. By eliminating potentially duplicative or conflicting regulation, the proposed amendments to Rules 15c3-1 and 15c3-1d should help to ensure that a broker-dealer/FCM does not unnecessarily use its assets to meet regulatory capital requirements, freeing those assets for business uses. Similarly, the proposed amendments to Rule 17a-11 should help the Commission to identify a broker-dealer/FCM that faces potential financial difficulties and allow the Commission to take corrective action to help that broker-dealer/FCM preserve its capital which, in turn, should help protect the broker-dealer/FCM's customers.

Finally, we preliminarily believe that the proposed amendments do not impose any competitive burden that is not necessary and appropriate in furtherance of the purposes of the Exchange Act. As discussed, the Commission is proposing amendments to Rules 15c3-1 and 15c3-1d to conform those rules to the CFTC's amended net capital rule. The proposed rules are intended to eliminate inconsistent and duplicative regulation on broker-dealer/FCMs. Furthermore, we preliminarily believe that the proposed amendments to Rule 17a-11 are necessary to provide the Commission with an early warning of potential capital insufficiencies at broker-dealer/FCMs. This early warning should help the Commission to protect customers and the integrity of the markets. The amendments to Rule 17a-11(c)(4), moreover, would require only that a broker-

dealer/FCM forward to the Commission a notice that it already must provide to the CFTC.

## **VII. REGULATORY FLEXIBILITY ACT CERTIFICATION**

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments to Rule 15c3-1, Rule 15c3-1d, and Rule 17a-11, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments would apply only to broker-dealers also registered as FCMs. As of July 31, 2006, there were approximately 67 broker-dealer/FCMs.<sup>28</sup> Only one of those broker-dealers would qualify as a small entity.<sup>29</sup> Accordingly, we do not believe that the proposed amendments would have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

## **VIII. CONSIDERATION OF IMPACT ON THE ECONOMY**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>30</sup> we must advise OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" if, upon adoption, it results or is likely to result in:

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<sup>28</sup> Selected FCM Financial Data as of July 31, 2006, CFTC Division of Clearing and Intermediary Oversight.

<sup>29</sup> See 17 CFR 240.0-10.

<sup>30</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
  - A major increase in costs or prices for consumers or individual industries;
- or
- Significant adverse effect on competition, investment or innovation.

If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

## **IX. STATUTORY AUTHORITY**

The Commission is proposing amendments to Rule 15c3-1, Rule 15c3-1d, and Rule 17a-11 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17 and 23(a).<sup>31</sup>

### **Text of Proposed Rule Amendments**

#### **List of Subjects**

##### **17 CFR Part 240**

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission hereby proposes that Title 17, Chapter II of the Code of Federal Regulation be amended as follows.

### **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:

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<sup>31</sup> 15 U.S.C. 78o, 78q and 78w(a).

**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, 79q, 79t, 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 240.15c3-1 is amended by revising paragraphs (a)(1)(iii) and (e)(2)(ii) to read as follows:

**§ 240.15c3-1 Net capital requirements for brokers or dealers.**

(a) \* \* \*

(1) \* \* \*

(iii) No broker or dealer registered as a futures commission merchant shall permit its net capital to be less than the greater of its requirement under paragraph (a)(1)(i) or (ii) of this section, or eight percent of the total risk margin requirement for positions carried by the futures commission merchant in customer accounts plus four percent of the total risk margin requirement for positions carried by the futures commission merchant in noncustomer accounts, as defined in the Commodity Exchange Act (7 U.S.C. 1 et seq.) and the rules thereunder.

\* \* \* \* \*

(e) \* \* \*

(2) \* \* \*

(ii) The broker-dealer is registered as a futures commission merchant, its net capital would be less than 120 percent of the aggregate amount of its total risk margin

requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of this section;

\* \* \* \* \*

3. Section 240.15c3-1d is amended by removing the authority citation at the end of the section and revising paragraphs (b)(6)(iii), (b)(7), (b)(8)(i)(A), (b)(10)(ii)(B), (c)(2), (c)(5)(i)(B), (c)(5)(ii)(A), and (c)(7) to read as follows:

**§ 240.15c3-1d Satisfactory Subordination Agreements (Appendix D to 17 CFR 240.15c3-1).**

\* \* \* \* \*

(b) \*\*\*

(6) \*\*\*

(iii) The secured demand note agreement also may provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender, with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer, may reduce the unpaid principal amount of the secured demand note. After giving effect to such reduction, the aggregate indebtedness of the broker or dealer may not exceed 1000 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, net capital may not be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 120 percent of the aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater. No single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn. No

Examining Authority shall consent to a reduction of the principal amount of a secured demand note if, after giving effect to such reduction, net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1.

#### Permissive Prepayments

(7) A broker or dealer at its option, but not at the option of the lender may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective. This restriction shall not apply to temporary subordination agreements that comply with the provisions of paragraph (c)(5) of this Appendix D. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of its aggregate debit items computed in accordance with § 240.15c3-3a, or if registered as a futures commission merchant, 120 percent of the

aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3-1. Notwithstanding the provisions of this paragraph, no Prepayment shall occur without the prior written approval of the Examining Authority for such broker or dealer.

Suspended Repayment

(8)(i) \* \* \*

(A) The aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital, or in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, 120 percent of the aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, or

\* \* \* \* \*

(10) \* \* \*

(ii) \* \* \*

(B) The aggregate indebtedness of the broker or dealer exceeding 1500 percent of its net capital or, in the case of a broker or dealer that has elected to operate under paragraph (a)(1)(ii) of § 240.15c3-1, its net capital is less than 2 percent of its aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, the aggregate amount of its total risk margin requirements for

positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact;

\* \* \* \* \*

(c) \* \* \*

(2) Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the broker or dealer either the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1, or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 120 percent of the aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3-1.

\* \* \* \* \*

(5) \* \* \*

(i) \* \* \*

(B) In the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital is less than 5 percent of aggregate debits computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, less than 120 percent of the aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section, or

\* \* \* \* \*

(ii) \* \* \*

(A) After giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 900 percent of its net capital or its net capital would be less than 200 percent of the minimum dollar amount required by § 240.15c3-1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 6 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 125 percent of the aggregate amount of its total risk margin requirements for positions carried in customer and noncustomer accounts under paragraph (a)(1)(iii) of § 240.15c3-1, if greater, or its net capital would be

less than 200 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section or

\* \* \* \* \*

(7) Subordination agreements in effect before adoption. Any subordination agreement that incorporates the net capital requirements in paragraphs (b)(6)(iii), (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), (c)(5)(i)(B), and (c)(5)(ii)(A), as in effect before adoption of the amendments incorporating the risk margin-based capital requirement in those paragraphs, and that has been deemed to be satisfactorily subordinated pursuant to § 240.15c3-1 as in effect before adoption of those amendments, shall continue to be deemed a satisfactory subordination agreement until the maturity of the agreement. Provided, That if the agreement is amended or renewed for any reason, then the agreement shall not be deemed a satisfactory subordination agreement unless the amended or renewed agreement meets the requirements of this Appendix D. Provided, further, That all subordination agreements must meet the requirements of this Appendix D within 5 years of the adoption of the amendments incorporating the risk margin-based capital requirements.

4. Section 240.17a-11 is amended by:
  - a. Revising the introductory text of paragraph (c);
  - b. In paragraph (c)(3) remove the period at the end of the paragraph and in its place add “; or”;
  - c. Redesignating paragraph (c)(4) as paragraph (c)(5); and
  - d. Adding new paragraph (c)(4) to read as follows:

**§ 240.17a-11 Notification provisions for brokers and dealers.**

\*\*\*\*\*

(c) Every broker or dealer shall send notice promptly (but within 24 hours) after the occurrence of the events specified in paragraph (c)(1), (c)(2), (c)(3), (c)(4) or (c)(5) of this section in accordance with paragraph (g) of this section:

\*\*\*\*\*

(4) For a broker or dealer registered as a futures commission merchant, if the Commodity Exchange Act (7 U.S.C. 1 et seq.) and the rules promulgated under the Commodity Exchange Act would require a futures commission merchant to provide notification to the Commodity Futures Trading Commission or a designated self-regulatory organization that its adjusted net capital has fallen below a specified threshold;

or

\*\*\*\*\*

By the Commission.

Nancy M. Morris  
Secretary

Date: October 5, 2006



**By: J. Lynn Taylor**  
**Assistant Secretary**

Chairman Cox  
Not Participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933  
Release No. 8748 / October 11, 2006

SECURITIES ACT OF 1934  
Release No. 54586 / October 11, 2006

INVESTMENT ADVISERS ACT OF 1940  
Release No. 2561 / October 11, 2006

INVESTMENT COMPANY ACT OF 1940  
Release No. 27513 / October 11, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-11292

In the Matter of

STEVEN B. MARKOVITZ,

Respondent.

ORDER MAKING FINDINGS AND  
IMPOSING DISGORGEMENT AND  
CIVIL PENALTIES PURSUANT TO  
SECTION 203(f) OF THE INVESTMENT  
ADVISERS ACT OF 1940 AND SECTION  
9(b) OF THE INVESTMENT COMPANY  
ACT OF 1940

I.

On October 2, 2003, the Securities and Exchange Commission ("Commission") instituted partially settled cease-and-desist and public administrative proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) 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 Steven B. Markovitz ("Markovitz" or "Respondent").

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## II.

Following institution of these proceedings, Markovitz submitted an Offer of Settlement (the "Offer") with respect to disgorgement and a civil penalty 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, Markovitz consents to the entry of this Order Making Findings and Imposing Disgorgement and Civil Penalties Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940 (the "Order"), as set forth below.

## III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

A. On October 2, 2003, the Commission issued, by consent, an order finding that Markovitz had willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, and caused violations of Rule 22c-1 under the Investment Company Act by engaging in late trading in certain mutual funds and ordered that Markovitz cease-and-desist from committing or causing any violations and any future violations of these provisions.

B. Markovitz's willful violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 involved fraud and created a significant risk of substantial losses to other persons and resulted in substantial pecuniary gain to Markovitz.

## IV.

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

Accordingly, it is hereby ORDERED:

A. That Respondent shall, within 30 days of the entry of this Order, pay disgorgement and prejudgment interest in the total amount of \$1 to the United States Treasury. 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

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<sup>1</sup> 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.

Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Steven B. Markovitz 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 Bruce Karpati, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, Northeast Regional Office, 3 World Financial Center, New York, New York 10281.

B. It is further ordered that Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$400,000 to the United States Treasury. 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 Steven B. Markovitz 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 Bruce Karpati, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, Northeast Regional Office, 3 World Financial Center, New York, New York 10281.

C. It is further ordered that the disgorgement and penalties referenced in Paragraphs IV.A and B above shall be paid into the Fair Fund created pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 in In the Matter of Millennium Partners, L.P. et al., Administrative Proceeding File No. 3-12116 (December 1, 2005). 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, Respondent agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he 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 Respondent 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.

Nancy Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
Assistant Secretary

Commissioner Atkins  
Disapproved

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933  
Release No. 8749 / October 12, 2006

SECURITIES EXCHANGE ACT OF 1934  
Release No. 57596 / October 12, 2006

INVESTMENT COMPANY ACT OF 1940  
Release No. 27517 / October 12, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12452

In the Matter of

WALL STREET ACCESS,

Respondent.

**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, SECTIONS 15(b) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934,  
AND SECTIONS 9(b) AND 9(f) OF THE  
INVESTMENT COMPANY ACT OF 1940**

**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"), Sections 15(b), and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Wall Street Access ("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 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,

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Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that

#### Summary

1. Wall Street Access, a registered broker-dealer, permitted its hedge fund customers to market time, and in one case late trade, mutual funds. Specifically, from April 2001 through October 2001, Wall Street Access accepted and executed more than 2,000 late trades in mutual funds for one customer. Registered representative ("RR") Gene T. Mancinelli ("Mancinelli") permitted a hedge fund customer ("Hedge Fund A") routinely to place orders to purchase, redeem or exchange mutual fund shares well after 4:00 p.m. ET, the time as of which funds calculate their net asset value ("NAV"). Mancinelli was well aware that the late trades would receive that day's NAV as opposed to the next trading day's NAV. Additionally, Mancinelli utilized deceptive tactics, such as using multiple accounts and multiple RR numbers, to hide the identity of his market timing customers from mutual funds, and otherwise facilitate his customers' market timing strategies.

#### Respondent

2. **Wall Street Access** is a registered broker-dealer located in New York, New York. Wall Street Access was formed as a partnership in 1981. It has been registered as a broker-dealer since 1981.

#### Background

3. In March 2001, Wall Street Access hired Mancinelli and other employees to develop a fixed income business with an expectation that he would also develop a mutual fund trading business. Wall Street Access had dealer agreements with numerous mutual funds' primary underwriters. Wall Street Access was also a correspondent firm of a clearing firm, and Wall Street Access was authorized to sell mutual funds pursuant to the clearing firm's dealer agreements with mutual funds.

4. Wall Street Access' and its clearing firm's dealer agreements contained provisions requiring the broker-dealers to sell the mutual fund shares in accordance with the federal securities laws. In addition, most dealer agreements contained some version of the following provision:

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<sup>1</sup> 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.

You are to offer and sell shares of each Fund only at the public offering price which shall then be currently in effect, and only in the manner and in accordance with the terms of the current prospectus and statement of additional information (hereafter, the "prospectus") and new account application for each such Fund.

Many of the mutual funds with which Wall Street Access and its clearing firm had dealer agreements had restrictions or prohibitions on market timing in their prospectuses.

5. The mutual fund prospectuses also disclosed the time that the NAV was set for purposes of determining the price at which shareholders may buy or redeem mutual fund shares. These prospectuses generally required that orders to purchase, redeem or exchange shares of a fund must be received no later than 4:00 p.m. ET to effect transactions at that day's NAV.

#### **Wall Street Access Expands Its Market Timing, Late Trading Business**

6. In April 2001, Mancinelli and another RR each had one customer that market timed mutual funds. Wall Street Access' market timing business then grew quickly. By October 2001, Wall Street Access had fourteen customers who were market timing mutual funds.

7. In April 2001, Hedge Fund A began late trading through Wall Street Access. Hedge Fund A would typically fax a sheet of proposed trades prior to 4:00 p.m. ET, which was labeled "tentative trades." The faxed sheet of proposed trades functioned as an order ticket. The faxed spreadsheet also stated, "Please wait for a call from [Hedge Fund A] for execution." Hedge Fund A would then contact Wall Street Access employees after 4:00 p.m. ET and instruct them to execute all or some of the proposed trades, change certain trades, or cancel certain trades, with the understanding that these trades would be executed at that day's NAV. Hedge Fund A often late traded in mutual funds with whom Wall Street Access had dealer agreements.

8. Recordings of telephone conversations demonstrate that Wall Street Access allowed Hedge Fund A to late trade. Hedge Fund A would often call Wall Street Access with its post 4:00 p.m. ET orders. On occasion, Wall Street Access employees called Hedge Fund A after 4:00 p.m. ET to ask whether Hedge Fund A wanted to trade that day. On numerous occasions, the taped phone calls show that Wall Street Access was willing to process trades even after 5:00 p.m. ET at Hedge Fund A's request.

#### **Wall Street Access Knew Late Trading Was Improper**

9. In approximately May 2001, Wall Street Access' former Vice-Chairman asked Wall Street Access' compliance officer and general counsel (the "General Counsel") about late trading. On June 11, 2001, the General Counsel followed up on the discussion with an email to the Vice-Chairman regarding "Purchases & Sales of Mutual Fund Shares." The email indicated that "[p]ermitting a customer to cancel an accepted order after 4:00 would appear to be inconsistent with Rule 22c-1 [under the Investment Company Act] and may open [Wall Street Access] up to liability for causing a disadvantage to other shareholders in the mutual fund. Therefore, [Wall

Street Access] should have a hard cut-off time for acceptance and cancellation of mutual fund orders that corresponds to the time that the mutual fund does their NAV calculation.”

10. Later on June 11, 2001, the Vice-Chairman forwarded this email to all relevant Wall Street Access employees, including Mancinelli. The Vice Chairman added:

I asked [the General Counsel] to review under what circumstances we could accept trades in mutual funds after 4PM. The attached memorandum explains our policy. Please make sure we advise our clients.

The only trades which should be excepted [sic] after 4PM are corrections.

11. Despite receiving this email, Mancinelli continued to permit Hedge Fund A to late trade. In fact, just four days later, on June 15, 2001, Mancinelli called a Wall Street Access employee at 5:02 p.m. ET and stated he “just got a phone call from [a Hedge Fund A representative], he needs to make a move.” Mancinelli then directed the employee to execute trades in five of Hedge Fund A’s accounts.

12. Hedge Fund A’s late trading continued unabated until mid-October 2001.

#### **Mancinelli Utilized Deceptive Practices to Facilitate His Customers’ Market Timing**

13. Mancinelli and his team also utilized deceptive practices to facilitate Mancinelli’s customers’ market timing of mutual funds. As an initial matter, after Mancinelli’s customers placed market timing trades in mutual funds, Mancinelli and other employees received letters from mutual funds complexes warning that the funds prohibited market timing and in some cases the funds prohibited future trading in their funds entirely. For example, a mutual fund complex sent three letters to Mancinelli dated September 10, 2001, which each stated that the listed accounts had “excessive exchange activity” and that it would “not tolerate abusive exchange activity due to the burden it places on other fund shareholders.” The September 10, 2001 letters stated that the mutual fund complex would reject all orders for the listed accounts effective immediately. Further, the September 10, 2001 letters stated the mutual fund complex would not accept any future investments on behalf of these Wall Street Access customers.

14. To facilitate their customers’ market timing trading, Wall Street Access employees provided advice to their hedge fund customers. For example, on March 7, 2001, a Wall Street Access supervisor instructed an RR to pass on information to a market timing customer that would “help keep them below the radar screen.”

15. Mancinelli and his team understood that using multiple accounts would help facilitate customers’ ability to market time. Wall Street Access opened multiple accounts for each market timing customer. For example, Hedge Fund A opened ten accounts at Wall Street Access.

16. Mancinelli and his team also used multiple RR numbers to help disguise their customers' market timing trading. Mutual fund complexes often identified market timers through the RR number on the brokerage account. If the RR used a different RR number for his customer accounts, he could deceive the mutual fund and enable his customer to trade in a mutual fund even after one account had been blocked. Specifically, Mancinelli used other employees' RR numbers, along with his own, to facilitate his customers' market timing strategies. For example, Hedge Fund A accounts had at least four different RR numbers, even though Mancinelli was the sole RR for these customers.

17. For example, on June 27, 2001, a mutual fund representative spoke to Mancinelli and informed him that his customers' accounts were restricted indefinitely from doing business with the mutual fund complex due to his customers' market timing activity. Additionally, on July 3, 2001, the same mutual fund complex sent a letter to Mancinelli that again stated that excessive exchanges were occurring in the brokerage accounts and that this exchange activity had a detrimental effect on fund performance. The letter further notified Mancinelli that, among other things, the fund complex would not allow any of his customers to make any future exchanges. Mancinelli, however, continued to allow his customers to trade in the complex's mutual funds. For example, on October 1, 2001, Mancinelli's customer placed additional trades in the mutual fund with a different account that had a different employee's RR number on the account. After subsequent trading, the mutual fund complex eventually blocked this account as well.

#### **Wall Street Access Failed to Maintain Required Books and Records**

18. Wall Street Access was unable to locate and produce to the Commission staff the vast majority of order tickets relating to trades executed for certain customers, including Hedge Fund A.

#### **Wall Street Access Profited From Market Timing and Late Trading**

19. Wall Street Access charged its customers an administrative fee for its services. Under this fee arrangement, the customer paid a percentage of the fair market value of the accounts for which Mancinelli executed market timing trades. From April 2001 through October 2001, Wall Street Access received approximately \$250,000 in administrative fees from its one late trading and other market timing customers. In addition to the administrative fees, Wall Street Access received other fees and commissions from the mutual funds. From April 2001 through October 2001, mutual funds paid Wall Street Access fees and commissions of approximately \$214,897.

#### **VIOLATIONS OF THE SECURITIES LAWS**

20. As a result of the conduct described above, Wall Street Access willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities. Specifically, Wall Street Access participated in a fraudulent

scheme to permit Hedge Fund A to place trades in mutual funds after the close of the United States equity markets, but nonetheless receive same-day NAV pricing. Wall Street Access consistently executed Hedge Fund A's post 4:00 p.m. ET trading instructions as though Wall Street Access had received the instructions before 4:00 p.m. Additionally, Wall Street Access utilized deceptive practices to conceal its customers' market timing trading from mutual funds.

21. As a result of the conduct described above, Wall Street Access willfully violated Section 15(c) of the Exchange Act and Rule 10b-3, which prohibit a broker or a dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Specifically, Wall Street Access participated in a fraudulent scheme to permit Hedge Fund A to place trades in mutual funds after the close of the United States equity markets, but nonetheless receive same-day NAV pricing. Wall Street Access consistently executed Hedge Fund A's post 4:00 p.m. ET trading instructions as though Wall Street Access had received the instructions before 4:00 p.m. Additionally, Wall Street Access utilized deceptive practices to conceal its customers' market timing trading from mutual funds.

22. As a result of the conduct described above, Wall Street Access willfully violated Section 17(a) of the Exchange Act and Rule 17a-4 thereunder, which require that broker-dealers preserve certain books and records, including order tickets required to be made pursuant to Rule 17a-3. Wall Street Access failed to preserve order tickets, including order tickets reflecting Hedge Fund A's trading.

23. As a result of the conduct described above, Wall Street Access willfully violated Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act, which prohibits dealers in a mutual fund's shares, among others, from executing a trade in that mutual fund's shares at that day's NAV if the trade was received after the time as of which the mutual fund has calculated that day's NAV (e.g., 4:00 p.m. ET). Wall Street Access, which had dealer agreements with the primary underwriters of several mutual funds that were late traded by Hedge Fund A, received numerous orders for trades in those mutual funds after 4:00 p.m. ET, yet executed the trades at the current day's NAV.

### **Undertaking**

24. Ongoing Cooperation. In determining to accept the Offer, the Commission has considered the following undertaking by Wall Street Access:

Wall Street Access shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings to which the Commission is a party relating to or arising from the matters described in the Order. In connection with such cooperation, Wall Street Access has undertaken:

- a. To produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff;

- b. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;
- c. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and
- d. That in connection with any testimony of Wall Street Access to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Wall Street Access:
  - i. Agrees that any such notice or subpoena for Wall Street Access' appearance and testimony may be served by regular mail on its attorney; and
  - ii. Agrees that any such notice or subpoena for Wall Street Access' appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

#### IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to impose the sanctions agreed to in Wall Street Access' Offer.

Accordingly, pursuant to Section 8A of the Securities Act, Sections 15(b) and 21C of the Exchange Act, and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Wall Street Access cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 10(b), 15(c) and 17(a) of the Exchange Act and Rules 10b-3, 10b-5 and 17a-4 thereunder, and Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act.

B. Respondent Wall Street Access is hereby censured.

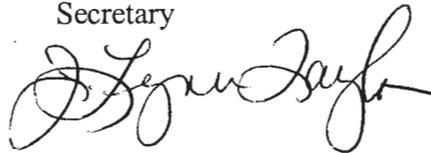
C. IT IS FURTHERED ORDERED that Respondent shall, within 30 days of the entry of this Order, pay disgorgement of \$464,897 and prejudgment interest of \$103,187.41 to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's 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,

Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Wall Street Access 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 Helene Glotzer, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281.

D. It is further ordered that Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$120,000 to the Securities and Exchange Commission. 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 Wall Street Access 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 Helene Glotzer, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281.

By the Commission.

Nancy M. Morris  
Secretary



By: J. Lynn Taylor  
Assistant Secretary

Commissioner Nazareth  
Not Participating

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 54600 / October 13, 2006

Admin. Proc. File No. 3-12230

In the Matter of the Application of

LAWRENCE GAGE  
c/o Steven B. Mirow, Esq.  
249 South 12th Street  
Philadelphia, PA 19107

For Review of Action Taken by the

PHILADELPHIA STOCK EXCHANGE, INC.

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE -- REVIEW OF EXCHANGE ACTION

Jurisdiction to Review Exchange Action

National securities exchange member sought Commission review of exchange's decision denying member's appeal of exchange's adoption of a proposed new rule. Held, the matter is not subject to Commission review because neither Section 19(b) nor Section 19(d) of the Securities Exchange Act of 1934 provides a basis for review of exchange's decision. Application for review is dismissed.

APPEARANCES:

Steven B. Mirow, for Lawrence Gage.

Stephen J. Kastenberg, Paul Lantieri III, and Adam Finkelstein, of Ballard Spahr Andrews & Ingersoll, LLP, for the Philadelphia Stock Exchange, Inc.

Appeal filed: March 3, 2006  
Last brief received: June 16, 2006

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Lawrence Gage, a member of the Philadelphia Stock Exchange, Inc. (the "PHLX" or the "Exchange") seeks Commission review of a February 2006 decision of the PHLX's Board of Governors rejecting his challenge to the Exchange's 2004 adoption of Exchange Rule 651, which requires Exchange members to reimburse the Exchange for its legal expenses under certain circumstances. The PHLX contends that Gage's appeal to the Commission should be dismissed for lack of jurisdiction. Our findings are based on an independent review of the record.

## II.

Background. On July 27, 2004, the Executive Committee of the PHLX's Board of Governors, acting pursuant to delegated authority under PHLX By-Law Article X, Section 10-14, authorized and approved for filing with the Commission proposed PHLX Rule 651. <sup>1/</sup> The Exchange notified its members of this action on July 28, 2004. Rule 651 provides that a member who brings legal proceedings related to the business of the Exchange against the Exchange or any of its board members, officers, committee members, employees, or agents shall pay to the Exchange all reasonable expenses, including attorneys' fees, incurred by the Exchange in defense of such legal proceedings where the member does not prevail in such proceedings and where the costs to the Exchange exceed \$50,000. The rule does not apply to disciplinary actions by the Exchange, administrative appeals of Exchange actions, or in any specific instance where the Board grants a waiver of the rule. On August 4, 2004, the PHLX filed this proposed rule change with the Commission and notified its membership of the filing.

On August 5, 2004, we issued a release designating Rule 651 effective upon filing pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and Exchange Act Rule 19b-4(f)(6). <sup>2/</sup> In that release, which was made available at the Commission's website and in the SEC Docket and published in the Federal Register on August 12, 2004, we stated that Rule 651

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<sup>1/</sup> Article X, Section 10-14 of the PHLX By-Laws provides that, when the Board of Governors is not in session, the Executive Committee shall have and may exercise, subject to certain conditions, all the powers and authority of the Board of Governors. Article IV, Section 4-4 of the By-Laws provides that the Board of Governors shall have the power to adopt such rules as it may deem appropriate.

<sup>2/</sup> Securities Exchange Act Rel. No. 50159 (Aug. 5, 2004), 83 SEC Docket 1768. On July 28, 2004, the PHLX, as required by Rule 19b-4(f)(6), pre-filed the proposed rule change with the Commission. We designated the proposed rule change effective upon filing because it did not significantly affect the protection of investors or the public interest, impose any significant burden on competition, or become operative for thirty days from the date on which it was filed. Id.; see also 15 U.S.C. § 78s(b)(3)(A); 17 C.F.R. § 240.19b-4(f)(6). At the PHLX's request, we waived the thirty-day operative delay.

was "consistent with existing precedent and [presented] no novel issues." <sup>3/</sup> We stated further that the purpose of the proposed rule change, according to the PHLX, was to "enable the Exchange to obtain reimbursement of legal costs incurred to defend litigation brought against the Exchange by member litigants where such persons or entities do not prevail in the litigation." <sup>4/</sup> As further noted in the release, the PHLX believed "that establishing a rule that may reduce non merit-based or vexatious legal proceedings against the Exchange by member litigants will help protect against Exchange resources being unnecessarily diverted from the Exchange's regulatory and business objectives, thus strengthening the overall organization." <sup>5/</sup> The release invited interested persons "to submit written data, views, and arguments concerning the [proposed rule change], including whether the proposed rule change is consistent with the [Exchange] Act." <sup>6/</sup> We also noted that, at any time within sixty days of its filing, the proposed rule change could be "summarily abrogate[d]" if such action was "necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange] Act." <sup>7/</sup>

Gage's Efforts to Challenge Rule 651. Gage did not submit comments to the Commission or request that the Commission abrogate the rule within the sixty-day period. Instead, on August 5, 2004, the same day we designated Rule 651 effective, Gage, in accordance with the PHLX's By-Laws, <sup>8/</sup> appealed to the PHLX's Board of Governors the Executive Committee's decision to file Rule 651 with the Commission. <sup>9/</sup> The Board appointed an Advisory Committee to review

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<sup>3/</sup> 83 SEC Docket at 1769. We also noted in the release that the PHLX described Rule 651 as similar to rules adopted by the American Stock Exchange, the Chicago Board Options Exchange, and the Pacific Stock Exchange. Id.; see also Exchange Act Rel. No. 47842 (May 13, 2003), 80 SEC Docket 655 (AMEX); Exchange Act Rel. No. 37421 (July 11, 1996), 62 SEC Docket 853 (CBOE); Exchange Act Rel. No. 37563 (Aug. 14, 1996), 62 SEC Docket 1661 (PSE).

<sup>4/</sup> 83 SEC Docket at 1768.

<sup>5/</sup> Id.

<sup>6/</sup> Id. at 1769.

<sup>7/</sup> Id.; see also 15 U.S.C. § 78s(b)(3)(C) (authorizing summary abrogation within sixty days of filing of the proposed rule change).

<sup>8/</sup> Article XI, Section 11-1(a) of the PHLX By-Laws provides that a member may appeal the decision of a Standing Committee to the Board of Governors within ten days.

<sup>9/</sup> The PHLX did not file a copy of Gage's appeal with the Commission. Although our rules do not expressly require that the PHLX file with the Commission communications received after the Commission designates a rule effective upon filing, we encourage self-regulatory organizations in circumstances similar to those presented here to file with the

(continued...)

the appeal. <sup>10/</sup> At oral argument before the Advisory Committee, Gage explained that he "was under the understanding that once I filed the appeal, the rule wouldn't even be sent down to the SEC," that he "didn't find out it was sent down to the SEC until they noticed to the members that the SEC had approved the rule," and that he therefore "missed commenting at the SEC and that's the opportunity that we are really looking for." <sup>11/</sup> Counsel for the PHLX responded that Rule 651 "was sent down [to the Commission] before we were notified of an appeal," that "[a] memo was sent out [to the PHLX membership] on August 4th [stating] that, in fact, we filed [Rule 651] with the SEC," and that "[i]t wasn't until the 5th that Mr. Gage appealed the adoption of 651 by the Executive Committee." <sup>12/</sup> On February 23, 2006, after receiving and reviewing the Advisory Committee's written recommendation, the Board of Governors denied Gage's appeal.

The Advisory Committee "recommend[ed] upholding the decision of the Executive Committee" on the ground that "the Executive Committee's approval of the proposed rule filing was proper in light of the similar filings at other exchanges, procedures of the Exchange and application of Exchange rules and the Act." On February 23, 2006, after receiving and reviewing the Advisory Committee's recommendation, the Board of Governors "affirmed in whole the recommendation of the Advisory Committee." This appeal followed.

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<sup>9/</sup> (...continued)

Commission all written communications, such as Gage's appeal, concerning a rule change open to comment in some form. Cf. General Instruction D to Form 19b-4 (stating that if, "after the rule change is filed but before the Commission takes final action on it, the self-regulatory organization receives or prepares any correspondence or other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning the proposed rule change, copies of the communications shall be filed" with the Commission). As indicated, however, the Exchange's failure to file Gage's appeal with the Commission does not affect the outcome of Gage's appeal.

<sup>10/</sup> Article XI, Section 11-2 of the PHLX By-Laws provides that on all appeals to the Board of Governors from a decision of a Standing Committee in accordance with Section 11-1 of the By-Laws, an advisory committee of three Governors shall examine the record on appeal and give an advisory opinion thereon to the Board of Governors.

<sup>11/</sup> In his brief to the PHLX, Gage argued that the PHLX erroneously treated Rule 651 as one that could be effective upon filing and thereby "deprived persons of their right to comment upon and object to [the proposed rule] with the SEC." Gage contended further that the "only goal of this proposed rule is to intimidate persons who might otherwise proceed to prosecute a grievance against the PHLX" and thus the proposed rule was "in violation of public policy." Gage's brief before us substantially repeats these arguments.

<sup>12/</sup> We also issued our release soliciting comments on the proposed rule on August 5, 2004. As noted, the Exchange had notified its members of its filing with the Commission on the previous day. Gage thus had the full sixty days to file an objection with the Commission.

## III.

A. Review Pursuant to Section 19(b). Gage bases his appeal in part on Exchange Act Section 19(b)(3)(C). Section 19(b)(3)(C) states that "within sixty days of the date of filing" of a proposed rule change under Section 19(b)(3)(A), "the Commission summarily may abrogate the change . . . if it appears . . . that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act]." <sup>13/</sup> Gage contends that we retain our ability to summarily abrogate the rule, despite the expiration of this sixty-day period, because the PHLX filed the proposed rule change improperly. According to Gage, the "filing was improper because, as the PHLX itself admits, Applicant filed a timely objection to proposed Rule 651." Gage argues, therefore, that Section 19(b)(3)(C) gives us "the power and responsibility to act upon Rule 651" in response to his appeal.

We find no basis for Gage's contention that the PHLX filed Rule 651 improperly. Although Gage apparently believes that his appeal of the Executive Committee's action should have prevented the PHLX from filing the rule with the Commission, the PHLX had already filed the proposed rule change with the Commission, and so notified its members, at the time of Gage's appeal. The PHLX's By-Laws also contain no suggestion that such an appeal prevents the PHLX from executing the decision of the Executive Committee.

In our release notifying the public of the proposed rule change, we solicited comments to be received within twenty-one days of the release's publication in the Federal Register, or August 12, 2004. <sup>14/</sup> As noted by the PHLX, Gage chose not to "comment on Rule 651 to the Commission or request its abrogation by the Commission." Gage decided instead to appeal the PHLX's decision to adopt the rule. We are aware of no authority that supports Gage's contention that his appeal extended or tolled the sixty-day period for summary abrogation. Accordingly, we do not believe that, at this point, Section 19(b)(3)(C) provides a basis for us to abrogate summarily Rule 651 in response to Gage's appeal of the PHLX's action.

Gage also argues that we may review the PHLX's action in order to ensure compliance with Section 19(b)(3)(C)'s mandate that a self-regulatory organization may enforce an effective-upon-filing rule change "to the extent it is not inconsistent with the provisions of [the Exchange Act], the rules and regulations thereunder, and applicable Federal and State law." <sup>15/</sup> We find this argument similarly unpersuasive. Gage's appeal does not concern any PHLX enforcement proceeding; the PHLX is not enforcing Rule 651 against Gage. Indeed, no evidence exists that

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<sup>13/</sup> 15 U.S.C. § 78s(b)(3)(C).

<sup>14/</sup> See 83 SEC Docket at 1769; 69 Fed. Reg. 49,933.

<sup>15/</sup> 15 U.S.C. § 78s(b)(3)(C).

Gage has acted, at this stage, in any way that implicates the rule. Thus, we see no basis for considering Gage's appeal pursuant to Section 19(b)(3)(C). 16/

B. Review Pursuant to Section 19(d). Gage argues further that Commission Rule of Practice 420(a), which discusses the availability of Commission review of the determination of a self-regulatory organization ("SRO"), authorizes our review of the PHLX's action. 17/ The grounds for Commission jurisdiction enumerated in Rule 420(a) are the same as those described in Section 19(d)(1) of the Exchange Act. 18/ Section 19(d)(1) authorizes our review of a self-regulatory organization action that i) imposes any final disciplinary sanction on any member or associated person; ii) denies membership or participation to any applicant; iii) prohibits or limits any person in respect to access to services offered by such organization or member; or iv) bars any person from becoming associated with a member. 19/

1. Denial of Membership or Participation. Gage argues that we have jurisdiction to hear his appeal because the PHLX's action constitutes "a condition placed upon membership by PHLX Rule 651." According to Gage, the adoption of the rule constitutes a condition on membership because, "if Applicant were not to agree to continue as a member of the PHLX under Rule 651, Applicant would have no alternative but to leave the PHLX." We have previously rejected similar arguments in decisions where we found that we lacked jurisdiction to review an SRO's denial of a rule exemption. In those cases, an SRO member sought relief from the operation of an SRO rule. We found, however, that the requirement that SRO members comply with SRO rules does not constitute a condition on membership providing a basis for jurisdiction.

In Joseph Dillon & Co., 20/ we found that we did not have jurisdiction to review an NASD decision denying a member firm an exemption from an NASD rule requiring that the firm adopt special supervisory procedures. The rule required that firms adopt such procedures if they employed a certain number of registered representatives associated, within the past three years,

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16/ We note that we have stated previously that a rule "requir[ing] members to pay [an] Exchange's costs of litigation under specified circumstances is consistent with the requirements of the Act and the rules and regulations thereunder." 62 SEC Docket at 854 (CBOE rule); 62 SEC Docket at 1663 (PSE rule).

17/ 17 C.F.R. § 201.420(a).

18/ Russell A. Simpson, 53 S.E.C. 1042, 1048 (1998).

19/ 15 U.S.C. § 78s(d)(1); see also Allen Douglas Secs., Inc., Exchange Act Rel. No. 50513 (Oct. 12, 2004), 83 SEC Docket 3570, 3575. Gage argues that "subsection 19(d) is not applicable to this matter" because this is not a "disciplinary type matter." As discussed below, we find that Section 19(d) does not provide a basis for jurisdiction. We note, however, that Section 19(d), as indicated, implicates more than disciplinary proceedings.

20/ 54 S.E.C. 960 (2000).

with member firms disciplined by NASD or the Commission. The firm argued that NASD's denial of an exemption from the rule constituted a denial of membership because its membership was "now expressly conditioned upon its compliance" with the rule. 21/ In rejecting this argument, we noted that, as here, the applicant was "seeking relief from the operation of the rule, not from any condition imposed on its membership by the NASD." 22/ The operation of the rule did not impose a condition on the firm's membership establishing a basis for jurisdiction because "[t]he membership of every NASD member is conditioned on the member's continued compliance with NASD rules." 23/ We lacked jurisdiction because "[t]he operation of the Rule and the NASD's exemption denial have no bearing on [the firm's] membership in the NASD, which continues unchanged whether or not an exemption is granted." 24/

We similarly found no jurisdiction to review an NASD decision denying a member firm an exemption from an NASD rule in Morgan Stanley & Co. 25/ In that case, the firm sought an exemption from a rule providing that "[n]o broker, dealer, or municipal securities dealer shall engage in municipal securities business . . . with an issuer within two years after any contribution to an official of such issuer made by . . . any municipal finance professional associated with such broker, dealer, or municipal securities dealer . . . ." 26/ We determined that NASD's denial of an exemption did not constitute a denial of membership because the firm's "inability to engage in certain aspects of the municipal securities business result[ed] . . . from the action of [its] own employee and the automatic operation of [the rule], not from any condition imposed by the NASD." 27/ We further held that "[t]he operation of [the rule] and the NASD's exemption denial ha[d] no bearing on [the firm's] membership in the NASD, which continue[d] unchanged whether or not an exemption [was] granted." 28/ We did not have jurisdiction because, as here, the firm sought "relief from the operation of the rule, not from any condition imposed on its membership by the NASD." 29/

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21/ Id. at 965 (emphasis in original).

22/ Id. at 965 n.9 (quoting Morgan Stanley & Co., 53 S.E.C. 379, 384 (1997)).

23/ Id. at 965.

24/ Id.

25/ 53 S.E.C. 379 (1997).

26/ Id. at 380 (quoting the text of the rule).

27/ Id. at 384.

28/ Id.

29/ Id.

In Morgan Stanley, we found that our conclusion was "underscored by the instances in which, pursuant to Section 19(d) of the Exchange Act, we have reviewed the NASD's imposition of or refusal to modify a restriction agreement, under which a firm agrees to certain restrictions on its business activities as a condition of NASD membership." 30/ We noted that "Section 19(d) authorizes review of such NASD action because it relates to the NASD's membership process." 31/ In Joseph Dillon, we also contrasted the firm's appeal of NASD's denial of an exemption from a rule with those cases where we found jurisdiction on the basis that "NASD had imposed conditions or limited the firm's actions in permitting the firm's membership." 32/

We find the principles articulated in Joseph Dillon and Morgan Stanley analogous to this case. Although Gage does not seek an exemption from a rule, he does challenge a rule that applies generally to all PHLX members. The membership of every PHLX member is conditioned on the member's compliance with the PHLX's rules. As in Joseph Dillon and Morgan Stanley, the PHLX's action does not relate to its membership process and does not impose conditions on Gage's membership. Neither Rule 651 nor the PHLX's denial of Gage's appeal have any bearing on Gage's membership in the PHLX, which continues unchanged. We thus agree with the PHLX that "an action by a self-regulatory organization that merely subjects a member to a rule of general applicability does not constitute a denial of membership."

2. Other Bases of Jurisdiction. Gage does not argue, and we do not find, that any other provision of Section 19(d) provides a basis for jurisdiction. Section 19(d) authorizes our review when an SRO, through its disciplinary process, imposes a final disciplinary sanction on a member or person associated with a member. 33/ In a disciplinary action, however, a sanction is imposed following a determination of wrongdoing. 34/ The PHLX took no such action here. It "did not employ its disciplinary procedures, did not make a determination that [the appellant] had violated a statute or rule, and did not impose a final disciplinary sanction." 35/ The PHLX's action also does not constitute a denial of access to services offered by the PHLX. Our previous decisions have found jurisdiction based on a denial of access only when "an SRO had denied or limited the applicant's ability to utilize one of the fundamentally important services offered by the

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30/ Id.

31/ Id.

32/ Joseph Dillon, 54 S.E.C. at 965 n.9.

33/ Allen Douglas Secs., 83 SEC Docket at 3575.

34/ Morgan Stanley, 53 S.E.C. at 383.

35/ Allen Douglas Secs., 83 SEC Docket at 3576; see also Morgan Stanley, 53 S.E.C. at 383; Joseph Dillon, 54 S.E.C. at 963-64.

SRO." 36/ The PHLX's action does not prevent Gage from utilizing any service offered by the PHLX.

Nor does the PHLX's action have the effect of barring any person from becoming associated with a PHLX member. We have held previously that SRO action having the effect of "barring" an individual from association with the SRO's members -- whether the individual is formally barred or not -- is reviewable under Section 19(d). 37/ In Frank R. Rubba 38/ and Exchange Services Inc., 39/ we had jurisdiction because the SRO's action denying the applicants a waiver of examination requirements, although not constituting a formal bar from association, had the effect of barring individuals from becoming associated with an SRO member. 40/ No evidence exists that the PHLX's action has produced such an effect. The PHLX's action neither formally bars nor has the effect of barring any person from associating with a PHLX member, and thus does not implicate this, or any other, prong of Section 19(d).

\* \* \*

We conclude, based on the foregoing, that no basis exists under either Exchange Act Sections 19(b) or 19(d) for us to review the PHLX's denial of Gage's appeal. To the extent Gage argues that we should consider his appeal despite Section 19's jurisdictional limitations on the ground that we have a "duty to consider [his] application," we note that we have previously rejected an applicant's claim of "compelling reasons" as a basis for review where, as here, the appeal did not satisfy the jurisdictional requirements set forth in Section 19. 41/ Nor do we believe that Gage's application presents compelling circumstances. As discussed above, our

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36/ Morgan Stanley, 53 S.E.C. at 385; see also Allen Douglas Secs., 83 SEC Docket at 3582 (finding that "[d]ecisions in which we have found jurisdiction based on this third prong of Section 19(d) have emphasized the impact that SRO decisions have on members' access to fundamentally important services provided by the SRO") (citing Tower Trading, L.P., Exchange Act Rel. No. 47537 (Mar. 19, 2003), 79 SEC Docket 3189 (finding Commission jurisdiction where exchange terminated member's status as a market maker); Scattered Corp., 52 S.E.C. 812, 813 (1996) (finding Commission jurisdiction where exchange refused to process member's application for registration as a market maker); William J. Higgins, 48 S.E.C. 713 (1987) (finding Commission jurisdiction where exchange limited member's access to "principal service" offered by exchange)).

37/ Joseph Dillon, 54 S.E.C. at 965-66.

38/ 53 S.E.C. 670 (1998).

39/ 48 S.E.C. 210 (1985).

40/ See Frank R. Rubba, 53 S.E.C. at 673; Exchange Services Inc., 48 S.E.C. at 210-11.

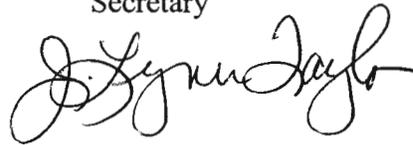
41/ Allen Douglas Secs., 83 SEC Docket at 3575 n.14; Joseph Dillon, 54 S.E.C. at 963 n.5.

release designating Rule 651 effective upon filing noted that Rule 651 was "consistent with existing precedent and [presented] no novel issues." 42/ This precedent included the approval of similar SRO rules and the designation of one such rule as effective upon filing. 43/ Under the circumstances, therefore, we have determined to dismiss Gage's application for review. 44/

An appropriate order will issue. 45/

By the Commission (Chairman COX and Commissioners ATKINS, CAMPOS, and CASEY; Commissioner NAZARETH not participating).

Nancy M. Morris  
Secretary



By: J. Lynn Taylor  
Assistant Secretary

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42/ See Exchange Act Rel. No. 50159, supra note 2, and accompanying text.

43/ See Exchange Act Rel. No. 47842, supra note 3 (designating AMEX rule providing for reimbursement of legal fees by members effective upon filing); see also Exchange Act Rel. No. 37421, supra note 3 (approving similar CBOE rule); Exchange Act Rel. No. 37563, supra note 3 (approving similar PSE rule).

44/ The PHLX filed a motion on June 6, 2006, seeking dismissal of Gage's application for lack of jurisdiction. Gage filed a response to this motion, and the PHLX filed a reply. The PHLX also argued for dismissal based on lack of jurisdiction in its opposition brief to Gage's opening brief. Although our briefing schedule provided Gage an opportunity to file a reply to the PHLX's opposition brief, he did not do so.

45/ We have considered all of the parties' contentions. They are rejected or sustained 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. 54600 / October 13, 2006

Admin. Proc. File No. 3-12230

In the Matter of the Application of

LAWRENCE GAGE  
c/o Steven B. Mirow, Esq.  
249 South 12th Street  
Philadelphia, PA 19107

For Review of Action Taken by the  
PHILADELPHIA STOCK EXCHANGE, INC.

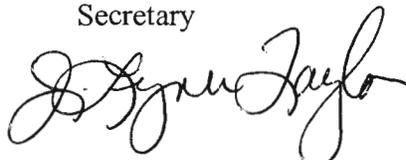
ORDER DISMISSING APPLICATION FOR REVIEW OF ACTION OF NATIONAL  
SECURITIES EXCHANGE

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

ORDERED that Lawrence Gage's application for review be, and it hereby is, dismissed.

By the Commission.

Nancy M. Morris  
Secretary



By: J. Lynn Taylor  
Assistant Secretary

*Commissioner Nazareth  
Not Participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54599 / October 13, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12453

In the Matter of  
  
STATOIL, ASA,  
  
Respondent.

**ORDER INSTITUTING CEASE-AND-  
DESIST PROCEEDINGS, MAKING  
FINDINGS, AND IMPOSING A  
CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF  
THE SECURITIES EXCHANGE ACT  
OF 1934**

**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 Statoil, ASA ("Statoil" or the "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 the Respondent and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

*Document 8 of 24*

### III. FACTS

On the basis of this Order and the Respondent's Offer, the Commission finds<sup>1</sup> that:

#### Summary

1. In June 2002 and January 2003, Statoil paid bribes to an Iranian government official (the "Iranian Official") in order for him to use his influence to: (i) assist Statoil in obtaining a contract to develop three phases of the South Pars oil and gas field in Iran (the "South Pars Project") and (ii) open doors to additional projects in the Iranian oil and gas exploration industry. The Iranian Official was the head of the Iranian Fuel Consumption Optimizing Organization ("IFCOO"), a subsidiary of the National Iranian Oil Company ("NIOC"). Statoil agreed to pay the Iranian Official through a consulting contract (the "Contract") with an intermediary company (the "Consulting Company") organized in the Turks and Caicos Islands and nominally owned by a third party located in London, England. The Contract obligated Statoil to make initial payments of \$200,000 and \$5 million, and ten subsequent annual payments of \$1 million each. In October 2002, Statoil obtained the contract to develop the South Pars Project. Statoil made the initial payments to the Iranian Official, but in June 2003, Statoil suspended payments under the Contract. On September 6, 2003, the Contract was publicly disclosed in the Norwegian press. On September 10, 2003, Statoil terminated the Contract. The next day, the Norwegian authorities announced an investigation into the Contract. During the relevant time period, Statoil employees circumvented Statoil's internal controls and procedures that were in place to prevent illegal payments, and Statoil lacked sufficient internal controls. In addition, by mischaracterizing the payments as legitimate consulting fees, Statoil violated the books and records provisions of the federal securities laws.

#### Respondent

2. Statoil is a public company organized under the laws of the Kingdom of Norway and headquartered in Stavanger, Norway. Statoil explores for and develops oil and gas resources around the globe, and has American Depositary Shares that trade under the symbol STO on the New York Stock Exchange and are registered pursuant to Section 12(b) of the Exchange Act (15 U.S.C. § 781(g)). Statoil is required to file reports with the Commission under Section 13 of the Exchange Act (15 U.S.C. § 78m), and is an "issuer" within the meaning of the Foreign Corrupt Practices Act ("FCPA"), 15 U.S.C. § 78dd-1.

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<sup>1</sup> 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.

## Background

3. Statoil is an international oil and gas company involved primarily in the exploration for, development, production, and sale of oil and natural gas from the Norwegian Continental Shelf and elsewhere. In late 2000 and early 2001, under its former Chief Executive Officer ("CEO"), Statoil was pursuing opportunities to expand its business internationally. At that time, Statoil held participation interests in several exploration and production licenses outside of Norway, but held only a few small operatorships outside of Norway. In the fall of 2000, Statoil hired a new senior executive to direct Statoil's International Exploration and Production Department ("Senior Executive"), who reported directly to the CEO.

4. Statoil identified Iran as a country to focus on to secure operatorships. The Iranian Ministry of Oil, through NIOC and various wholly-owned companies, controls the rights to develop the oil and gas resources of Iran. In November 2000, Statoil and NIOC entered into a Cooperation Agreement, which identified areas of mutual interest for future cooperation between Statoil and NIOC.

5. In the spring of 2001, certain Statoil employees in Iran accepted an invitation from one of the Iranian Official's relatives to meet with the Iranian Official. These Statoil employees learned that the Iranian Official's father was a former president of Iran who led the Expediency Council, a body that mediated between the politically-elected and the clerically-controlled parts of Iran's government. After meeting with the Iranian Official, Statoil tested and assessed the Iranian Official's influence by, among other things, having the Iranian Official send a message back to Statoil through the Iranian Oil Minister. A Statoil employee described the test as demonstrating that the Iranian Official was "powerful" and was the "link" to opportunities to obtain business in Iran. After the initial contacts, Statoil determined that the Iranian Official was an advisor to the Oil Minister, and that the Iranian Official's family was powerful and highly influential in the oil and gas business in Iran. At the time Statoil employees made contact with the Iranian Official, Statoil employees knew of publicly reported accusations of corruption against the Iranian Official's family, but did not perform any due diligence to investigate the accusations.

6. In August 2001, the Iranian Official visited Statoil's facilities in Stavanger, Norway, and met with senior Statoil employees, including a chief adviser to the CEO, the Senior Executive, and a senior employee in Statoil's International Exploration and Production Department who had direct responsibility for Statoil's activities in Iran (the "E & P Executive"). The Iranian Official's position and influence were well known to Statoil management participating in this meeting. The written agenda for the visit referred to the Iranian Official as "President NIOC, Iranian Fuel Cons. Org." The Iranian Official was also described in internal Statoil documents as an "advisor[] to the Iranian Oil Minister" and a "very important guest[]." At the time, internal Statoil memoranda described the Iranian Official's family as "control[ling] all contract awards within oil and gas in Iran."

## The Bribery

7. In the second half of 2001 and into 2002, the Senior Executive discussed with Statoil's CEO the possibility of entering into a consulting contract to arrange payments to the Iranian Official, and began negotiating the terms with the Iranian Official. In November 2001, Iranian authorities proposed that Statoil consider seeking a participation interest in a subcontract to develop the South Pars Project, under a contract awarded to an Iranian oil and gas development company (the "Development Company") that was indirectly owned and controlled by the Iranian Ministry of Oil.

8. In December 2001, the Iranian Official sent a sample consulting contract and payment proposal to the Senior Executive, which the Iranian Official represented had previously been used in his dealings with other multinational oil companies. In January 2002, the Senior Executive provided the CEO with a memorandum that described a proposal from the Iranian Official that would have required Statoil to (i) pay a "success fee" payable upon Statoil's being awarded a participation interest in the development of the South Pars Project; (ii) provide money for "charities" of the Iranian Official's choice; and (iii) make payments through an offshore company.

9. Although the CEO objected to the Iranian Official's proposal, the CEO ultimately approved Statoil's entering into a contract with the Iranian Official in the total amount of \$15.2 million to be paid over approximately 11 years. The final Contract was structured as a payment for vaguely-defined consulting services through a third-party offshore company. The Iranian Official was not named in the Contract because disclosing Statoil's relationship with the Iranian Official could likely jeopardize Statoil's ability to obtain business in Iran.

10. In return for the payments, the Iranian Official used his influence to assist Statoil in obtaining business in Iran. For example, the Iranian Official (i) provided Statoil employees in Iran nonpublic information concerning oil and gas projects in Iran and (ii) showed Statoil copies of bid documents of competing companies that Statoil could not access through appropriate channels.

11. On May 15, 2002, Statoil and the Development Company entered into an agreement in principle that provided the central terms for Statoil's participation in the offshore portion of the Development Company's contract for the South Pars Project. At that time, it was contemplated that the contract for the South Pars Project would be finalized by June 15, 2002, although several issues remained to be negotiated.

12. On June 12, 2002, the E & P Executive, acting on a power of attorney from the CEO, signed the Contract on behalf of Statoil. When Statoil signed the Contract, the Senior Executive believed that Statoil would be awarded a participation interest in the development of the South Pars Project. Statoil and the Development Company signed a Participation Agreement in October 2002, which Statoil expected would yield millions of dollars in profit.

13. In late June 2002, Statoil received an invoice from the Consulting Company instructing it to pay \$200,000 under the terms of the Contract, and instructing that the money be routed through a United States bank in New York, New York to a bank account in Switzerland held by a company not named in the Contract. Statoil made the payment on June 26, 2002, according to the instructions in the invoice. In December 2002, Statoil received a second invoice from the Consulting Company instructing it to pay \$5 million, with payment instructions identical to those in the June 2002 invoice. On January 15, 2003, Statoil paid \$5 million pursuant to the instructions in the invoice.

14. Statoil violated the anti-bribery provisions of the federal securities laws contained in the Foreign Corrupt Practices Act when it arranged for the payments to the Iranian Official. The payments were intended to (i) induce the Iranian Official to use his influence with NIOC; (ii) influence NIOC's decision about whether to award Statoil a participation interest in the development of the South Pars Project that would net Statoil several millions of dollars; and (iii) secure improper advantage for Statoil by positioning it to obtain future business in Iran, potentially worth hundreds of millions of dollars.

#### **Books and Records Violations**

15. Statoil failed to properly account for the illegal payments and failed to accurately describe the Contract in its books and records. Instead, Statoil improperly characterized the payments it made as legitimate payments for "consulting fees for special consultants and analyses relating to technical, administrative, tax, and financial matters..." and improperly characterized the Contract as an ordinary consulting agreement.

#### **Internal Controls Violations**

16. In entering into the Contract, certain Statoil management responsible for the Contract circumvented Statoil's internal controls designed to prevent illegal payments. They concealed the Contract's true nature and true parties, and violated Statoil's procurement policies by directing that the Contract should be entered into and that payments be made under the Contract to parties not named in the Contract. Statoil management responsible for the Contract performed no due diligence concerning the named or unnamed parties to the Contract. Statoil had inadequate systems for review of the Contract and lacked controls sufficient to provide reasonable assurances that the Contract complied with applicable laws. Statoil's lack of sufficient internal controls enabled executives responsible for the Contract to conceal the illegal payments to the Iranian Official.

#### **Statoil's Response and Recent Events**

17. In late March 2003, Statoil's internal audit department reported to Statoil's Chief Financial Officer ("CFO") that Statoil had paid \$5.2 million under a consulting agreement to an entity that had not been named in the Contract. In compliance with Statoil's internal procedures, and at the direction of the CFO and head of internal audit,

Statoil's security group began an inquiry into the Contract. As part of its inquiry, the security group determined that even though he was not named in the Contract, the Iranian Official was the "consultant" under the Contract, and confirmed his position and family ties in Iran. In early June 2003, the security group prepared an "internal investigative report" which concluded that there was "a strong indication of the consultant being involved in corrupt-like practices," and that by entering into the Contract, Statoil may have violated Norwegian and U.S. anti-bribery laws.

18. In spite of the security group's troubling report, Statoil's senior management failed to take appropriate action to address the Contract and Statoil's relationship with the Iranian Official. On June 5, 2003, the security group and Statoil's chief internal auditor presented their findings to Statoil's then-Chairman of the Board, who, instead of taking up the matter, told them that the matter should be investigated further and taken up by the CEO. Later in June 2003, the security group presented its findings to the CEO, recommending that no more payments be made under the Contract and that the Contract be terminated. The CEO agreed to suspend payments under the Contract, but the CEO refused to terminate the Contract or to address further the principal concerns of the security group.

19. On September 6, 2003, the Contract was disclosed in the Norwegian press and on September 10, 2003, Statoil terminated the Contract, while Statoil's internal audit and security group divisions were still working to finalize a letter to the Board of Directors addressing the Contract. After the Contract's existence became public knowledge, the Senior Executive and the Chairman of the Board resigned. As a consequence of Statoil's Board of Directors expressing no confidence in him, the CEO also resigned.

20. On September 23, 2003, the Commission staff contacted Statoil to inform Statoil of the staff's inquiry. Since then, Statoil has cooperated with the staff's investigation, producing all documents and information that the staff requested, including voluntary production of documents protected by the attorney-client privilege pursuant to a non-waiver agreement and early production and identification to the staff of relevant documents. Statoil also agreed to make employees available for interviews and encouraged employee cooperation by agreeing to pay travel expenses and attorneys' fees. Statoil's Board of Directors has taken remedial actions, including retaining outside counsel to conduct an investigation of the Contract, and a separate investigation into other non-Norwegian contracts, the results of which were provided to the staff. Statoil has also designed and is implementing a remedial plan, which includes (i) the creation of a corporate compliance officer and ethics committees, (ii) expanded roles for Statoil's Audit Committee to oversee compliance with the FCPA and other applicable foreign bribery laws, (iii) new reporting lines directly to the Audit Committee and Board of Directors, (iv) new ethics, procurement, and due diligence policies, (v) enhanced programs for educating and training executives and employees on ethical matters, including FCPA/anti-bribery compliance training, and (vi) an ethical help-line operated by a third-party, which provides anonymity for callers.

### Norwegian Authorities' Actions

21. On September 11, 2003, Norwegian government authorities from the National Authority for Investigation and Prosecution of Economic and Environmental Crime ("Økokrim") seized documents from Statoil's offices as part of an investigation of Statoil. On June 29, 2004, following its investigation, Økokrim issued penalty notices to Statoil in the amount of approximately \$3 million and to the Senior Executive in the amount of approximately \$30,000, charging them with violating Norway's trading-influence statute. Statoil and the Senior Executive agreed to pay the penalties without admitting or denying the violations.

#### **IV. FEDERAL SECURITIES LAW VIOLATIONS**

1. As a result of the conduct described above, Statoil violated Section 30A of the Exchange Act, which prohibits any issuer with a class of securities registered pursuant to Section 12 of the Exchange Act, in order to obtain or retain business, from giving, or authorizing the giving of, anything of value to any foreign official for purposes of influencing the official or inducing the official to act in violation of his or her lawful duties, or to secure any improper advantage; or to induce a foreign official to use his influence with a foreign government or foreign governmental instrumentality to influence any act or decision of such government or instrumentality.

2. As a result of the conduct described above, Statoil 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 disposition of their assets.

3. As a result of the conduct described above, Statoil violated Section 13(b)(2)(B) of the Exchange Act, which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded in accordance with management's general or specific authorization; transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets; access to assets is permitted only in accordance with management's general or specific authorization; and the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

4. As a result of the conduct described above, Statoil violated Section 13(b)(5) of the Exchange Act, which prohibits any person or company from knowingly circumventing or knowingly failing to implement a system of internal accounting controls as described in Section 13(b)(2)(B), or knowingly falsifying any book, record, or account as described in Section 13(b)(2)(A).

5. As a result of the conduct described above, Statoil violated Rule 13b2-1 of the Exchange Act, which prohibits any person or company from, directly or indirectly, falsifying or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A).

## V.

In determining to accept the Offer, the Commission considered remedial acts undertaken by the Respondent and cooperation afforded the Commission staff.

## VI. UNDERTAKINGS

Respondent undertakes to:

1. Retain, through its Board of Directors, within sixty (60) calendar days of the issuance of this Order, and for a period of three years from the date of retention, an independent compliance consultant ("Compliance Consultant"), not unacceptable to the staff of the Commission, to review and evaluate Statoil's internal controls, record-keeping, and financial reporting policies and procedures as they relate to Statoil's compliance with the books and records, internal accounting controls, and anti-bribery provisions of the FCPA, codified at Sections 13(b)(2)(A), 13(b)(2)(B), and 30A of the Exchange Act. This review and evaluation shall include an assessment of those policies and procedures as actually implemented in practice. The compensation and expenses of the Compliance Consultant, and of the persons hired under his or her authority, shall be paid by Statoil. Statoil may extend the time period for retention of the Compliance Consultant with prior written approval of the Commission staff.

2. Statoil shall cooperate fully with the Compliance Consultant. The Compliance Consultant shall have the authority to take such reasonable steps, in the Compliance Consultant's view, as necessary to be fully informed about the operations of Statoil within the scope of his or her responsibilities under this Order. To that end, Statoil shall provide the Compliance Consultant with access to files, books, records, and personnel that fall within the scope of his or her responsibilities under this Order, provided that Statoil shall not be obligated to provide the Compliance Consultant with files, books and records that are protected by the attorney-client privilege or work product doctrine and that are not the subject of a non-waiver of privilege agreement with the Commission. However, if the Compliance Consultant requests access to materials or information that Statoil reasonably believes to be protected by the attorney client privilege or the work product doctrine, Statoil shall in good faith consider that request, and shall consider whether providing access would assist the Compliance Consultant in performing his or her duties. It shall be a condition of the Compliance Consultant's retention that the Compliance Consultant is independent of Statoil and that no attorney-client relationship shall be formed between them.

3. Statoil shall require the Compliance Consultant to assess whether Statoil's policies and procedures are reasonably designed to detect and prevent violations of the

FCPA, and during the three-year consultancy, Statoil shall require the Compliance Consultant to conduct an initial review and prepare an initial report, followed by two follow-up reviews and follow-up reports as described below. With respect to each of the three reviews, after initial consultations with Statoil, the United States Department of Justice ("DOJ"), and the Commission staff, Statoil shall require the Compliance Consultant to prepare a written work plan for each of the three reviews, which shall be submitted to Statoil, the Commission staff, and DOJ. Statoil shall require the Compliance Consultant to submit the same work plan to the Commission staff and DOJ, and the work plan as finally adopted by the Compliance Consultant shall be the same for both agencies. In order to conduct an effective initial review and to fully understand any existing deficiencies in controls, policies, and procedures related to the FCPA, the Compliance Consultant's initial work plan shall include such steps as are necessary to develop an understanding of the facts and circumstances surrounding the violations described above in Section III. As a condition of the Compliance Consultant's retention by Statoil, the Compliance Consultant shall agree to maintain the confidentiality of Statoil's trade secrets and other confidential business information in conformity with Norwegian law, and to give due consideration to Statoil's need for operational flexibility and preservation of business relationships with third parties, provided that nothing in this paragraph shall preclude the Compliance Consultant from sharing such confidential information with the Commission staff and DOJ.

4. In connection with the initial review, Statoil shall require the Compliance Consultant to issue a written report, within one hundred twenty (120) calendar days after being retained, setting forth the Compliance Consultant's assessment and making recommendations reasonably designed to improve Statoil's program, policies, and procedures for ensuring compliance with the FCPA. Statoil shall require that the Compliance Consultant provide the report to Statoil's Board of Directors and contemporaneously transmit a copy to the following individuals or their successors: (1) Bruce Karpati, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Room 4300, New York, NY 10281-1022; (2) Deborah E. Landis, Assistant United States Attorney, 1 St. Andrews Plaza, New York, NY 10007; and (3) Mark F. Mendelsohn, Deputy Chief, Fraud Section, Criminal Division, U.S. Department of Justice, 10<sup>th</sup> and Constitution Ave., N.W. (Bond), Washington, D.C. 20530. Statoil shall allow the Compliance Consultant to extend the time period for issuance of the report with prior written approval of the DOJ and the Commission staff.

5. Within one hundred twenty (120) calendar days after receiving the report, Statoil shall adopt all recommendations in the report of the Compliance Consultant; provided, however, that within one hundred twenty (120) calendar days after receiving the report, Statoil shall advise the Compliance Consultant and the Commission staff in writing of any recommendations that it considers to be unduly burdensome, impractical, costly, or contrary to Norwegian law. With respect to any recommendation that Statoil considers unduly burdensome, impractical, costly, or contrary to Norwegian law, Statoil need not adopt that recommendation within that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or

purpose. As to any recommendation on which Statoil and the Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within sixty (60) calendar days after Statoil serves the written advice. In the event Statoil and the Compliance Consultant are unable to agree on an alternative proposal, Statoil shall abide by the determinations of the Compliance Consultant, to the extent such proposal would not cause Statoil to violate Norwegian law. With respect to any recommendation that the Compliance Consultant determines cannot reasonably be implemented within one hundred twenty (120) calendar days after receiving the report, Statoil shall allow the Compliance Consultant to extend the time period for implementation with prior written approval of the Commission staff and DOJ.

6. Statoil shall require the Compliance Consultant to undertake two follow-up reviews to determine whether Statoil's policies and procedures are reasonably designed to detect and prevent violations of the FCPA. Within one hundred twenty (120) calendar days of initiating each follow-up review, the Compliance Consultant (i) shall complete the review, (ii) certify whether Statoil's anti-bribery compliance program, including its policies and procedures, is appropriately designed and implemented to ensure compliance with the FCPA, and (iii) report on the Compliance Consultant's findings in the same fashion as set forth in paragraph VI.4 with respect to the initial review. Statoil shall adopt the follow-up recommendations in the same fashion as set forth in paragraph VI.5 with respect to the initial review. The first follow-up review shall commence one year after retention of the Compliance Consultant, and the second follow-up review shall commence at least one year after completion of the first follow-up review. Statoil shall allow the Compliance Consultant to extend the time period for these follow-up reviews with prior written approval of the Commission staff and DOJ, provided that the tenure of the Compliance Consultant shall only exceed three years if Statoil has not fulfilled its responsibilities as described in this Undertakings section.

7. In undertaking the reviews described in Paragraphs VI.1 through VI.6 above, Statoil shall require the Compliance Consultant to formulate conclusions based on sufficient evidence obtained through, among other things, (i) inspection of documents, including, but not limited to, all of Statoil's policies and procedures relating to Statoil's anti-bribery compliance program; (ii) onsite observation of Statoil's systems and procedures, including, but not limited to, Statoil's internal controls, recordkeeping and internal audit procedures; (iii) meetings with and interviews of Statoil employees, officers, directors and any other relevant persons; and (iv) analyses, studies and testing of Statoil's anti-bribery compliance program. In undertaking such assessment and reviews, the Compliance Consultant, at his or her own discretion, may rely, to a reasonable extent and after reasonable inquiry, on reports, studies, and analyses issued or undertaken by other consultants hired by Statoil prior to the date of this Order.

8. The Compliance Consultant's charge, as described above, is to review Statoil's controls, policies and procedures related to the compliance with the FCPA. To the extent the Compliance Consultant, during the course of his or her assessment, discovers that corrupt payments or corrupt transfers of property or interests may have been offered, promised, paid, or authorized by any Statoil entity or person, or any entity

or person working directly or indirectly for Statoil, Statoil shall require the Compliance Consultant to promptly report such payments to Statoil's Corporate Compliance Officer, to its Audit Committee, and to its outside counsel for further investigation. If the Compliance Consultant refers the matter to Statoil's Corporate Compliance Officer, its Audit Committee, and its outside counsel, Statoil shall promptly report the same to the Commission staff and DOJ at the addresses listed in paragraph VI.4. If the Compliance Consultant reasonably concludes that disclosure to Statoil's Corporate Compliance Officer, its Audit Committee, or its outside counsel would be inappropriate for any reason, the Compliance Consultant may limit such disclosure to any one or more of the foregoing parties. If the Compliance Consultant reasonably concludes that disclosure to even one of the foregoing parties would be inappropriate for any reason, Statoil shall allow the Compliance Consultant to refer the matter directly to the Commission staff, DOJ, or Norwegian law enforcement officials or authorities. In the event of such a direct referral, Statoil shall require the Compliance Consultant to make a similar disclosure to Statoil's Corporate Compliance Officer, its Audit Committee, or its outside counsel as soon as the reason for the nondisclosure has abated, unless directed not to do so by the Commission staff, DOJ, or other relevant authorities. If Statoil fails to make such disclosure within ten (10) calendar days of the report of such payments to Statoil's Corporate Compliance Officer, to its Audit Committee, or to its outside counsel, Statoil shall allow the Compliance Consultant to independently disclose his/her findings to the staff of the Commission and DOJ at the addresses listed in paragraph VI.4. Further, in the event that any Statoil entity or person, or any entity or person working directly or indirectly for Statoil, refuses to provide information necessary for the performance of the Compliance Consultant's responsibilities, Statoil shall require the Compliance Consultant to disclose that fact to the Commission staff and to DOJ. Statoil shall not take any action to retaliate against the Compliance Consultant for such disclosures. The Compliance Consultant is not precluded from reporting other criminal or regulatory violations discovered in the course of performing his or her duties, in the same manner as described above.

9. It is understood that no provision of this Order is intended to, or can, prejudice or otherwise affect Norway's jurisdiction and right to enforce within Norway its relevant national laws and treaty obligations, nor shall any provision of this Order require Statoil to take any action that constitutes a breach of Norwegian law.

10. Statoil shall require the Compliance Consultant to enter into an agreement with Statoil that provides that for the period of engagement and for a period of two years from completion of the engagement, the Compliance Consultant shall not enter into any additional employment, consultant, attorney-client, auditing or other professional relationship with Statoil, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Compliance Consultant will require that any firm with which he or she is affiliated or of which he or she is a member, and any person engaged to assist the Compliance Consultant in performance of his or her duties under this Order shall not, without prior written consent of the Securities and Exchange Commission's Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional

relationship with Statoil, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement. To ensure the independence of the Compliance Consultant, Statoil shall not have the authority to terminate the Compliance Consultant without the prior written approval of the Commission staff and the DOJ.

## VII.

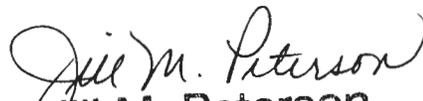
In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Statoil's Offer.

Accordingly, it is hereby ORDERED that:

- i. Respondent Statoil cease and desist from committing or causing any violations and any future violations of Exchange Act Sections 30A, 13(b)(2)(A), 13(b)(2)(B), 13(b)(5), and Rule 13b2-1 thereunder;
- ii. Respondent Statoil comply with the undertakings enumerated in Section VI. above; and
- iii. Respondent Statoil, within ten days of the entry of this Order, pay disgorgement of \$10,500,000 to the United States Treasury. 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, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Statoil as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Helene T. Glotzer, Associate Director, Northeast Regional Office, Securities and Exchange Commission, 3 World Financial Center, Suite 4300, New York, NY 10281.

By the Commission.

Nancy M. Morris  
Secretary

  
By: **Jill M. Peterson**  
**Assistant Secretary**

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54606 / October 16, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2493 / October 16, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12456

In the Matter of

SCHNITZER STEEL  
INDUSTRIES, INC.,

Respondent.

ORDER INSTITUTING CEASE-AND-  
DESIST PROCEEDINGS, MAKING  
FINDINGS, AND IMPOSING A CEASE-  
AND-DESIST ORDER PURSUANT TO  
SECTION 21C OF THE SECURITIES  
EXCHANGE ACT OF 1934

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 Schnitzer Steel Industries, Inc. ("Schnitzer" 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, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

#### Summary

1. This matter involves violations of the Foreign Corrupt Practices Act of 1977 ("FCPA") by Schnitzer Steel Industries, an Oregon-based steel company that sells scrap metal. From at least 1999 through 2004, Schnitzer has paid cash kickbacks or made gifts to managers of government-controlled steel mills in China to induce those managers to purchase scrap metal from Schnitzer. Schnitzer made the payments on its own behalf and as a broker for Japanese steel companies. During this period, Schnitzer also paid bribes to managers of private steel mills in China and South Korea, and improperly concealed those payments in its books and records.

#### Facts

2. Schnitzer, incorporated in Oregon and headquartered in Portland, Oregon, operates three business segments that include a steel manufacturer, a metals recycling business and an auto parts business. Schnitzer reported revenue of \$853 million for its fiscal year ended August 31, 2005. At the time of the conduct described below, Schnitzer's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was listed on the NASDAQ National Market. Schnitzer filed reports with the Commission pursuant to Section 13 of the Exchange Act.

3. As part of its metals recycling business, Schnitzer buys and resells metal, including selling scrap metal to steel mills in Asia. In 1995, Schnitzer acquired an entity with two subsidiaries: a subsidiary in South Korea that it renamed SSI International Far East Ltd. ("SSI Korea"), and a U.S. subsidiary in Tacoma, Washington that it renamed SSI International, Inc. ("SSI International"). Thereafter, Schnitzer used these subsidiaries to facilitate its Asian scrap metal sales.

#### A. Sales to Government-owned Steel Mills in China

4. From at least 1999 through 2004, employees and agents of SSI International and SSI Korea made improper cash payments to managers of scrap metal customers owned, in whole or in part, by the Chinese government. These payments were intended to induce those managers to purchase scrap metal from Schnitzer.

5. During the period 1999 through 2004, Schnitzer paid over \$205,000 in improper payments to managers of its government-owned customers in China in connection with 30 sales transactions. Schnitzer's gross revenue for those transactions totaled approximately \$96 million, and Schnitzer earned \$6,259,104 in net profits on the sales.

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<sup>1</sup> 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.

6. Schnitzer paid two types of kickbacks to the general managers of its scrap metal customers. For the first type, Schnitzer paid a "standard" kickback, which was generally \$3,000 to \$6,000 per shipment. Schnitzer paid these kickbacks out of the revenue it earned on the scrap metal sale. Schnitzer also paid the general managers of Chinese customers a second kickback that Schnitzer referred to internally as a "refund" or "rebate." To pay the "refunds," Schnitzer participated in a scheme whereby the general manager of a steel mill would cause the steel mill to overpay Schnitzer for the steel purchase, and would then personally recover the "overpayment" from Schnitzer, in amounts ranging from \$3,000 to \$15,000.

7. Schnitzer wired the money for the improper payments to secret bank accounts in South Korea opened by the head of SSI Korea specifically for receiving these payments. The head of SSI International and the head of SSI Korea would then use funds from the secret accounts to make improper cash payments to managers of Schnitzer's customers. In addition to the cash payments, the Schnitzer officers gave gifts to the managers of the government-owned customers. A Schnitzer senior official was aware of and authorized the wire transfers to the secret bank accounts.

8. Separate from SSI Korea's role as a seller of Schnitzer's metals, SSI Korea also acted as a broker for Japanese scrap metal companies that sold scrap metal in China, receiving brokerage commissions for locating scrap metal buyers in China. Since at least 1999, Japanese companies provided SSI Korea with funds to make improper payments to managers of the Chinese steel mills similar to the payments made by Schnitzer for scrap metal it sold. On behalf of Schnitzer, the funds were delivered to the managers of the Japanese steel mill customers.

9. From 1999 to 2004, Schnitzer made improper payments on behalf of its Japanese customers to managers of steel mills owned, in whole or in part, by the Chinese government in approximately eight scrap metal transactions. SSI Korea earned \$58,610 in brokerage commissions and realized \$19,991 in net profits from those eight transactions.

10. In order to conceal the improper payments, Schnitzer falsely described those payments to the foreign officials as "sales commissions," "commission to the customer," "refunds," or "rebates" in Schnitzer's books and records.

#### **B. Sales to Privately Owned Steel Mills in China and South Korea**

11. In addition to making improper payments for scrap metal sales to government-owned steel mills in China, Schnitzer paid bribes to managers of privately owned steel mills in China and South Korea. Schnitzer falsely described the payments as "sales commissions," "commission to the customer," "refunds," or "rebates" in Schnitzer's books and records.

12. From 1999 to 2004, Schnitzer made over \$420,000 in improper payments to managers of privately owned Chinese steel mills to induce them to purchase scrap metal from Schnitzer. Schnitzer paid managers of the privately owned South Korean steel mills approximately \$1,273,000 in bribes from 1999 to 2004 to induce them to purchase scrap metal from Schnitzer. From 1999 to 2004, SSI Korea also earned \$1,513,097 in commissions for brokered sales on

behalf of Japanese companies in which such kickbacks were paid. Schnitzer also provided non-cash gifts to general managers of Korean customers.

### **C. Schnitzer's Lack of Internal Controls**

13. During the period of the foreign transactions described above, Schnitzer provided no training or education to any of its employees, agents or subsidiaries regarding the requirements of the FCPA. Schnitzer also failed to establish a program to monitor its employees, agents and subsidiaries for compliance with the FCPA.

### **D. Schnitzer's Investigation and Subsequent Events**

14. In May 2004, Schnitzer's compliance department uncovered the improper payments and Schnitzer began to investigate the potential FCPA violations. At that time, a senior executive of Schnitzer prohibited any further payments, but nonetheless authorized Schnitzer employees to pay at least two additional bribes that Schnitzer previously had promised private customers. The same senior executive also authorized Schnitzer employees to increase entertainment expenses in lieu of cash payments to its private and government-owned scrap metal customers. In response, Schnitzer employees gave managers of Schnitzer's scrap metal customers additional gifts, including gift certificates worth \$10,000 and a watch worth \$2,400.

15. After Schnitzer began its internal investigation, but before it had issued a directive to its employees to preserve documents related to the scrap metal transactions, SSI Korea employees destroyed documents concerning the improper payments.

### **Legal Analysis**

16. The FCPA, enacted in 1977, added Section 30A to the Exchange Act to prohibit public companies from, among other things, making improper payments to foreign officials for the purpose of influencing their decisions in order to obtain or retain business. *See* 15 U.S.C. § 78dd-1.

17. The FCPA also added Exchange Act Section 13(b)(2)(A) to require public companies to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and Exchange Act Section 13(b)(2)(B) to require such companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's general or specific authorization; and (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets. *See* 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

18. In each of the transactions described above, Schnitzer was aware of the high probability that its employees or agents intended to make gifts or payments in order to obtain or retain business for Schnitzer. In each instance described in paragraphs 4 through 9, by proceeding

with the transactions, Schnitzer made or authorized the making of illegal payments to foreign officials, in violation of Section 30A. Schnitzer violated Section 13(b)(2)(A) by improperly recording in its books and records payments it made in the transactions involving its subsidiary in Korea. Finally, Schnitzer violated Section 13(b)(2)(B) by failing to devise and maintain an effective system of internal controls to prevent and detect violations of the FCPA.

### **Schnitzer's Remedial Efforts**

19. In determining to accept the Offer, the Commission considered remedial acts undertaken by Respondent and cooperation afforded the Commission staff.

## **IV.**

### **Undertakings**

Respondent undertakes to:

1. Retain, through its Board of Directors, within sixty (60) calendar days of the issuance of this Order, and for a period of three years thereafter, an independent compliance consultant ("Compliance Consultant"), not unacceptable to the staff of the Commission, to review and evaluate Schnitzer's internal controls, record-keeping, and financial reporting policies and procedures as they relate to Schnitzer's compliance with the books and records, internal accounting controls, and anti-bribery provisions of the FCPA, codified at Sections 13(b)(2)(A), 13(b)(2)(B), and 30A of the Exchange Act and other applicable foreign bribery laws. This review and evaluation shall include an assessment of those policies and procedures as actually implemented in practice. The compensation and expenses of the Compliance Consultant, and of the persons hired under his or her authority, shall be paid by Schnitzer. Schnitzer may extend the time period for retention of the Compliance Consultant with prior written approval of the Commission staff;

2. Schnitzer shall cooperate fully with the Compliance Consultant. Schnitzer shall grant the Compliance Consultant the authority to take such reasonable steps, in the Compliance Consultant's view, as necessary to be fully informed about the operations of Schnitzer within the scope of his or her responsibilities under this Order. To that end, Schnitzer shall provide the Compliance Consultant with access to files, books, records, and personnel that fall within the scope of his or her responsibilities under this Order. It shall be a condition of the Compliance Consultant's retention that the Compliance Consultant is independent of Schnitzer and that no attorney-client relationship shall be formed between them. In connection with the Compliance Consultant's work, Schnitzer shall not withhold from the Commission or the Commission's staff, and shall require the Compliance Consultant to agree not to withhold from the Commission or the Commission's staff, any documents or information on the basis of any privilege or work product claims. This paragraph does not apply to communications and information shared among Schnitzer and counsel representing Schnitzer solely for the purpose of rendering legal advice in connection with investigations conducted by the Department of Justice ("DOJ") and the Commission.

3. Schnitzer shall order the Compliance Consultant to assess whether Schnitzer's policies and procedures are reasonably designed to detect and prevent violations of the FCPA, and during the three-year consultancy, conduct an initial review and prepare an initial report, followed by two follow-up reviews and follow-up reports as described below. With respect to each of the three reviews, after initial consultations with Schnitzer, DOJ, and the Commission staff, Schnitzer shall require the Compliance Consultant to prepare a written work plan for each of the three reviews, which shall be submitted to Schnitzer, the Commission staff, and DOJ. In order to conduct an effective initial review and to fully understand any existing deficiencies in controls, policies, and procedures related to the FCPA and other applicable foreign bribery laws, Schnitzer shall require that the Compliance Consultant's initial work plan include such steps as are necessary to develop an understanding of the facts and circumstances surrounding the violations described above in Section III.

4. In connection with the initial review, Schnitzer shall require the Compliance Consultant to issue a written report, within one hundred twenty (120) calendar days after being retained, setting forth the Compliance Consultant's assessment and making recommendations reasonably designed to improve Schnitzer's program, policies, and procedures for ensuring compliance with the FCPA. Schnitzer shall require that the Compliance Consultant provide the report to Schnitzer's Board of Directors and contemporaneously transmit a copy to the following individuals or their successors: (1) Helene L. Morrison, District Administrator, Securities and Exchange Commission, 44 Montgomery St., Suite 2600, San Francisco, California 94104; and (2) Mark F. Mendelsohn, Deputy Chief, Fraud Section, Criminal Division, U.S. Department of Justice, 10<sup>th</sup> and Constitution Ave., N.W. (Bond), Washington, D.C. 20530. Schnitzer shall allow the Compliance Consultant to extend the time period for issuance of the report with prior written approval of the DOJ and the Commission staff;

5. Within one hundred twenty (120) calendar days after receiving the report, Schnitzer shall adopt all recommendations in the report of the Compliance Consultant; provided, however, that within one hundred twenty (120) calendar days after receiving the report, Schnitzer shall in writing advise the Compliance Consultant and the Commission staff in writing of any recommendations that it considers to be unduly burdensome, impractical or costly. With respect to any recommendation that Schnitzer considers unduly burdensome, impractical or costly, Schnitzer need not adopt that recommendation within that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose. As to any recommendation on which Schnitzer and the Compliance Consultant do not agree, Schnitzer shall attempt in good faith to reach an agreement within sixty (60) calendar days after Schnitzer serves the written advice. In the event Schnitzer and the Compliance Consultant are unable to agree on an alternative proposal, Schnitzer shall abide by the determinations of the Compliance Consultant. With respect to any recommendation that the Compliance Consultant determines cannot reasonably be implemented within one hundred twenty (120) calendar days after receiving the report, Schnitzer shall allow the Compliance Consultant to extend the time period for implementation with prior written approval of the Commission staff and DOJ.

6. Schnitzer shall require the Compliance Consultant to undertake two follow-up reviews to determine whether Schnitzer's policies and procedures are reasonably designed to detect and prevent violations of the FCPA and other applicable foreign bribery laws. Within one

hundred twenty (120) calendar days of initiating each follow-up review, Schnitzer shall (i) require the Compliance Consultant to complete the review, (ii) require the Compliance Consultant to certify whether Schnitzer's anti-bribery compliance program, including its policies and procedures, is appropriately designed and implemented to ensure compliance with the FCPA, (iii) report on the Compliance Consultant's findings in the same fashion as set forth in paragraph IV.4 with respect to the initial review, and (iv) adopt recommendations in the same fashion as set forth in paragraph IV.5 with respect to the initial review. Schnitzer shall require the Compliance Consultant to commence the first follow-up review one year after retention of the Compliance Consultant, and the second follow-up review at least one year after completion of the first follow-up review. Schnitzer shall allow the Compliance Consultant to extend the time period for these follow-up reviews with prior written approval of the Commission staff and DOJ.

7. In undertaking the initial review and follow-up reviews described in Paragraphs IV.2 through IV.6 above, Schnitzer shall require the Compliance Consultant to formulate conclusions based on sufficient evidence obtained through, among other things, (i) inspection of documents, including all of Schnitzer's policies and procedures relating to Schnitzer's anti-bribery compliance program; (ii) onsite observation of FCPA systems and procedures, including Schnitzer's internal controls, recordkeeping and internal audit procedures; (iii) meetings with and interviews of Schnitzer employees, officers, directors and any other relevant persons; and (iv) analyses, studies and testing of Schnitzer's anti-bribery compliance program. In undertaking such assessment and reviews, Schnitzer shall allow the Compliance Consultant, at his or her own discretion, to rely, to a reasonable extent and after reasonable inquiry, on reports, studies, and analyses issued or undertaken by other consultants hired by Schnitzer prior to the date of this Order.

8. The Compliance Consultant's charge, as described above, is to review Schnitzer's controls, policies and procedures related to the compliance with the FCPA. To the extent the Compliance Consultant, during the course of his or her assessment, discovers that corrupt payments or corrupt transfers of property or interests may have been offered, promised, paid, or authorized by any Schnitzer entity or person, or any entity or person working directly or indirectly for Schnitzer, Schnitzer shall require the Compliance Consultant promptly to report such payments to Schnitzer's Corporate Compliance Officer, to its Audit Committee, and to its outside counsel (who must have experience providing advice and conducting investigations regarding FCPA matters) for further investigation, unless the Compliance Consultant believes, in the exercise of his or her discretion, that such disclosure should be delayed. In such circumstances, Schnitzer shall allow the Compliance Consultant to refer the matter directly to the staff of the Commission or DOJ at the address listed above in paragraph IV.4. If the Compliance Consultant refers the matter only to Schnitzer's Corporate Compliance Officer, its Audit Committee, and its outside counsel, Schnitzer shall promptly report the same to the Commission staff and DOJ at the addresses listed above in paragraph IV.4. If Schnitzer fails to make such disclosure within ten (10) calendar days of the report of such payments to Schnitzer's Corporate Compliance Officer, to its Audit Committee, and to its outside counsel, Schnitzer shall require the Compliance Consultant to independently disclose his/her findings to the staff of the Commission and DOJ. Further, in the event that any Schnitzer entity or person, or any entity or person working directly or indirectly for Schnitzer, refuses to provide information necessary for the performance of the Compliance Consultant's responsibilities, Schnitzer shall require the Compliance Consultant to disclose that

fact to the Commission staff and to DOJ. Schnitzer shall not take any action to retaliate against the Compliance Consultant for such disclosures. Schnitzer shall not preclude the Compliance Consultant from reporting other criminal or regulatory violations discovered in the course of performing his or her duties, in the same manner as described above.

9. Schnitzer shall require the Compliance Consultant to enter into an agreement with Schnitzer that provides that for the period of engagement and for a period of two years from completion of the engagement, the Compliance Consultant shall not enter into any additional employment, consultant, attorney-client, auditing or other professional relationship with Schnitzer, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Compliance Consultant will require that any firm with which he or she is affiliated or of which he or she is a member, and any person engaged to assist the Compliance Consultant in performance of his or her duties under this Order shall not, without prior written consent of the Securities and Exchange Commission's Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Schnitzer, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement. To ensure the independence of the Compliance Consultant, Schnitzer shall not have the authority to terminate the Compliance Consultant without the prior written approval of the Commission staff and the DOJ.

#### V.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Schnitzer's Offer.

Accordingly, it is hereby ORDERED that:

A. Respondent Schnitzer cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), 13(b)(2)(B), and 30A of the Exchange Act.

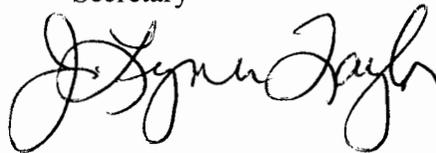
B. Respondent shall comply with the undertakings enumerated in Section IV above.

C. IT IS FURTHERED ORDERED that Respondent shall, within ten days of the entry of this Order, pay disgorgement and prejudgment interest in the total amount of \$7,725,201, consisting of \$6,279,095 in disgorgement and \$1,446,106 in prejudgment interest, to the United States Treasury. 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, Mail Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Schnitzer

Steel Industries, Inc. 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 Helene L. Morrison, District Administrator, Securities and Exchange Commission, 44 Montgomery Street, 26<sup>th</sup> Floor, San Francisco, CA 94104.

By the Commission.

Nancy M. Morris  
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**

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 54630 / October 20, 2006

**ADMINISTRATIVE PROCEEDING**  
File No. 3-12459

**In the Matter of**  
  
**Globe Staff Consulting 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 Globe Staff Consulting Corporation ("Globe Staff" or "Respondent").

**II.**

In anticipation of the institution of these proceedings, Globe Staff 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, Globe Staff 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 the Offer submitted by Respondent, the Commission finds that:

1. Globe Staff (CIK No. 1076564) is a Nevada corporation based in Philadelphia, Pennsylvania with operations in Bayonne, France. At all times relevant to this proceeding, the common stock of Globe Staff was registered with the Commission

under Exchange Act Section 12(g). As of October 17, 2006, the common stock of Globe Staff (symbol "GSFC") was quoted on the Pink Sheets, had no market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

2. Globe Staff has failed to comply with Exchange Act Section 13(a) and Rules 13a-1, 13a-11, and 13a-13 thereunder while its securities were registered with the Commission in that it has not filed current reports nor any periodic reports for any fiscal period subsequent to the period ended December 31, 2001 when its predecessor PowerSource Corporation filed a Form 10-KSB.

#### IV.

Section 12(j) of the Exchange Act provides as follows:

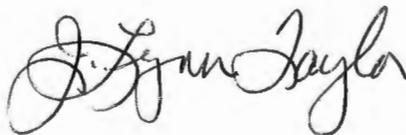
The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice 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 the Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Globe Staff's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Nancy M. Morris  
Secretary



By: J. Lynn Taylor  
Assistant Secretary

*Commissioner Campos  
Not Participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54634 / October 20, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2496 / October 20, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12460

In the Matter of  
  
RONALD J. GOEDDE, CPA,  
  
Respondent.

ORDER INSTITUTING PUBLIC  
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 Ronald J. Goedde ("Respondent" or "Goedde") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.<sup>1</sup>

**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

<sup>1</sup> 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.

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 Public 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 Ronald J. Goedde, age 56, is a certified public accountant licensed in the state of California since 1977 whose license has been inactive since about 1996. From 1996 until June 30, 2001 he was the Chief Financial Officer of Cornerstone Propane Partners, L.P. ("Cornerstone").
2. Cornerstone, a Delaware limited partnership, formerly with headquarters in Watsonville, California, was at one time one of the nation's largest propane marketers, and at the time of the conduct discussed herein, its units were traded on the New York Stock Exchange and were registered under Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act").
3. On October 10, 2006, a final judgment was entered against Respondent permanently enjoining him from future violations of Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1 and 13b2-2 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder in the civil action S.E.C. v. Keith G. Baxter, et al. (Civil Action 05-3843 RMW, N.D. Cal.). Respondent was ordered to pay disgorgement of \$82,717, prejudgment interest of \$20,629.88, and a \$35,000 civil money penalty.
4. The Commission's complaint alleged, among other things, that Respondent signed a materially false Form 10-K for Cornerstone for fiscal year 2000 and three Forms 10-Q for fiscal year 2001 that he knew or was reckless in not knowing failed to conform with Generally Accepted Accounting Principles ("GAAP"). The complaint further alleged that Cornerstone's subsidiary Coast Energy Group ("CEG") had suffered a comprehensive failure to accurately and timely record transactions on its books and records. It also alleged that CEG, before the 2000 Form 10-K was filed, had embarked on a project to systematically reconcile numerous account balances at the company. The complaint further alleged that Cornerstone's financial statements were not presented in conformity with GAAP because all material transactions had not been properly recorded and the company's accounting records did not accurately reflect its transactions. It also alleged the financial statements in Cornerstone's 2000 Form 10-K and 2001 Forms 10-Q failed to conform with GAAP in at least three respects. First, GAAP requires that all assets, liabilities and other items contained in an issuer's balance sheet be based upon reliable information. The complaint alleged that the scope of Cornerstone's unsupported accounts rendered Cornerstone's financial statements materially unreliable. Second, GAAP requires that when an issuer identifies a reasonably

possible loss, the issuer disclose the potential loss in its financial statement footnotes. The complaint alleged that Cornerstone failed to include any disclosure of this potential loss in Cornerstone's Commission filings. Third, provisions governing consolidation in GAAP and Regulation S-X require that inter-company items and transactions eliminate in the preparation of the consolidated financial statements. If an issuer's inter-company balances are not eliminated in consolidation, Regulation S-X requires disclosure of the balances and the methods of treatment. The complaint further alleged the financial statements did not include such disclosure. The complaint also alleged that Respondent signed four management representation letters to the company's outside auditors that were false.

#### 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:

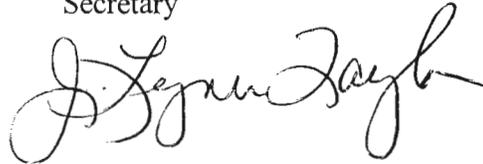
- A. Goedde is suspended from appearing or practicing before the Commission as an accountant.
- B. After five years from the date of this Order, Goedde may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing 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 Goedde'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. Goedde, 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. Goedde, 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 Goedde's or the firm's quality control system that would indicate that Goedde will not receive appropriate supervision;
    - c. Goedde 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. Goedde acknowledges his responsibility, as long as Goedde 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 Goedde 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 Goedde's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Nancy M. Morris  
Secretary

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

By: J. Lynn Taylor  
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC- 27521; 812-13191]

Investment Technology Group, Inc.; Notice of Application

October 23, 2006

Agency: Securities and Exchange Commission ("Commission").

Action: Notice of application for a permanent order under section 9(c) of the Investment Company Act of 1940 (the "Act").

Summary: Applicant requests an exemption from section 9(a) of the Act with respect to a securities-related injunction entered in 1987.

Applicant: Investment Technology Group, Inc. ("ITG").

Filing Dates: The application was filed on May 24, 2005 and amended on June 23, 2006.

Hearing or Notification of Hearing: Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on November 17, 2006 and should be accompanied by proof of service on applicants in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary. An order granting the application will be issued unless the Commission orders a hearing.

Addresses: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicant, 380 Madison Avenue, 4th Floor, New York, NY 10017.

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For Further Information Contact: Emerson Davis, Sr., Senior Counsel, or Stacy L. Fuller, Branch Chief, at (202) 551-6821, Division of Investment Management, Office of Investment Company Regulation.

Supplementary Information: The following is a summary of the application. The complete application is available for a fee from the Commission's Public Reference Branch, 100 F Street, NE, Washington, DC 20549-1580 (202-551-8090).

Applicant's Representations:

1. ITG, a Delaware corporation, provides electronic execution, technology-based equity trading, and research services to a number of large institutional clients. ITG began operations in 1987 as a division of Jefferies & Company, Inc. ("Jefferies Broker-Dealer"), a broker-dealer registered under the Securities Exchange Act of 1934 ("1934 Act") and a wholly owned subsidiary of Jefferies Group, Inc. ("Jefferies Group"). In 1991, ITG was incorporated separately as a wholly owned subsidiary of Jefferies Group. In 1994, ITG made an initial public offering of its common stock, with Jefferies Group continuing to own approximately 80% of ITG's outstanding common stock. In 1999, Jefferies Group transferred all of its assets and liabilities relating to its full-service brokerage and investment banking business, including Jefferies Broker-Dealer (and not including ITG, which remained as Jefferies Group's sole asset), to a new corporation ("New Jefferies Group"), and distributed shares of New Jefferies Group to Jefferies Group's shareholders. Jefferies Group then merged with and was renamed ITG. New Jefferies Group and ITG are not affiliated persons within the meaning of the Act. The Chairman

of the Board, President and Chief Executive Officer of ITG, Mr. Raymond L. Killian, was an Executive Vice President of Jefferies Group at the time of, but was not involved in the conduct underlying, the 1987 Injunction, as defined below.

2. On March 19, 1987, the United States District Court for the Southern District of New York entered a permanent injunction against Mr. Boyd L. Jefferies ("Mr. Jefferies"), Jefferies Broker-Dealer, and Jefferies Group, prohibiting them from violating, or aiding and abetting violations of, certain provisions of the 1934 Act ("1987 Injunction").<sup>1</sup> The violations involved manipulating the market in certain securities and engaging in "parking" during the period 1985-86. The Commission also instituted and settled administrative proceedings against Mr. Jefferies and Jefferies Broker-Dealer.<sup>2</sup>

Applicant's Legal Analysis:

1. Section 9(a) of the Act, in relevant part, prohibits any person who has been enjoined from engaging in or continuing any conduct or practice in connection with the purchase or sale of a security, and any other company of which the person is or hereafter becomes an affiliated person, from acting, among other things, as a principal underwriter or investment adviser for registered investment companies ("funds"). Applicant states that the 1987 Injunction prohibits it from serving funds in the manner described in section 9(a). Applicant further states that, although it has not served and does not serve in any

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<sup>1</sup> Securities and Exchange Commission v. Boyd L. Jefferies, et al., Litigation Release No. 11370 (March 19, 1987).

such capacity with respect to any fund, as a financial services company, applicant in the future may determine to become an investment adviser or principal underwriter to funds, or an affiliated person of such an adviser or underwriter.

2. Section 9(c) of the Act provides that the Commission shall grant an application for an exemption from the disqualification provisions of section 9(a) if it is established that these provisions, as applied to the applicant, are unduly or disproportionately severe or that the conduct of applicant has been such as not to make it against the public interest or the protection of investors to grant the application. Applicant seeks an order under section 9(c) with respect to the 1987 Injunction. Applicant acknowledges that any such order will not extend to New Jefferies Group, or any person of which New Jefferies Group is or becomes an affiliated person.

Applicant states that Mr. Jefferies died in 2001.

3. Applicant states that the prohibitions of section 9(a) as applied to it would be unduly and disproportionately severe. Applicant states that none of the persons involved in the conduct underlying the 1987 Injunction was or is a director, officer, or employee of ITG. Applicant also states that it has not been the subject of any other injunction or any disciplinary proceeding brought by the Commission, any state securities regulator, or any self-regulatory organization. Applicant further states that New Jefferies Group has no ownership interest in

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<sup>2</sup> In the Matter of Jefferies & Company, Inc. and Boyd L. Jefferies, Exchange Act Release No. 24231 (March 19, 1987).

ITG, ITG has no ownership interest in New Jefferies Group, and the two entities are independent enterprises.

By the Commission.

A handwritten signature in cursive script that reads "Nancy M. Morris". The signature is written in black ink and is positioned above the printed name and title.

Nancy M. Morris  
Secretary

SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 27522; 812-13309]

Integrated ARROs Fund I, et al.; Notice of Application

October 23, 2006

Agency: Securities and Exchange Commission ("Commission").

Action: Notice of application for an order under section 38(a) of the Investment Company Act of 1940 ("Act").

Summary of the Application: Applicants request an order to rescind a prior order dated April 21, 1987 (the "Prior Order").<sup>1</sup>

Applicants: Integrated ARROs Fund I, Integrated ARROs Fund II, and IR Pass-through Corporation ("IRPT").

Filing Date: The application was filed on June 23, 2006.

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on November 17, 2006, and should be accompanied by proof of service on applicants in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

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<sup>1</sup> Integrated ARROs Fund I, et al., Investment Company Act Rel. Nos. 15492 (Dec. 22, 1986) (notice) and 15693 (Apr. 21, 1987) (order).

Addresses: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Applicants: c/o Barbara Leary, Winthrop Management LLC, 7 Bullfinch Place, Suite 500, Boston, MA 02114.

For Further Information Contact: Jean E. Minarick, Senior Counsel, at (202) 551-6811, or Mary Kay Frech, Branch Chief, at (202) 551-6821 (Office of Investment Company Regulation, Division of Investment Management).

Supplementary Information: The following is a summary of the application. The complete application may be obtained for a fee at the Commission's Public Reference Branch, 100 F Street, NE, Washington, DC 20549-0102 (telephone (202) 551-5850).

Applicants' Representations and Legal Analysis:

1. The Funds were organized in 1987 as grantor trusts by IRPT, a Delaware corporation and a wholly-owned subsidiary of Integrated Resources, Inc. The Funds were registered with the Commission as closed-end investment companies. On October 17, 2005, the Funds made final payment to all of their unitholders after the maturity, sale or other disposition of all their securities assets. Pursuant to the terms of the Funds' trust indentures, the Funds terminated automatically upon the final payments. On November 18, 2005, each Fund filed an application under section 8(f) of the Act for an order of deregistration. On May 24, 2006, the Commission issued orders under section 8(f) declaring that each Fund had ceased to be an investment company.<sup>2</sup>

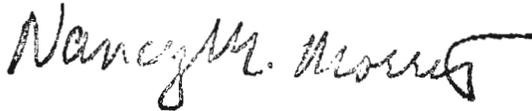
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<sup>2</sup> Investment Company Act Rel. Nos. 27308 (Apr. 28, 2006) (notice) and 27376 and 27377 (May 24, 2006) (orders).

2. On April 21, 1987, the Commission issued the Prior Order under sections 6(c), 17(b) and 17(d) of the Act exempting the Funds, IRPT and certain future similarly organized closed-end investment companies ("Future Funds") from various provisions of the Act. The Applicants state they have not organized, and do not intend to organize, any Future Funds in reliance on the Prior Order.

3. Applicants request an order under section 38(a) of the Act rescinding the Prior Order. Section 38(a) of the Act states, in relevant part, that the Commission shall have authority to rescind such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in the Act. Applicants submit that the requested order is appropriate to the exercise of the Commission's powers under the Act.

By the Commission.

A handwritten signature in cursive script that reads "Nancy M. Morris". The signature is written in black ink and is positioned to the right of the typed name.

Nancy M. Morris  
Secretary

## SECURITIES AND EXCHANGE COMMISSION

[Release No. PA-37; File No. S7-17-06]

**Privacy Act of 1974:** Establishment of a New System of Records: Photographic Files (SEC-54)

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Notice of the establishment of a new system of records.

**SUMMARY:** In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a, the Securities and Exchange Commission gives notice of a proposed Privacy Act system of records: "Photographic Files (SEC-54)." This system of records will contain a collection of photographic materials, in print and electronic format, related to Commission staff and events.

**DATES:** The new system will become effective [insert date that is 40 days after publication in the Federal Register] unless further notice is given. The Commission will publish a new notice if the effective date is delayed to review comments or if changes are made based on comments received. To be assured of consideration, comments should be received on or before [insert date that is 30 days after 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/other.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-17-06 on the subject line.

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Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-17-06. 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, Room 1580, Washington, DC 20549. 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:** Barbara A. Stance, Chief Privacy Officer, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312-2413, (202)551-7209.

**SUPPLEMENTARY INFORMATION:** The Commission gives notice of the proposed establishment of a new system of records entitled "Photographic Files (SEC-54)." The new system of records will contain photographic materials, in print and electronic format, related to Commission staff and events. Many of the physical photographic materials are old and fragile. Repeated handling of these materials causes additional damage. Digitizing this collection will serve to preserve the materials and make them accessible. The records may also be indexed and therefore retrievable by such data elements as date, event, and personal name.

The Commission has submitted a report of the new system of records to the Senate Committee on Homeland Security and Governmental Affairs, the House Committee on Government Reform, and the Office of Management and Budget, pursuant to 5 U.S.C. 552a(r) of the Privacy Act of 1974, as amended, and Appendix I to OMB Circular A-130, "Federal Agency Responsibilities for Maintaining Records About Individuals," as amended on February 20, 1996 (61 FR 6435).

Accordingly, the Commission is adding a new system of records to read as follows:

**SEC-54**

**SYSTEM NAME:** Photographic Files.

**SYSTEM LOCATION:** Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

Commission staff, visitors from other Federal agencies and members of the public.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

The records in the system include photographic prints, negatives, and slides. Records may also include digital photographs, as well as digitized images of photographic prints, negatives, and slides. Indexing data, including such data elements as date, event, and personal name, will be created for these materials.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

5 U.S.C. 301, Departmental Regulations.

**PURPOSE(S):**

Photographic files are provided to the Securities and Exchange Commission library (“Library”) on an ongoing basis for inclusion in the Library’s collection. Many of the photographic materials in the collection are old and fragile. Repeated handling of these materials causes further damage. Digitizing this collection will support the preservation of these materials, and indexing the collection by such information as date, event, and personal name, will make these materials accessible to Commission staff and the public.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSE OF SUCH USES:**

These records may be disclosed to the public as follows:

- (1) For reproduction by Commission staff organizing such events as awards ceremonies, farewell ceremonies and receptions, Commission anniversary ceremonies and receptions, and Commission training and educational programs;
- (2) For distribution and presentation for news, public relations and community affairs purposes; and
- (3) In support of research activities conducted by staff of the Commission and other Federal agencies, as well as members of the public.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:** The photographic prints, negatives, and slides are stored in the Commission’s Library in a locked file room. These photographic materials will be transferred to the Office of Filings and Information Services after they have been digitized. Digital images, along with indexing data, will be stored on secure Commission

servers and made available on the Commission's intranets and public Web site, as appropriate.

**RETRIEVABILITY:** Records may be retrieved by such information as date of event, name of event, and/or name(s) of individual(s), where such information is available.

**SAFEGUARDS:** Physical photographic materials are stored in a locked file room in the Commission's Library. The Library is in a secured area. Digital records and indexing data are stored on secure servers. Server access is limited to authorized personnel whose duties require such access.

**RETENTION AND DISPOSAL:** Physical and electronic photographic file records are permanent. Records will be retired to Washington National Records Center.

**SYSTEM MANAGER(S) AND ADDRESS:** Cynthia Plisch, Assistant Director, Reference and Information Services, Securities and Exchange Commission, Library, 100 F Street, NE, Room 1550, Washington, DC 20549-1550, 202-551-5450.

**NOTIFICATION PROCEDURE:** Individuals seeking to determine whether information about themselves is contained in this system should address written inquiries to: Privacy Act Officer, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Mail Stop 0-7, Alexandria, VA 22312-2413.

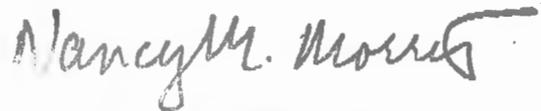
**RECORD ACCESS PROCEDURES:** Persons wishing to obtain information on the procedures for gaining access to, or contesting the contents of, this record may contact: Privacy Act Officer, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Mail Stop 0-7, Alexandria, VA 22312-2413.

**CONTESTING RECORDS PROCEDURES:** See record access procedures above.

**RECORD SOURCE CATEGORIES:** Photographic files are provided to the Library for inclusion in the Library's collection on an ongoing basis. Donors include Commission employees who have photographed an event or individuals donating their photographic collections to the Library for the purposes of preservation and access. Indexing information is derived from information recorded on photographs, or from Commission staff or other individuals who have knowledge of the event and individuals photographed.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:** None

By the Commission.

A handwritten signature in cursive script that reads "Nancy M. Morris". The signature is written in dark ink and is positioned above the printed name and title.

Nancy M. Morris  
Secretary

Date: October 24, 2006

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 270**

**[Release No. IC-27539; File No. S7-37-04]**

**RIN 3235-AJ31**

**Definition of Eligible Portfolio Company under the Investment Company Act of 1940**

**AGENCY:** Securities and Exchange Commission (the "Commission").

**ACTION:** Reproposed rule.

**SUMMARY:** The Commission is reproposing for comment an additional definition of the term "eligible portfolio company" under the Investment Company Act of 1940 ("Investment Company Act" or "Act"). The reproposed rule is intended to more closely align the definition of eligible portfolio company, and the investment activities of business development companies ("BDCs"), with the purpose that Congress intended. The reproposed rule would expand the definition of eligible portfolio company to include certain companies that list their securities on a national securities exchange ("Exchange").

**DATES:** Comments should be received on or before [insert date 60 days after 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>); or

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- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-37-04 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 Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-37-04. 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>).

Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. 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:** Rochelle Kauffman Plesset, Senior Counsel, or Elizabeth G. Osterman, Assistant Chief Counsel, Office of Chief Counsel, (202) 551-6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5030.

**SUPPLEMENTARY INFORMATION:** The Commission today is reproposing Rule 2a-46(b) [17 CFR 270.2a-46] under the Investment Company Act [15 U.S.C. 80a et seq.].<sup>1</sup>

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<sup>1</sup> The Commission today issued a release adopting Rule 2a-46, which defines eligible portfolio company as a company whose securities are not listed on an Exchange, and Rule 55a-1, which conditionally permits BDCs to make additional (follow-on) investments in certain companies. Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27538 (Oct. 25, 2006) (“Adopting Release”).

## I. BACKGROUND

BDCs are closed-end investment companies that Congress established for the purpose of making capital more readily available to certain types of companies.<sup>2</sup> To accomplish this purpose, the Investment Company Act prohibits a BDC from making any investment unless, at the time of the investment, at least 70 percent of its total assets (“70% basket”) are invested in securities of certain specific types of companies, including “eligible portfolio companies.”<sup>3</sup>

The Investment Company Act defines eligible portfolio company to include domestic operating companies that, among other things, do not have any class of securities that are marginable under rules promulgated by the Federal Reserve Board.<sup>4</sup> In 1998, for reasons unrelated to small business capital formation, the Federal Reserve Board amended its definition of margin security to increase the types of securities that would fall within that definition under its rules. This amendment had the result of reducing the number of companies that qualify as eligible portfolio companies.

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<sup>2</sup> Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94<sup>th</sup> Stat. 2274 (1980) (codified at scattered sections of the United States Code) (“SBIIA”). See also generally H.R. Rep. No. 1341, 96<sup>th</sup> Cong., 2d Sess. 21 (1980) (“House Report”).

<sup>3</sup> See Section 2(a)(46) of the Investment Company Act (statutory definition of eligible portfolio company) [15 U.S.C. 80a-2(a)(46)]. See also Section 55(a) of the Investment Company Act (regulating the activities of BDCs) [15 U.S.C. 80a-54(a)].

<sup>4</sup> Section 2(a)(46)(C)(i) of the Investment Company Act. See also Section 2(a)(46)(C)(ii) (defines eligible portfolio company to include companies that are controlled by the investing BDC or certain of its affiliates); Section 2(a)(46)(C)(iii) (defines eligible portfolio company to include certain very small companies).

In November 2004, the Commission proposed Rule 2a-46<sup>5</sup> and Rule 55a-1 to address the impact of the Federal Reserve Board's 1998 amendments on the definition of eligible portfolio company.<sup>6</sup> As proposed, Rule 2a-46(a) would have defined eligible portfolio company to include any domestic operating company<sup>7</sup> that does not have a class of securities listed on an Exchange;<sup>8</sup> and Rule 2a-46(b) would have defined eligible portfolio company to include any domestic operating company that has a class of securities listed on an Exchange, but is in danger of having its securities delisted because of financial difficulties. As proposed, Rule 55a-1 would have conditionally permitted a BDC to continue to invest in a company that had met the proposed definition of eligible

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<sup>5</sup> Under Section 2(a)(46)(C)(iv), the term eligible portfolio company includes any issuer that, in addition to meeting the requirements of Sections 2(a)(46)(A) and (B), "meets such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of [the Act]." See House Report at 23 ("... the Commission is given rulemaking authority to expand the class of eligible portfolio companies, following certain specific standards."). The legislative history of the SBIIA also makes clear that the intent of this provision "is to enable the Commission through the administrative process to broaden, if appropriate, the category of eligible portfolio company." While stating that BDCs "already have substantial freedom of action to purchase securities of companies which are not eligible portfolio companies," referring to the investments permitted to be made outside of the 70% basket, Congress also noted its expectation that "the Commission would institute [rulemaking] proceedings to consider whether the definition of eligible portfolio company can be expanded, consistent with the purpose of the legislation, to increase the flow of capital to small, developing businesses or financially troubled businesses. In providing the Commission with rulemaking authority, Congress noted "[a]mong the objective factors which the Commission may consider in [rulemaking] proceedings are the size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies." See House Report at 31.

<sup>6</sup> The rules were proposed in Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 26647 (Nov. 1, 2004) [69 FR 64815 (Nov. 8, 2004)] ("2004 Proposing Release").

<sup>7</sup> The proposed rule would have incorporated the provisions of Section 2(a)(46)(A) and (B). Section 2(a)(46)(A) of the Investment Company Act defines eligible portfolio company to include (among other things) companies organized under the laws of, and with their principal business in, one or more states of the United States. Section 2(a)(46)(B) of the Investment Company Act generally excludes from the definition of eligible portfolio company any company that meets the definition of investment company under Section 3 of the Investment Company Act, or that is excluded from the definition of investment company by Section 3(c) of that Act, but includes as an eligible portfolio company a small BDC that is licensed by the Small Business Administration and that is a wholly-owned subsidiary of a BDC.

<sup>8</sup> The rule as proposed also would have defined eligible portfolio company to include any domestic operating company that does not have any class of securities listed on an automated interdealer quotation system of a national securities association (i.e., The NASDAQ Stock Market LLC) ("Nasdaq"). On August

portfolio company at the time of the BDC's initial investment(s) in it, but did not subsequently meet that definition.

Today, the Commission adopted Rule 2a-46, initially proposed as Rule 2a-46(a), and Rule 55a-1.<sup>9</sup> The Commission did not adopt proposed Rule 2a-46(b) based on commenters' concerns that the proposed rule would be unworkable and too narrow.

## II. DISCUSSION

### A. Comments Received on 2004 Proposing Release

We received thirty-six comment letters that addressed the proposed rules.<sup>10</sup> Most commenters argued that proposed Rule 2a-46(b), which would have defined eligible portfolio company to include domestic operating companies whose securities were listed on an Exchange but were in danger of being delisted because of financial difficulties, would be unworkable.<sup>11</sup> Some commenters also argued that the proposed rule would be too narrow because it would not include some small companies that list their securities on an Exchange, but that nevertheless may have difficulties accessing conventional sources of capital and raising additional capital on the public capital markets. They argued that

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1, 2006, Nasdaq began operating as a national securities exchange registered under Section 6(a) of the Exchange Act. See [www.nasdaq.com/newsroom/news/pr2006/ne\\_section06\\_097.stm](http://www.nasdaq.com/newsroom/news/pr2006/ne_section06_097.stm).

<sup>9</sup> See *supra* note 1.

<sup>10</sup> Commenters included members of Congress, BDCs, law firms, trade associations and small businesses that had received financing from a BDC. The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549 (File No. S7-37-04). They also may be viewed at <http://www.sec.gov/rules/proposed/ic-26647.htm>.

<sup>11</sup> See, e.g., comments of Shearman & Sterling LLP (Jan. 7, 2005) ("... we believe that the requirement for a delisting notice would frustrate one of the purposes of proposed Rule 2a-46(b), which as expressed in the proposing release, seeks to address the need of, and provide access to capital readily to, financially troubled issuers that have not reached the dire financial straits contemplated by Section 55(a)(3) of the 1940 Act. In our experience, the delisting process often lags the 'facts on the ground,' and properly so, as Exchanges are reluctant to impose a premature death sentence on listed companies. Thus, we submit that a company that receives a delisting notice would likely be in severe financial distress."); comments of American Capital Strategies Ltd. (Jan. 7, 2005) (generally arguing that the minimum initial listing standards of an Exchange would exclude many of the companies Congress intended to benefit from BDC financing, and noting that

these companies should qualify as eligible portfolio companies under the rule.<sup>12</sup> Many commenters urged us to adopt a size-based standard and suggested a specific numeric threshold.<sup>13</sup>

### **B. Reproposed Rule 2a-46(b)**

After considering the comments received, the Commission believes that it is appropriate to seek further input on including additional companies in the definition of eligible portfolio company. Accordingly, the Commission is revising and reproposing Rule 2a-46(b) to provide an additional definition of eligible portfolio company.<sup>14</sup> We have included two alternatives of reproposed Rule 2a-46(b) for comment. Each alternative would include certain domestic, operating companies that list their securities on an Exchange.<sup>15</sup> The first alternative would include companies whose public float is less than \$75 million (“Alternative One”).<sup>16</sup> The second alternative (two versions) would

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the requirement for a delisting notice “could result in substantially the same situation as was caused by the Federal Reserve Board changes to the margin securities regulations”).

<sup>12</sup> See, e.g., comments of Allied Capital (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005). But see comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005) (supporting proposal in full); comments of the Investment Company Institute (Jan. 6, 2005) (supporting proposal in full).

<sup>13</sup> See, e.g., comments of Capital Southwest Corporation (Dec. 28, 2004); comments of Representative Sue Kelly and Representative Nydia Velázquez (Jan. 5, 2005); comments of Shearman & Sterling LLP (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005); comments of Williams & Jensen (Feb. 17, 2006).

<sup>14</sup> We are also proposing to renumber Rule 2a-46 as Rule 2a-46(a). We are not proposing any other changes to that rule.

<sup>15</sup> Like Section 2(a)(46) and proposed Rule 2a-46, reproposed Rule 2a-46(b) would define eligible portfolio company to include only domestic operating companies. See supra note 7.

<sup>16</sup> Public float is the aggregate market value of a company’s outstanding voting and non-voting common equity (i.e., a company’s market capitalization) minus the aggregate market value of common equity held by the company’s affiliates. See, e.g., Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992) [57 Fed. Reg. 48970 (Oct. 29, 1992)]. Rule 2a-46(b)(2) would define the term “affiliate” for purposes of Alternative One by reference to the definition of the same term in Rule 405 under the Securities Act of 1933 (“Securities Act”) [17 CFR 230.405].

include companies whose market capitalization is less than either \$150 million or \$250 million (“Alternative Two”).

Under both alternatives, a company’s size would be calculated using the price at which the company’s common equity was last sold, or the average of the bid and asked prices of the company’s common equity, in the principal market for such common equity on any day in the 60-day period immediately before the BDC’s acquisition of its securities.<sup>17</sup> This provision is similar to the methodology used in current Commission rules that differentiate among companies based on their size,<sup>18</sup> and is intended to reduce regulatory complexity.

We discuss the use of a size-based standard and each of the alternatives below.

### **1. Size-Based Standard**

In the 2004 Proposing Release, we questioned whether a size-based standard could: (1) result in a company’s eligible portfolio company status fluctuating frequently as a result of market and economic conditions; (2) allow a company to manipulate its capital structure to fall below a specified level; and (3) introduce regulatory arbitrage by encouraging registered closed-end funds to elect BDC status so that they could have the benefit of the lighter regulatory burdens applicable to BDCs under the Investment Company Act. We also noted that it was unclear what level of market capitalization would be appropriate to define an eligible portfolio company.<sup>19</sup>

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<sup>17</sup> Reproposed Rule 2a-46(b)(1). Reproposed Rule 2a-46(b)(2) would define the term “common equity” for purposes of Rule 2a-46(b) by reference to the definition of the same term in Rule 405 under the Securities Act.

<sup>18</sup> See Form S-3 [17 CFR 239.13]; Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [67 FR 44722 (Aug. 3, 2005)] (“Securities Offering Reform”).

<sup>19</sup> See 2004 Proposing Release, supra note 6 at nn. 34-36 and accompanying text.

After careful review, we have reconsidered our initial concerns about using a size-based standard and believe that these concerns may be addressed. First, we have addressed our concern that a company's eligible portfolio company status may fluctuate based on market conditions by proposing, in both Alternative One and Alternative Two of Rule 2a-46(b), that the size would be computed using the price at which the company's common equity was last sold, or the average of the bid and asked prices of the company's common equity, in the principal market for such common equity, determined as of a single date within 60 days immediately prior to a BDC's acquisition of the company's securities. Second, permitting a company to meet the size-based standard on a single date within the 60-day period immediately prior to a BDC's acquisition of the company's securities also lessens our concern that a company might manipulate its capital structure to meet that standard. Third, with respect to our regulatory arbitrage concern, based upon further evaluation of the differences between registered closed-end funds and BDCs, we believe that most closed-end funds probably would not elect BDC status merely because of the different regulatory framework. Unlike BDCs, most closed-end funds are not structured so as to be able to offer managerial assistance to their portfolio companies. In addition, we believe that most closed-end funds probably would not choose a regulatory framework that would cause them to forego some investment flexibility by requiring them to invest a large percentage of their assets in privately negotiated transactions. One commenter also noted that a closed-end fund would be unlikely to elect BDC status "unless it was committed to the BDC mission to finance small and developing companies" because of certain regulatory requirements to which BDCs, but not closed-end funds, currently are subject.<sup>20</sup> Finally, based on our review of the comments, we

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<sup>20</sup> Comments of Allied Capital (Jan. 7, 2005). See also comments of UTEK (Jan. 7, 2005). These

believe that a size-based standard would provide a bright-line test that is easy to administer.

## **2. Alternative Proposals**

As one commenter pointed out, there is no single standard that precisely defines the types of companies that could benefit from BDC financing.<sup>21</sup> After carefully considering the comments on the original proposal and with this in mind, we are proposing the following two alternatives of Rule 2a-46(b) that we believe are consistent with the purpose Congress intended. In addition, as noted above, we have addressed the concerns we originally had regarding the use of a size-based standard.

### **(a) \$75 Million Public Float (Alternative One)**

Alternative One would define eligible portfolio company to include companies whose securities are listed on an Exchange and have a public float of less than \$75 million.<sup>22</sup> Alternative One incorporates the size-based standard used in Form S-3 and Rule 12b-2 under the Exchange Act.<sup>23</sup> We have used this standard to delineate between small, unseasoned companies, and larger, seasoned companies whose securities are listed on an Exchange.<sup>24</sup> For example, to register a primary securities offering for cash on

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commenters noted compliance costs related to the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), and reporting obligations under the Exchange Act, as some of the regulatory burdens that might act to deter a closed-end fund that has no reason to elect BDC status, other than an interest in a different regulatory framework, from seeking to elect that status.

<sup>21</sup> Comments of Allied Capital (Jan. 7, 2005).

<sup>22</sup> Reproposed Rule 2a-46(b).

<sup>23</sup> Alternative One, while based on the requirements of Form S-3 and Rule 12b-2, does not incorporate any of the reporting requirements found in those rules out of concern that doing so could capture some companies that may not qualify to use Form S-3 or be considered an accelerated filer only because they were not in compliance with the reporting requirements. We are soliciting comments on this concern.

<sup>24</sup> Under recently adopted rules, an "unseasoned issuer" is defined as a company that is required to file reports under Section 13 or Section 15(d) of the Exchange Act [15 U.S.C. 78m or 78o(d)], but does not satisfy the requirements of Form S-3 for a primary offering of its securities; a "seasoned issuer" is defined as a company that is eligible to use Form S-3 for a primary offering of securities; and a "well-known

Form S-3, a company must have public float of at least \$75 million.<sup>25</sup> Companies that meet the eligibility requirements of Form S-3 are mature enough to be able to take advantage of short-form registration, including the resultant benefits of incorporation by reference and quick access to the capital markets through “shelf registration.” Similarly, under Rule 12b-2 under the Exchange Act, a company with \$75 million public float or more would be an “accelerated filer,” and thus be required to meet accelerated deadlines in filing certain Exchange Act reports.<sup>26</sup>

We believe that Alternative One would capture companies that Congress intended to benefit from BDC financing. In this regard, the Commission’s Office of Economic Analysis (“OEA”) estimates that, based on June 2006 data, Alternative One would increase the percentage of public domestic operating companies that would meet the definition of eligible portfolio company by 9.1 percent (a total of 896 companies). OEA’s calculations relating to public float are based, for the most part, on a public float definition that is similar to the definition of public float used for purposes of Form S-3

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seasoned issuer” is defined to include a company that, among other things, has at least \$700 million public float. Securities Offering Reform, *supra* note 18.

<sup>25</sup> In addition to having public float of at least \$75 million, a company is eligible to use Form S-3 to register a primary offering of its securities for cash if it: (1) is organized under the laws of the United States or any state and has its principal business operations in the United States; (2) has a class of securities registered under Section 12(b) or a class of equity securities registered under Section 12(g) of the Exchange Act [15 U.S.C. 781(b) or (g)], or is required to file periodic reports under Section 15(d) of the Exchange Act [15 U.S.C. 78o(d)]; (3) has been subject to the requirements of Section 12 or Section 15(d) of the Exchange Act and has filed in a timely manner all of the material required to be filed under Sections 13, 14 or 15(d) of the Exchange Act for at least one year [15 U.S.C. 78m, 78n or 78o(d)]; and (4) has not failed to pay a dividend or sinking fund installment on preferred stock or defaulted on certain specified obligations since the end of the last fiscal year.

<sup>26</sup> Accelerated filers, in addition to having a public float of \$75 million or more, are companies that meet the following conditions as of the end of their fiscal year: (1) they have been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (2) they previously have filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (3) they are not eligible to use Forms 10-KSB and 10-QSB [17 CFR 249.310(b) and 17 CFR 249.308(b)]. See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 8128 (Sept. 5, 2002) [67 FR 58480 (Sept. 16, 2002)].

and is included in Alternative One.<sup>27</sup> New Rule 2a-46, based on June 2006 data, includes approximately 61.4 percent of public domestic operating companies (a total of 6,041 companies).<sup>28</sup> Thus, approximately 70.5 percent (6,937/9,845) of existing domestic public operating companies could qualify as eligible portfolio companies under new Rule 2a-46 and Alternative One of repropoed Rule 2a-46(b).<sup>29</sup>

We note that Alternative One is similar to a suggestion made by one commenter, a BDC.<sup>30</sup> This commenter suggested that we define eligible portfolio company to include public companies that have market capitalization of less than \$100 million to ensure that BDCs continue to invest most of their assets in smaller companies.<sup>31</sup>

Finally, we note that Congress intended that we consider a number of factors in engaging in any rulemaking to define eligible portfolio company, including the extent of

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<sup>27</sup> OEA relied on the estimate of public float provided by Bloomberg LLP in calculating the estimates used in this Release. Bloomberg defines public float as the number of shares outstanding less shares held by insiders and those deemed to be “stagnant shareholders.” “Stagnant shareholders” include ESOPs, ESOTs, QUESTs, employee benefit trusts, corporations not actively engaged in managing money, venture capital companies and shares held by governments. Bloomberg provides estimates of public float for 3,471 out of 3,804 (91%) of the domestic operating companies identified. For the 333 companies for which OEA was unable to obtain an estimate of public float, OEA used each company’s market capitalization. Since small public companies often have a high percentage of insider investors, using market capitalization most likely results in a number that underestimates the number of companies that have a public float of less than \$75 million.

<sup>28</sup> See Adopting Release, supra note 1 at text following n.17.

<sup>29</sup> We note that our estimates reflect only those companies with less than \$75 million public float whose securities are listed on Nasdaq, the New York Stock Exchange (“NYSE”) and the American Stock Exchange (“Amex”). The estimates do not reflect those companies whose securities are exclusively listed on a regional exchange (i.e., those companies whose securities are not dually listed on the NYSE, the Amex or Nasdaq) because such information is not available on our primary data source. While there are only a limited number of these companies, we believe that most of them have a public float of less than \$75 million and thus would also be eligible portfolio companies under either of the proposed alternatives of Rule 2a-46(b).

<sup>30</sup> Comments of Capital Southwest Corporation (Dec. 28, 2004).

<sup>31</sup> We estimate that there is little difference between the number of companies that would be included under the standard proposed under Alternative One and a standard using \$100 million market capitalization. OEA estimates that approximately 918 public domestic operating companies would be included under a \$100 million market capitalization standard, compared to 896 public domestic operating companies that would be included under a \$75 million public float standard (a difference of 22 companies).

companies' public ownership.<sup>32</sup> We have considered this factor in proposing Alternative One, which, by using public float, excludes insider ownership of a company.<sup>33</sup> Nevertheless, as discussed below, we are also soliciting comment on using a market capitalization test.

**(b) \$150/\$250 Million Market Capitalization (Alternative Two)**

Alternative Two would define eligible portfolio company to include companies that have securities listed on an Exchange based on their market capitalizations. As discussed below, we propose two ceilings under this alternative - - \$150 million market capitalization and \$250 million market capitalization.<sup>34</sup>

We solicited comment on the possibility of using a market capitalization standard in the 2004 Proposing Release. Many commenters urged us to adopt a numeric threshold based on market capitalization.<sup>35</sup> Some commenters noted that companies with market capitalization up to \$300 million generally are followed by fewer analysts, have lower institutional ownership and have lower trading volume than companies at higher levels of market capitalization.<sup>36</sup> These commenters concluded that such companies have

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<sup>32</sup> See supra note 5.

<sup>33</sup> See supra note 16.

<sup>34</sup> Reproposed Rule 2a-46(b).

<sup>35</sup> Supra note 13.

<sup>36</sup> Comments of Representatives Sue Kelly and Nydia Velázquez at n.12 (Jan. 5, 2005); comments of Williams & Jensen (Feb. 17, 2006). These commenters referred to analysis prepared by OEA in connection with Securities Offering Reform. See memorandum dated December 3, 2004 ("OEA Memorandum") attached to comments of Williams & Jensen (Feb. 17, 2006) (exhibit entitled "SEC Data Demonstrates Lack of Market Following for Companies with Market Capitalizations of \$300 million or less"). We note that OEA prepared this memorandum to support differentiating among public companies for purposes of defining well-known seasoned issuers. See supra note 24. Also, the OEA Memorandum does not exclude foreign companies and certain domestic, financial companies. See Sections 2(a)(46)(A) and (B), supra, note 5. The set of companies discussed in that memorandum therefore is not directly comparable to the set of companies that might be defined as eligible portfolio companies under Rule 2a-46 and proposed Rule 2a-46(b). See also comments of Allied Capital (Jan. 7, 2005) (data compiled by Banc of America Securities LLC at Appendix A used to make similar point); comments of UTEK (Jan. 7, 2005) (general statement of similar point).

difficulty accessing the public capital markets. We recognize that, at some level of market capitalization, there may be a difference in public awareness of a company as measured by analyst coverage, institutional ownership and other factors that may be related to the company's ability to attract capital.<sup>37</sup>

In addition, we note that many investment companies classify themselves with reference to the size of the companies in which they invest.<sup>38</sup> Similar size-based classifications also are often used by market participants. These classifications generally assist investors in making their investment choices. In particular, we note the general use of the term "microcap" to identify some small, public companies. This classification typically refers to companies with market capitalization of less than \$150 million to less than \$300 million.<sup>39</sup> Microcap issuers often include, among others, small start-up companies.<sup>40</sup>

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<sup>37</sup> See Background Statistics: Market Capitalization & Revenue of Public Companies, August 1, 2005 revision, prepared by OEA and included at Appendix I of Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, Securities Act Release No. 8666 (modified Mar. 15, 2006), available at [www.sec.gov/rules/other/33-8666.pdf](http://www.sec.gov/rules/other/33-8666.pdf). This data does not exclude foreign companies and certain domestic, financial companies. Like the set of companies discussed in the OEA Memorandum, it therefore is not directly comparable to the set of companies that might be defined as eligible portfolio companies under Rule 2a-46 and proposed Rule 2a-46(b). See Sections 2(a)(46)(A) and (B), *supra*, note 5.

<sup>38</sup> See, e.g., [http://biz.yahoo.com/funds/sm\\_mf2.html](http://biz.yahoo.com/funds/sm_mf2.html).

<sup>39</sup> There is no one generally accepted definition of microcap issuer. Morgan Stanley and the Motley Fool define a microcap issuer to be issuers with market capitalizations of less than \$150 million. See e.g., <http://www.fool.com/school/glossary/glossaryc.htm>; <http://www.morganstanleyindividual.com/customerservice/dictionary>. Yahoo generally refers to microcap funds as funds that invest in companies with less than \$250 million. *Supra* note 38. See also [http://www.investorwords.com/3050/micro\\_cap.html](http://www.investorwords.com/3050/micro_cap.html) (microcap companies include those companies with market capitalization of under \$250 million). Lipper Inc. defines microcap funds as those funds that invest primarily in companies with market capitalization less than \$300 million at the time of purchase. Lipper, U.S. Open-End, Closed-End, Variable Annuity, and Overseas Fund Classifications Descriptions (Version 1.2, updated: April 11, 2006), available at [www.Lipperweb.com](http://www.Lipperweb.com).

<sup>40</sup> Some larger, more established public companies, in addition to small, start-up public companies, would qualify as eligible portfolio companies under Alternative Two. We note that certain larger companies were historically included under the definition of eligible portfolio company before 1998. See 2004 Proposing Release, *supra* note 6.

We believe that market-based classifications are useful to consider in designing a standard to define the type of company that could benefit from BDC financing.

Nevertheless, we note that market participants use different bases to determine these classifications. Accordingly, we are proposing for comment two different market capitalization ceilings. The first ceiling would define an eligible portfolio company to include companies that have securities listed on an Exchange that have less than \$150 million market capitalization. This is similar to the classification that some market participants use to identify some small, public companies.<sup>41</sup> The second ceiling would define an eligible portfolio company to include companies that have securities listed on an Exchange that have less than \$250 million market capitalization. This ceiling mirrors legislation proposed last year<sup>42</sup> and is also similar to the classification that other market participants use to identify some small, public companies.<sup>43</sup>

OEA estimates that based on June 2006 data, Alternative Two would increase the percentage of public domestic operating companies that would meet the definition of eligible portfolio company. A ceiling of \$150 million market capitalization would

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<sup>41</sup> See supra note 39.

<sup>42</sup> The “Increased Capital Access for Growing Business Act” was passed by the House of Representatives on April 6, 2005. H.R. 436, 109th Cong., 1st Sess. (2005) (previously H.R. 3170); S. 1396, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2005) (mirrors H.R. 436). Both H.R. 436 and S. 1396 currently are pending before the Senate Committee on Banking, Housing and Urban Affairs.

This ceiling is also consistent with some commenters’ suggestions. See comments of Williams & Jensen (Feb. 17, 2006) (“The \$250 million market capitalization level included in the legislation is consistent with the original Congressional intent.”). See also comments of Representatives Sue Kelly and Nydia Velázquez (Jan. 5, 2005); comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005); comments of American Capital (Jan. 7, 2005); comments of Representative Michael Oxley, Representative Richard Baker and Representative Sue Kelly (Nov. 15, 2005); comments of Chamber of Commerce of the United States of America (Dec. 13, 2005); comments of Senator Charles Schumer and Senator Robert Menendez (Apr. 24, 2006).

<sup>43</sup> See supra note 39.

increase the percentage of eligible portfolio companies by 11.8 percent (a total of 1,168 companies). Since new Rule 2a-46, based on June 2006 data, includes approximately 61.4 percent of public domestic operating companies (a total of 6,041 companies), approximately 73.2 percent (7,209/9,845) of existing domestic public operating companies could qualify as eligible portfolio companies under the combination of the two provisions. A ceiling of \$250 million market capitalization would increase the percentage of eligible portfolio companies by 16 percent (a total of 1,562 companies), for a total of approximately 77.2 percent (7,603/9,845) of existing domestic public operating companies under the combination of new Rule 2a-46 and this version of Alternative Two.

### **3. Solicitation of Comments**

We are requesting comment on whether Alternative One, one of the two versions of Alternative Two, or another alternative not discussed in this Release, would accomplish the objective of more closely aligning the definition of eligible portfolio company with the purpose that Congress intended. We are particularly interested in comments from small businesses with respect to the impact that the alternatives (Alternative One and both versions of Alternative Two) may have on them. We are also interested in receiving information about small businesses' experiences relating to their ability to raise capital through securities offerings or to borrow money through conventional sources (e.g., banks).

We specifically request comment on the following points:

- Please provide your view as to whether Alternative One or one of the two versions of Alternative Two more closely aligns the definition of eligible portfolio company with the purpose that Congress intended. Do any of the proposals (Alternative One or one of the two versions of Alternative Two) better expand the

definition of eligible portfolio company consistent with the purpose of SBIIA? Please provide empirical and analytical evidence that supports your response. If you believe that none of the proposals meets the objective of expanding the definition consistent with the purpose of SBIIA, please provide us with another suggestion that meets this objective, with supporting empirical and analytical evidence. In particular, please comment on whether the ceiling in any suggestion should be lower or higher than those included in the proposals. Please also comment on whether it is more appropriate to use a standard based on public float or market capitalization. For example:

- Alternative One mirrors the standard used in Form S-3 and Rule 12b-2 of \$75 million public float. Would it be more appropriate to use a lower ceiling based on Regulation S-B under the Securities Act of 1933 and the Exchange Act, which defines a “small business issuer” as, among other things, an issuer that has revenues of less than \$25 million, but would not include an issuer that has public float of \$25 million or more?
- Would a ceiling other than the one included under Alternative One or one of the two versions of Alternative Two, or another ceiling not discussed in this Release, be a better way of achieving our objective of more closely aligning the definition of eligible portfolio company with Congress’s intent? For example, one commenter suggested a ceiling

of \$300 million market capitalization based on its analysis of companies that have difficulty accessing capital.<sup>44</sup>

- We are particularly mindful of the unique position of BDCs as regulated investment companies under the Investment Company Act. Congress amended the Investment Company Act in recognition of the differences between BDCs and other investment companies, and the “valuable function in the capital formation process” that BDCs provide.<sup>45</sup> In enacting these amendments, Congress was careful to balance investor protections against the benefits of increasing the flow of public capital to certain companies.<sup>46</sup> One commenter expressed its concern that a high size-based standard could result in BDCs focusing their investment activities on larger companies to the detriment of the companies that BDCs were intended to help.<sup>47</sup> We solicit comment on this concern. We also request comment on whether either of the proposed alternatives, or a different alternative, would have a negative impact on BDC investors.
- Congress noted that we may consider a number of factors in adopting rules to define eligible portfolio company, including the extent of

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<sup>44</sup> Comments of Williams & Jensen (Feb. 17, 2006).

<sup>45</sup> House Report at 21. See Section I, 2004 Proposing Release, supra note 6.

<sup>46</sup> House Report at 22 (“the Committee is cognizant of the need to avoid compromising needed protection for investors in the name of reducing regulatory burdens. . . . Consequently, [SBIIA] is intended to preserve to the fullest possible extent [the application of investor protections of the federal securities laws to BDCs and their operators], while at the same time reducing unnecessary regulatory burdens.”). See 2004 Proposing Release, supra note 6 at n.4 and accompanying text (discussing regulatory flexibility given to BDCs).

<sup>47</sup> See supra notes 30-31 and accompanying text. See also comments of Investment Company Institute (Jan. 6, 2005).

companies' public ownership.<sup>48</sup> We have used public float (which excludes insider ownership of a company<sup>49</sup>) as the basis for Alternative One. We have used market capitalization (which includes all public ownership, including insiders' interests) as the basis for Alternative Two. Please comment on which standard (public float or market capitalization) you believe more closely aligns the definition of eligible portfolio company with Congress's purpose.

- We understand that it is more difficult to obtain a company's public float from reliable third-party sources than it would be to obtain a company's market capitalization, which is readily available through such sources.<sup>50</sup> Although public float information is not readily available through third-party sources, we expect that the costs involved in a BDC complying with these requirements would be minimal. Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and we anticipate that a BDC would be able to obtain this information from the company during the course of those

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<sup>48</sup> See supra note 5.

<sup>49</sup> See supra note 16.

<sup>50</sup> Although companies required to file reports with us under the Exchange Act are required to disclose their public float on the cover page of Form 10-K [17 CFR 249.310], that information may be outdated at the time a BDC seeks to invest in that company.

negotiations.<sup>51</sup> Are these assumptions accurate, or would it be burdensome for a BDC to determine a company's eligible portfolio company status if it is based on public float rather than market capitalization?

- Unlike Form S-3 and Rule 12b-2, Alternative One of repropoed Rule 2a-46(b) does not incorporate any of the qualifying requirements included in Form S-3 or Rule 12b-2 based on the issuer's reporting history under the Exchange Act out of concern that doing so could capture some larger companies that may not qualify to use Form S-3, or be considered accelerated filers, solely because they had not complied with the respective regulation's reporting requirements (e.g., company missed deadlines because of auditing issues). We solicit comment on this concern. Should such reporting requirements be included in the definition of eligible portfolio company under Alternative One? In other words, to the extent that you believe Alternative One is an appropriate standard, should it exclude a company from the definition of eligible portfolio company because the company cannot meet all of the eligibility requirements for use of Form S-3 or because it does not meet the definition of accelerated filer under Rule 12b-2?
- We are proposing that a company must only meet the standard on a single date within the 60-day period immediately prior to the BDC's acquisition of the company's securities for purposes of determining its status as an eligible portfolio company under the repropoed definition. Is this timing appropriate? Should a

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<sup>51</sup> We also understand that the question of whether a company would meet the public float standard would only be at issue if that company has a market capitalization of the dollar amount specified under the standard (e.g., in the case of Alternative One, \$75 million) or greater.

company be required to meet the standard for more than one day during the 60-day period (e.g., at least for 5, 10, 20 non-consecutive days within the 60-day period, or an average over a specified period of time)? Should the requirement be that a company must meet the size-based standard using the average of the 60-day period immediately before an acquisition by a BDC? Is the 60-day period appropriate? Would a shorter or longer time period (e.g., 30 days, 75 days), or an average over a specified period of time, be more appropriate? In your response, please explain why your alternative would be more appropriate than the 60-day period that we are proposing.

- The 2004 Proposing Release was intended to address the need of financially troubled companies that are at risk of losing their listing status to access BDC capital, as well as small, developing companies.<sup>52</sup> One commenter indicated that proposed Rule 2a-46(b) would not include all of the financially troubled companies that provision was intended to include - - that is, companies that have a class of securities listed on an Exchange, but that are in danger of having their securities delisted because they no longer meet the relevant Exchange's quantitative requirements for continued listing on that Exchange and that do not satisfy an Exchange's initial quantitative requirements for listing any class of their securities.<sup>53</sup> We believe that many of such companies would meet the size-based criteria specified under either alternative of repropose Rule 2a-46(b), and

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<sup>52</sup> See 2004 Proposing Release, supra note 6 at nn. 37-41 and accompanying text.

<sup>53</sup> Comments of Shearman & Sterling LLP (Jan. 7, 2005).

therefore be included under the repropoed definition. In addition, such companies might be permissible investments for BDCs to make under Section 55(a)(3), which permits a BDC to include in its 70 percent basket securities of a company purchased from the company or certain affiliates of the company in specific situations demonstrating financial distress, including bankruptcy proceedings. Nevertheless, we request comment as to whether there are some financially troubled companies that could benefit from BDC financing but would not meet the definition of eligible portfolio company under Alternative One or Alternative Two of repropoed Rule 2a-46(b). If you believe that there are, we request comment on how such companies could be defined. For example, should the definition be based on a company's failure to meet one or more initial or continuing quantitative listing standards of any Exchange for a certain period of time? If yes, which quantitative listing standard(s) would be appropriate on which to base eligibility? How long must a company be out of compliance with the quantitative listing standard(s) before it would meet the definition?

### **III. GENERAL REQUEST FOR COMMENT**

We request comment on repropoed Rule 2a-46(b) and on other matters that might have an effect on our proposal. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, we also request information regarding the potential impact of repropoed Rule 2a-46(b) on the economy on an annual basis. Commenters are requested to provide empirical data to support their views.

### **IV. COST-BENEFIT ANALYSIS**

We are sensitive to the costs and benefits that result from our rules. In the Proposing Release we requested public comment and specific data regarding the costs

and benefits of repropoed Rule 2a-46(b). While commenters agreed that proposed Rule 2a-46 would benefit some companies, most urged the Commission to modify the proposed rule to expand the definition to include more companies.

#### **A. Benefits**

Both Alternative One and Alternative Two of the expanded definition of eligible portfolio company are designed to benefit many of the companies that may have lost their eligible portfolio company status because of the 1998 changes to the Federal Reserve Board's definition of margin stock. Specifically, both alternatives are designed to benefit certain companies by expanding the definition of eligible portfolio company to include any domestic operating company with a class of securities listed on an Exchange that meets the specified size-based standard. Many public companies that would be included under repropoed Rule 2a-46(b) may need capital for continued development and growth, but, notwithstanding that their securities are listed on an Exchange, may find it difficult to raise capital through additional offerings or borrow money through other conventional sources. By including such companies within the definition of eligible portfolio company, those companies and their shareholders would benefit because of the expanded sources of capital from which the companies may seek to obtain financing.

Both Alternative One and Alternative Two of repropoed Rule 2a-46(b) would also benefit BDCs by expanding the universe of investments that BDCs may include as part of their 70 percent basket. In addition, both would benefit BDCs by addressing the uncertainty caused by changes in the margin rules in the operation of BDCs.<sup>54</sup> Industry participants have informed us that the 1998 amendment to the margin rules has

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<sup>54</sup> See, e.g., comment of American Capital Strategies (Jan. 7, 2005).

substantially reduced the number of issuers which BDCs may include in their 70 percent basket and accordingly has adversely affected their business operations.

OEA estimates that as of June 30, 2006, there were a total of 896 domestic operating companies whose securities are listed on Nasdaq, the NYSE and the Amex that have a public float of less than \$75 million, and therefore would qualify as eligible portfolio companies under Alternative One. OEA reached this estimate by first calculating the number of companies whose securities were listed on Nasdaq, the NYSE and the Amex (a total of 6,786 companies), corrected for cases where individual companies had multiple classes of securities listed (60 companies), and then removing from the estimate all foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c) of the Investment Company Act (e.g., REITS, banks, insurance companies) because both Section 2(a)(46) of the Investment Company Act and Rule 2a-46 exclude these types of companies from the definition of eligible portfolio company (a deduction of 2,982 companies) to reach a total of 3,804 companies.<sup>55</sup> OEA determined that of these companies, 896 had a public float of less than \$75 million.<sup>56</sup> OEA further estimates that Alternative One, together with new Rule 2a-46 (which would be redesignated as Rule 2a-46(a)),<sup>57</sup> would include

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<sup>55</sup> As we discussed in the Adopting Release, one commenter argued that the Commission incorrectly calculated the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated. The commenter's figure is lower than the figure calculated by OEA. It appears that the commenter did not deduct from its calculation foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c). See Adopting Release, supra note 1 at n.33.

<sup>56</sup> See supra note 27.

<sup>57</sup> OEA estimated that, based on June 2006 data, Rule 2a-46 as adopted today includes 6,041 domestic operating companies (61.4% of all domestic operating companies). See Adopting Release, supra note 1 at Section III.A.

within the definition of eligible portfolio company 6,937 companies, representing 70.5 percent (6,937/9,845<sup>58</sup>) of public domestic operating companies.

OEA estimates that there are a total of 1,168 domestic operating companies whose securities are listed on Nasdaq, the NYSE and the Amex that have a market capitalization of less than \$150 million,<sup>59</sup> and therefore would qualify as eligible portfolio companies under the \$150 million market capitalization standard set forth in Alternative Two.<sup>60</sup> Accordingly, OEA estimates that this standard, together with new Rule 2a-46 (which would be redesignated as Rule 2a-46(a)), would include within the definition of eligible portfolio company 7,209 companies, representing 73.2 percent (7,209/9,845) of public domestic operating companies.<sup>61</sup>

Finally, OEA estimates that there are a total of 1,562 domestic operating companies whose securities are listed on Nasdaq, the NYSE and the Amex that have a market capitalization of less than \$250 million,<sup>62</sup> and therefore would qualify as eligible portfolio companies under the \$250 million market capitalization standard set forth in

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<sup>58</sup> OEA estimates that, as of June 2006, there were 9,845 public domestic operating companies by calculating the number of companies whose securities are listed on Nasdaq, the NYSE and the Amex, in addition to those companies whose securities are trading through the over-the-counter bulletin board and on Pink Sheets LLC, correcting these figures for cases where individual companies had multiple classes of securities listed, and then removing from these figures foreign companies, investment companies, and companies that are excluded from the definition of investment company by Section 3(c).

<sup>59</sup> As with Alternative One, OEA reached this estimate after first calculating the number of companies whose securities are listed on Nasdaq, the NYSE and the Amex, corrected for cases where individual companies had multiple classes of securities listed, and then removing from these figures all foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c) (e.g., REITS, banks, insurance companies) because both Section 2(a)(46) and Rule 2a-46 exclude these types of companies from the definition of eligible portfolio company.

<sup>60</sup> Market capitalization data was obtained from CRSP, Center for Research in Security Prices, Graduate School of Business, The University of Chicago [2006]. Used with permission. All rights reserved. [www.crsp.uchicago.edu](http://www.crsp.uchicago.edu).

<sup>61</sup> See *supra* note 57.

<sup>62</sup> See *supra* note 59.

Alternative Two.<sup>63</sup> Accordingly, OEA estimates that this standard, together with new Rule 2a-46, would include within the definition of eligible portfolio company 7,603 companies, representing 77.2 percent (7,603/9,845) of public domestic operating companies.<sup>64</sup>

#### **B. Costs**

Both Alternative One and Alternative Two of re-proposed Rule 2a-46(b) might impose certain administrative compliance costs on BDCs. It is our understanding, however, that these costs are similar to the types of compliance costs that a BDC currently undertakes when it invests in an issuer.

Under Alternative One, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's public float was less than \$75 million as of a date within 60 days prior to the date of the BDC's investment. Although public float information is not readily available through third-party sources,<sup>65</sup> we expect that the costs involved in a BDC complying with these requirements would be minimal. Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and we anticipate that a BDC would be able to obtain this information from the company during the course of those negotiations.

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<sup>63</sup> See *supra* note 60.

<sup>64</sup> See *supra* note 57. OEA's analysis of the number and percentage of companies that could qualify as eligible portfolio companies under Alternative One and the two versions of Alternative Two are based on market capitalization and public float calculated as of a particular day. Because both Alternative One and Alternative Two allow for companies to meet the test on any date within a 60-day period, OEA's figures may underestimate the number of companies that would be eligible under either version.

<sup>65</sup> Although companies required to file reports with us under the Exchange Act are required to disclose their public float on the cover page of Form 10-K [17 CFR 249.310], that information may be outdated at the time a BDC seeks to invest in that company.

Under the \$150 million market capitalization version of Alternative Two, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was less than \$150 million as of a date within 60 days prior to the date of the BDC's investment. Similarly, under the \$250 million market capitalization version of Alternative Two, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was less than \$ 250 million as of a date within 60 days prior to the date of the BDC's investment. We expect that the compliance costs on BDCs might be slightly lower under either version of Alternative Two because information about the market capitalization of companies is readily available from third-party sources. Finally, we anticipate that both Alternative One and Alternative Two of repropoed Rule 2a-46(b) would impose only minimal, if any, costs on portfolio companies.

### **C. Request for Comments**

We request comment on the potential costs and benefits identified above and any other costs and benefits that may result from either Alternative One or Alternative Two of repropoed Rule 2a-46(b). Are there any direct or indirect costs that we have not identified? For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the impact of each alternative on the economy on an annual basis. Commenters are requested to provide data to support their views.

## V. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act mandates that the Commission, when engaging in rulemaking that requires it 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.<sup>66</sup> In the 2004 Proposing Release, we requested comment on our analysis of the impact of proposed Rule 2a-46 on efficiency, competition and capital formation. As discussed in Section II of this Release, some commenters argued that proposed Rule 2a-46(b) would be too narrow and would not capture all of the companies that could benefit from BDC financing. We interpreted these comments to suggest that capital formation may have been limited under the proposed rule. In addition, one commenter wrote that the proposal failed to identify private investments in public equity (“PIPE”) as one source of competition for BDC financing.<sup>67</sup> The commenter also believed that the proposal failed to consider the impact on the shareholders of companies receiving BDC or PIPE financing.<sup>68</sup>

In light of the comments received, the Commission is reproposing Rule 2a-46(b) to more closely align the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose intended by Congress. Both alternatives of the

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<sup>66</sup> 15 U.S.C. 80a-2(c).

<sup>67</sup> The commenter explained that entities that provide financing through PIPE transactions include hedge funds and private venture capital funds, both of which compete with BDCs in providing capital in the small business market. The commenter also noted its belief that the use of PIPE transactions illustrates the lack of access to traditional forms of capital for certain public companies. Comments of Williams & Jensen (Feb. 17, 2006).

<sup>68</sup> Id.

reproposed definition are designed to promote efficiency, competition and capital formation.

Specifically, efficiency would be enhanced because both Alternative One and Alternative Two of reproposed Rule 2a-46(b) would expand the definition of eligible portfolio company so as to allow BDCs to compete with other entities that provide capital to certain companies. To the extent that BDCs provide capital at lower cost to these companies, the rules promote a more efficient flow of capital, potentially allowing those companies to take on additional or different investment projects. Both alternatives of reproposed Rule 2a-46(b) in our view also would promote efficiency by providing a workable test for determining whether a company is an eligible portfolio company.

We also believe that both Alternative One and Alternative Two of reproposed Rule 2a-46(b) would promote competition. The market for private equity and debt investments can be highly competitive. Since their establishment, BDCs have competed with various sources of capital, including private equity funds, hedge funds, investment banks and other BDCs, to provide financing to certain companies. We believe that both alternatives of the reproposed rule would encourage such competition.<sup>69</sup> In addition, to the extent that BDCs provide either additional or less expensive capital to these companies, those companies may be more competitive in the marketplace.

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<sup>69</sup> Williams & Jenson commented that we did not consider PIPE transactions in our discussion in the 2004 Proposing Release of how proposed Rule 2a-46 would promote competition. This argument, however, focuses on one particular type of financing that is used by entities that compete with BDCs in funding small businesses. Neither Rule 2a-46 adopted today, nor reproposed Rule 2a-46(b), however, differentiates among the types of financing that may be offered to eligible portfolio companies. Instead, the rule, as adopted and reproposed, provides a definition of eligible portfolio company that would permit BDCs to invest their 70% baskets without regard to the type of financing offered. Thus, BDCs and eligible portfolio companies would be permitted to negotiate the type of financing (including PIPE transactions) that is most appropriate under the circumstances.

In response to the commenter's concern that the proposal did not consider the impact on shareholders of companies receiving BDC or PIPE financing, we note that shareholders of companies that had lost their status as eligible portfolio companies would benefit under either version of the repropose rule because such companies would be able to more readily consider BDCs as a source of financing. We anticipate that these companies would consider both the type of financing offered and the entity offering the financing when determining the type and source of financing that would be in their best interests and the best interests of their shareholders.

Finally, we believe that both Alternative One and Alternative Two of repropose Rule 2a-46(b) would promote capital formation. BDC investments represent additional capital to companies. Each version would expand the definition of eligible portfolio company. We estimate that a total of 896 public domestic operating companies would qualify as an eligible portfolio company under Alternative One, 1,168 public domestic operating companies would qualify as an eligible portfolio company under the \$150 million market capitalization version of Alternative Two, and 1,562 public domestic operating companies would qualify as an eligible portfolio company under the \$250 million market capitalization version of Alternative Two.<sup>70</sup>

## **VI. PAPERWORK REDUCTION ACT**

The Commission has determined that these rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act [44 U.S.C. 3501 et seq.].

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<sup>70</sup> See supra notes 55-64 and accompanying text.

## **VII. INITIAL REGULATORY FLEXIBILITY ANALYSIS**

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to repropoed Rule 2a-46(b) under the Investment Company Act. The Commission is proposing two alternatives of an additional definition of eligible portfolio company. Both alternatives would expand the definition of eligible portfolio company to include certain companies whose securities are listed on an Exchange. Alternative One would define eligible portfolio company to include a company whose securities are listed on an Exchange but that has public float of less than \$75 million. Alternative Two would define eligible portfolio company to include a company whose securities are listed on an Exchange but has a market capitalization of less than either \$150 million or \$250 million.

### **A. Reasons for the Proposed Action**

As described in Section I of this Release, the reason for repropoed Rule 2a-46(b) is to further address the unintended impact of the Federal Reserve Board's 1998 amendments to the definition of eligible portfolio company.

### **B. Objectives of the Proposed Action**

As described in Section II of this Release, the Commission today adopted Rule 2a-46 under the Investment Company Act, which defines eligible portfolio company to include all companies whose securities are not listed on an Exchange. Repropoed Rule 2a-46(b) would expand the definition of eligible portfolio company to include certain companies with a class of securities listed on an Exchange. These companies may need BDC financing for continued development and growth, but, notwithstanding the fact that their securities are listed on an Exchange, may find it difficult to raise additional capital in new offerings or borrow money through other conventional sources.

### **C. Small Entities Subject to the Rule**

Both Alternative One and Alternative Two of repropoed Rule 2a-46(b) would affect BDCs and companies that qualify as small entities under the Regulatory Flexibility Act. For purposes of the Regulatory Flexibility Act, a BDC is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>71</sup> As of December 2005, there were 87 BDCs, of which 66 were small entities. A company other than an investment company is a small entity under the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>72</sup> We estimate that there are approximately 2,500 companies, other than investment companies, that may be considered small entities.

As discussed in this Release, repropoed Rule 2a-46(b) is intended to benefit certain companies that need capital for continued development and growth, but may be unable to borrow money through conventional sources despite their securities being listed on an Exchange. Both Alternative One and Alternative Two of repropoed Rule 2a-46(b) would also benefit BDCs, including those that are small entities, by expanding the universe of investments that BDCs may include as part of their 70 percent basket. We have no reason to expect that those BDCs and companies that are small entities for purposes of the Regulatory Flexibility Act would be disproportionately affected by either alternative. We request comment on the effects and costs of both Alternative One and Alternative Two on small entities.

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<sup>71</sup> 17 CFR 270.0-10.

<sup>72</sup> 17 CFR 230.157; 17 CFR 240.0-10.

#### **D. Reporting, Recordkeeping and Other Compliance Requirements**

Neither Alternative One nor Alternative Two of repropoed Rule 2a-46(b) would impose any new reporting or recordkeeping requirements on BDCs or on companies. They also would impose only minimal, if any, compliance requirements on portfolio companies.

Both Alternative One and Alternative Two of repropoed Rule 2a-46(b), however, would impose minimal compliance requirements on BDCs, including small entities. It is our understanding that these costs are similar to the types of compliance costs that a BDC currently undertakes when it invests in an issuer.

Under Alternative One, a BDC, prior to investing in a company, would need to determine whether the company has a class of securities listed on an Exchange and whether that company's public float was less than \$75 million as of a date within 60 days prior to the date of the BDC's investment in the company. Public float information is not readily available through third-party sources. Section 55 of the Investment Company Act, however, generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and so we anticipate that a BDC would be able to obtain this information from the company during the course of these negotiations.

Similarly, we expect that the compliance burden imposed on BDCs, including those that are small entities, would be minimal under either the \$150 million market capitalization version of Alternative Two or the \$250 million market capitalization version of Alternative Two. Under the \$150 million market capitalization version, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was

less than \$150 million as of a date within 60 days prior to the date of the BDC's investment. Similarly, under the \$250 million market capitalization version, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was less than \$250 million as of a date within 60 days prior to the date of the BDC's investment. We expect that the compliance burden imposed on BDCs, including those that are small entities, would be slightly lower under either version of Alternative Two than it would be under Alternative One because information about the market capitalization of companies is readily available from third-party sources.

Finally, we anticipate that both Alternative One and Alternative Two of repropoed Rule 2a-46(b) would impose only minimal, if any, compliance requirements on portfolio companies, including those that are small entities.

#### **E. Duplicative, Overlapping or Conflicting Federal Rules**

There are no rules that duplicate, overlap or conflict with either Alternative One or Alternative Two of repropoed Rule 2a-46(b).

#### **F. Significant Alternatives**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (1) establishing different compliance or reporting standards that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying the compliance requirements for small entities; (3) the use of performance rather than design standards; and (4) exempting small entities from the coverage of the rules, or any part thereof.

Establishing different compliance or reporting requirements for small entities would not be appropriate under repropose Rule 2a-46(b). As discussed above, neither Alternative One nor Alternative Two would impose any reporting requirements on BDCs or on companies. In addition, neither of the alternatives would impose any compliance requirements on portfolio companies. Both Alternative One and Alternative Two of repropose Rule 2a-46(b) would, however, impose some compliance requirements on BDCs that are intended to ensure that BDCs invest primarily in certain types of companies. These requirements should, however, impose only minimal burdens on BDCs.

We believe that clarifying, consolidating or simplifying the compliance requirements for small entities under either alternative would be inappropriate. As discussed above, neither Alternative One nor Alternative Two would impose any compliance requirements on portfolio companies. Although both alternatives of repropose Rule 2a-46(b) would impose some compliance requirements on BDCs, as discussed above, these requirements, which we believe would impose minimal burdens on BDCs, are designed to ensure that BDCs would invest in companies in accordance with the proposed rule.

We believe that using performance rather than design standards would add unnecessary complexity. Both Alternative One and Alternative Two of repropose Rule 2a-46(b) provide a clear, bright-line, workable test for determining whether a company is an eligible portfolio company. A standard based on performance could be unduly complicated and cause further uncertainty to BDCs, including those that are small entities, when determining whether a company is an eligible portfolio company.

Likewise, the use of a performance standard would bring uncertainty to companies in determining whether they meet the definition of eligible portfolio company.

Finally, we believe that it would be inappropriate to exempt BDCs that are small entities from the coverage of the repropose Rule 2a-46(b). Both Alternative One and Alternative Two of repropose Rule 2a-46(b) should benefit BDCs and companies, including those that are small entities, by expanding the definition of eligible portfolio company to include certain companies whose securities are listed on an Exchange. Exempting BDCs and companies that are small entities from all or part of either proposed alternative would be contradictory to the purpose of this rulemaking.

#### **G. Solicitation of Comments**

We encourage the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by Alternative One and each version of Alternative Two and the likely impact on Alternative One and Alternative Two (both versions) on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of repropose Rule 2a-46(b) and will be reflected in the Final Regulatory Flexibility Analysis.

### **VIII. STATUTORY AUTHORITY**

We are proposing to amend Rule 2a-46 and repropose Rule 2a-46(b) pursuant to our rulemaking authority under Sections 2(a)(46)(C)(iv) and 38(a) of the Investment Company Act.

#### **List of Subjects in 17 CFR Part 270**

Investment companies, Reporting and recordkeeping requirements, Securities.

## TEXT OF PROPOSED RULES

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

### PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

2. Revise § 270.2a-46 to read as follows:

#### § 270.2a-46 Certain issuers as eligible portfolio companies.

The term eligible portfolio company shall include any issuer that meets the requirements set forth in paragraphs (A) and (B) of section 2(a)(46) of the Act (15 U.S.C. 80a-2(a)(46)(A) and (B)) and that:

- (a) Does not have any class of securities listed on a national securities exchange; or
- (b) Has a class of securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity [held by non-affiliates of less than \$75 million] [of less than \$150 million] [of less than \$250 million]. For purposes of this paragraph:

- (1) The aggregate market value of an issuer's outstanding voting and non-voting common equity shall be computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the

principal market for such common equity as of a date within 60 days prior to the date of acquisition of its securities by a business development company; and

(2) Common equity [has] [and affiliate have] the same meaning[s] as in 17 CFR 230.405.

By the Commission.

A handwritten signature in cursive script that reads "Nancy M. Morris". The signature is written in black ink and is positioned to the right of the typed name.

Nancy M. Morris  
Secretary

Date: October 25, 2006

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 270**

**[Release No. IC-27538; File No. S7-37-04]**

**RIN 3235-AJ31**

**Definition of Eligible Portfolio Company under the Investment Company Act of 1940**

**AGENCY:** Securities and Exchange Commission (the "Commission").

**ACTION:** Final rule.

**SUMMARY:** The Commission today is adopting two new rules under the Investment Company Act of 1940 ("Investment Company Act" or "Act"). The new rules more closely align the definition of eligible portfolio company, and the investment activities of business development companies ("BDCs"), with the purpose that Congress intended. The rules expand the definition of eligible portfolio company in a manner that promotes the flow of capital to certain small, developing and financially troubled companies.

**EFFECTIVE DATE:** [insert date 30 days after publication in the Federal Register].

**FOR FURTHER INFORMATION CONTACT:** Rochelle Kauffman Plesset, Senior Counsel, or Elizabeth G. Osterman, Assistant Chief Counsel, Office of Chief Counsel, (202) 551-6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5030.

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**SUPPLEMENTARY INFORMATION:** The Commission today is adopting new Rule 2a-46 [17 CFR 270.2a-46] and new Rule 55a-1 [17 CFR 270.55a-1], both under the Investment Company Act [15 U.S.C. 80a *et seq.*].<sup>1</sup>

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### **I. BACKGROUND**

In 1980, Congress enacted the Small Business Investment Incentive Act (“SBIIA”), which, among other things, established BDCs as a means of making capital more readily available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing.<sup>2</sup> Consistent with this purpose, Section 55(a) of the Investment Company Act

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<sup>1</sup> Rules 2a-46 and 55a-1 were proposed in Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 26647 (Nov. 1, 2004) [69 FR 64815 (Nov. 8, 2004)] (“2004 Proposing Release”). The Commission today also issued a release repropounding Rule 2a-46(b). Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27539 (Oct. 25, 2006).

<sup>2</sup> Pub. L. No. 96-477, 94<sup>th</sup> Stat. 2274 (1980) (codified at scattered sections of the United States Code). See generally H.R. Rep. No. 1341, 96<sup>th</sup> Cong., 2d Sess. 21 (1980) (“House Report”).

generally prohibits a BDC from acquiring any assets unless, at the time of acquisition, at least 70 percent of its total assets are invested in securities of certain specified types of companies (“70 percent basket”).<sup>3</sup> Among other things, the 70 percent basket may include securities of eligible portfolio companies purchased in transactions not involving any public offering,<sup>4</sup> securities of eligible portfolio companies already controlled by the BDC without regard to the nature of the offering,<sup>5</sup> and securities of certain financially distressed companies that do not meet the definition of eligible portfolio company and that are purchased in transactions not involving any public offering.<sup>6</sup>

The definition of eligible portfolio company is central to the restrictions of Section 55(a) and the purpose of SBIIA. Section 2(a)(46) first generally defines eligible

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<sup>3</sup> Section 55(a) of the Investment Company Act [15 U.S.C. 80a-54(a)]. See House Report at 23 (“The restrictions are designed to assure that companies electing special treatment as [BDCs] are in fact those that [SBIIA] is intended to aid – companies providing capital and assistance to small, developing or financially troubled businesses that are seeking to expand, not passive investors in large, well-established businesses.”).

Congress did not specifically regulate how a BDC should invest the remainder of its assets (“30% basket”). See *id.* at 31, 38-40. Congress clarified, however, that a BDC would be required to invest its 30% basket in a manner consistent with the overall purpose of SBIIA. *Id.* at 39-40 (“One such purpose would be to allow an investment . . . in a publicly-held company whose success may be stimulated or revived by the infusion of new capital or managerial assistance. A second purpose might be to recognize the need for [BDCs] . . . to have a source of cash flow to fund current operations or to meet contingencies which may arise.”).

<sup>4</sup> See Section 55(a)(1) of the Investment Company Act. See also Section 2(a)(46) of the Investment Company Act [15 U.S.C. 80a-2(a)(46)] (statutory definition of eligible portfolio company).

<sup>5</sup> See Section 55(a)(2) of the Investment Company Act, referring to companies with respect to which the BDC satisfies the requirements of Section 2(a)(46)(C)(ii) of the Act. Section 2(a)(46)(C)(ii) provides that a company that meets the initial requirements set forth in Sections 2(a)(46)(A) and (B) is an eligible portfolio company if “it is controlled by a [BDC], either alone, or as part of a group acting together, and such [BDC] in fact exercises a controlling influence over the management or policies of such eligible portfolio company and, as a result of such control, has an affiliated person who is a director of such eligible portfolio company.”

<sup>6</sup> See Section 55(a)(3) of the Investment Company Act (includes, among others, companies that have filed for bankruptcy). In addition, a BDC generally may purchase the securities of an eligible portfolio company from any person in a non-public offering if there is no ready market for the securities and, immediately before the purchase, the BDC owns at least 60% of the issuer’s outstanding equity securities. Section 55(a)(4) of the Investment Company Act. BDCs may also invest in securities received in exchange for, or distributed on or with respect to, the securities described in paragraphs (1) through (4) of Section 55(a) or pursuant to the exercise of options, warrants or other rights relating to these securities and in cash and certain short-term securities. Sections 55(a)(5) and (6) of the Investment Company Act.

portfolio company to include only domestic companies that are not investment companies under the Investment Company Act (“domestic operating companies”).<sup>7</sup> Section 2(a)(46)(C) further defines eligible portfolio company under three categories. Many BDCs invest in companies that historically met the criteria of Section 2(a)(46)(C)(i).<sup>8</sup> Under Section 2(a)(46)(C)(i), an eligible portfolio company includes any company that does not have any class of securities with respect to which a member of a national securities exchange, broker or dealer may extend or maintain margin credit pursuant to the rules or regulations adopted by the Federal Reserve Board under Section 7 of the Securities Exchange Act of 1934 (“Exchange Act”). At the time that Section 2(a)(46) was adopted, Congress generally perceived the Federal Reserve Board’s definition of “margin security” to be a “rational and objective test” that could be used to determine whether a company has ready access to the public capital markets or other sources of financing.<sup>9</sup> Nevertheless, Congress recognized that the definition’s reliance on the Federal Reserve Board’s margin rules might need to be adjusted in the future. Accordingly, Congress specifically gave the Commission rulemaking authority under

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<sup>7</sup> See House Report at 29. Sections 2(a)(46)(A) of the Investment Company Act defines eligible portfolio company to include (among other things) companies organized under the laws of, and with their principal business in, one or more states of the United States. Section 2(a)(46)(B) of the Investment Company Act generally excludes from the definition of eligible portfolio company any company that meets the definition of investment company under Section 3 of the Investment Company Act, or that is excluded from the definition of investment company by Section 3(c) of the Act, but includes as an eligible portfolio company any small BDC that is licensed by the Small Business Administration and that is a wholly-owned subsidiary of a BDC.

<sup>8</sup> In addition to Section 2(a)(46)(C)(i), discussed *infra*, Section 2(a)(46)(C)(ii) includes in the definition of eligible portfolio company any issuer in which the BDC or certain affiliates own a controlling interest, *see supra* note 5, and Section 2(a)(46)(C)(iii), enacted in 1996, includes in the definition any issuer that has total assets of not more than \$4 million, and capital and surplus (shareholder equity minus retained earnings) of not less than \$2 million.

<sup>9</sup> See House Report at 30-31.

Section 2(a)(46)(C)(iv) of the Investment Company Act to expand the definition of eligible portfolio company.<sup>10</sup>

Since 1980, the Federal Reserve Board has periodically amended its definition of margin security to increase the types of securities that would fall within that definition under its rules. In 1998, for reasons unrelated to small business capital formation, the Federal Reserve Board adopted amendments to those rules that had the unintended consequence of reducing the number of companies that meet the definition of eligible portfolio company by expanding the definition of margin security to include all publicly traded equity securities and most debt securities.<sup>11</sup>

On November 1, 2004, we proposed for comment Rules 2a-46 and 55a-1 under the Investment Company Act.<sup>12</sup> The proposed rules were designed to address the impact of the Federal Reserve Board's 1998 amendments on the definition of eligible portfolio company by realigning that definition, and the investment activities of BDCs, with the purpose of SBIIA.

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<sup>10</sup> House Report at 31. Under Section 2(a)(46)(C)(iv), the term eligible portfolio company includes any issuer that, in addition to meeting the requirements of Sections 2(a)(46)(A) and (B), "meets such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of [the Act]." See House Report at 23 ("... the Commission is given rulemaking authority to expand the class of eligible portfolio companies, following certain specific standards."). The legislative history also makes clear that the intent of this provision "is to enable the Commission through the administrative process to broaden, if appropriate, the category of eligible portfolio company." While stating that BDCs "already have substantial freedom of action to purchase securities of companies which are not eligible portfolio companies," referring to the 30% basket, Congress also noted its expectation that "the Commission would institute [rulemaking] proceedings to consider whether the definition of eligible portfolio company can be expanded, consistent with the purpose of the legislation, to increase the flow of capital to small, developing businesses or financially troubled businesses. Among the objective factors which the Commission may consider in such proceedings are the size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies."). See House Report at 31.

<sup>11</sup> See 2004 Proposing Release, supra note 1 at nn.19-23 and accompanying text.

<sup>12</sup> Id.

Generally, proposed Rule 2a-46 would have defined eligible portfolio company in one of two ways. Proposed Rule 2a-46(a) would have defined eligible portfolio company to include any domestic operating company<sup>13</sup> that does not have any class of securities listed on a national securities exchange (“Exchange”).<sup>14</sup> Proposed Rule 2a-46(b) would have defined eligible portfolio company to include any domestic operating company that has a class of securities listed on an Exchange but (1) has received notice that its securities will be delisted and (2) is not eligible to list its securities on any Exchange. Proposed Rule 55a-1 would have conditionally permitted a BDC to include in its 70 percent basket follow-on investments in any company that was an eligible portfolio company as defined by proposed Rule 2a-46 at the time of the BDC’s initial investment(s) in it, but no longer met that definition.

## II. DISCUSSION

We received thirty-six comment letters that addressed the proposed rules.<sup>15</sup> Commenters generally agreed that Commission rulemaking is appropriate at this time. Virtually all commenters supported proposed Rule 55a-1, and most commenters agreed with the definition of eligible portfolio company set forth in proposed Rule 2a-46(a). Some commenters, however, were concerned that proposed Rule 2a-46(b) would not include many of the small public companies whose securities are listed on an Exchange

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<sup>13</sup> The proposed rule incorporated the provisions of Section 2(a)(46)(A) and (B). See *supra* note 7.

<sup>14</sup> The rule as proposed also would have defined eligible portfolio company to include any domestic operating company that does not have any class of securities listed on an automated interdealer quotation system of a national securities association (*i.e.*, The NASDAQ Stock Market LLC (“Nasdaq”). On August 1, 2006, Nasdaq began operating as a national securities exchange registered under Section 6(a) of the Exchange Act.

<sup>15</sup> Commenters included members of Congress, BDCs, law firms, trade associations and small businesses that had received financing from a BDC. The comment letters are available for inspection in the Commission’s Public Reference Room at 100 F Street, NE, Washington, DC 20549 (File No. S7-37-04). They also may be viewed at <http://www.sec.gov/rules/proposed/ic-26647.htm>.

that historically would have met the definition of eligible portfolio company before the margin rule amendments. In addition, some commenters argued that some small companies that list their securities on an Exchange may not fall within the definition set forth in proposed Rule 2a-46(b), but nevertheless may have difficulties accessing conventional sources of capital and raising capital on the public capital markets. These commenters argued that these companies should qualify as eligible portfolio companies under the rule.<sup>16</sup> Commenters also generally stated that proposed Rule 2a-46(b) was unworkable.<sup>17</sup>

After considering the comments received, the Commission today is adopting Rule 2a-46, initially proposed as Rule 2a-46(a), to define “eligible portfolio company” to include all private companies and all public companies whose securities are not listed on an Exchange. We estimate that, based on June 2006 data, 61.4 percent (6,041/9,845) of all public domestic operating companies qualify as eligible portfolio companies under Rule 2a-46.

We are not, however, adopting proposed paragraph (b). We are sensitive to some commenters’ concerns that the proposed rule was too narrow. Accordingly, we are seeking comment on repropoed Rule 2a-46(b) in a separate release.<sup>18</sup>

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<sup>16</sup> See, e.g., comments of UTEK (Jan. 7, 2005); comments of Gladstone Capital (Jan. 6, 2005); comments of Thompson & Knight (Jan. 4, 2005). But see comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005) (supporting proposal in full); comments of the Investment Company Institute (Jan. 6, 2005) (supporting proposal in full). A few commenters also argued that the proposed rule may harm BDC shareholders because it would increase the risk profile of a BDC. See, e.g., comments of Allied Capital (Jan. 7, 2005). We discuss this comment below. See infra notes 24-25 and accompanying text.

<sup>17</sup> See, e.g., comments of Sherman & Sterling LLP (Jan. 7, 2005).

<sup>18</sup> See supra note 1.

We also are adopting Rule 55a-1 today.<sup>19</sup> That rule conditionally allows BDCs to make follow-on investments in companies that met the definition of eligible portfolio company under Rule 2a-46 at the time of a BDC's initial investment(s) in them, but that do not meet that definition at the time of the BDC's follow-on investment.

We discuss the rules that we are adopting today in greater detail below.

**A. Rule 2a-46**

Rule 2a-46 defines eligible portfolio company to include all private domestic operating companies<sup>20</sup> and those public domestic operating companies whose securities are not listed on an Exchange.<sup>21</sup> Public domestic operating companies whose securities are quoted on the over-the-counter bulletin board ("OTCBB") and through Pink Sheets LLC ("Pink Sheets") are not listed on an Exchange, and therefore are eligible portfolio companies under this provision.

Rule 2a-46 in our view provides a workable and appropriate test for determining whether a company is an eligible portfolio company. The rule more closely aligns the definition of eligible portfolio company with the purpose of SBIIA by including many of the types of companies that Congress originally intended to benefit from BDC financing that may have lost their eligible portfolio company status because of the change in the margin rules. Rule 2a-46 is consistent with the public interest, the protection of investors

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<sup>19</sup> Rule 55a-1 as adopted has been modified from the proposed rule merely to refer to Rule 2a-46 as adopted, rather than reciting the definition of eligible portfolio company set forth in Rule 2a-46.

<sup>20</sup> Like Section 2(a)(46) and the proposed rule, Rule 2a-46 defines eligible portfolio company to include only domestic operating companies. See supra notes 7 and 13 and accompanying text.

<sup>21</sup> Under this provision, an issuer would be an eligible portfolio company if it does not have a class of securities listed on a national securities exchange registered under Section 6(a) of the Exchange Act, [15 U.S.C. 78f(a)] such as the New York Stock Exchange ("NYSE"), the American Stock Exchange ("Amex"), and Nasdaq. See supra note 14.

and the purposes fairly intended by the policy and provisions of the Investment Company Act.<sup>22</sup>

Most commenters supported proposed Rule 2a-46(a), and agreed that this approach would establish a clear, workable standard that correlates to whether a company has access to publicly raised capital.<sup>23</sup> A few commenters, however, raised a concern that this provision, when coupled with the definition set forth in proposed paragraph (b), would cause BDCs to focus their investment activities on companies that are in financial distress because of their view that most public companies that are quoted on the OTCBB or through Pink Sheets are financially troubled.<sup>24</sup>

Rule 2a-46 does not require BDCs to focus their investment activities in financially troubled companies whose securities are traded on the OTCBB or through Pink Sheets. Although some companies have their shares traded on the OTCBB or through Pink Sheets because of financial circumstances, this is not true for all companies whose securities are traded on these quotation mediums. Rather, OTCBB and Pink

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<sup>22</sup> See *supra* note 10.

<sup>23</sup> See, e.g., comments of American Capital Strategies Ltd. (Jan. 7, 2004); comments of Sherman & Sterling LLP (Jan. 7, 2005). We note that the House of Representatives has passed legislation that in part defines eligible portfolio company in a manner similar to the definition that we are adopting today. See H.R. 436, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2005) (an eligible portfolio company includes any company that “does not have any class of equity securities listed for trading on a national securities exchange or traded through the facilities of a national securities association as described in Section 15A of the Securities Exchange Act of 1934”). S. 1396, which is identical to H.R. 436, was introduced in the Senate on July 14, 2005. S. 1396, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2005). Both H.R. 436 and S. 1396 are currently pending before the Senate Committee on Banking, Housing and Urban Affairs.

<sup>24</sup> Comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005). Some commenters also raised the concern that the proposed rule would harm BDC shareholders by raising BDCs’ risk profiles. Rule 2a-46, however, is intended to address the inadvertent reduction in the number of companies that qualify under Section 2(a)(46) by the amendment to the margin rules. The rule does not alter the statutory mandate or requires a BDC to invest in any particular company. Further, Congress addressed investor protection concerns with respect to BDC shareholders in 1980. See House Report at 22 (explaining that SBIIA “is intended to preserve to the fullest possible extent . . . [investor] protections, while at the same time reducing unnecessary regulatory burdens.”). In this regard, the federal securities laws require, among other things, BDCs to disclose to their shareholders the risks associated with investment and to manage their business consistent with their fiduciary obligations.

Sheets companies also include small public companies that do not meet the minimum listing standards of one of the Exchanges, and companies that wish to become more developed before applying to list their securities on an Exchange even though they may already be eligible to do so.<sup>25</sup> In other words, although companies whose securities are traded on the OTCBB and through Pink Sheets include financially troubled companies, they also include small, developing, financially stable public companies. Thus, we believe that including companies that are traded on the OTCBB or through Pink Sheets as eligible portfolio companies under Rule 2a-46 will not require BDCs to change their investment strategies to focus on financially troubled companies. Instead, the rule is designed to more closely align the definition with the purpose of SBIIA.

We note that OTCBB and Pink Sheets companies also include a few large companies that do not list their securities on an Exchange even though they may meet applicable listing requirements. With this in mind, we had asked in the Proposing Release whether we should exclude from the definition of eligible portfolio company any company that would meet the lowest initial quantitative listing standard of any Exchange, regardless of whether the company enters into a listing agreement with the Exchange. Commenters, however, argued that a company that may meet the lowest initial quantitative listing of any Exchange may nevertheless not have access to the public capital markets.<sup>26</sup> These comments have persuaded us not to adopt this approach.

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<sup>25</sup> See "A Little About The Pink Sheets" at [www.PennyMarkets.com](http://www.PennyMarkets.com). See also Testimony of James A. Connolly III representing the CEO Council before the Subcommittee of Oversight and Investigations of the House Committee on Financial Services (Sept. 23, 2004) (the OTCBB and Pink Sheet companies are "engines of economic growth, job creation and innovation." Our market space of 7000 companies includes hundreds of millions of dollars in market capitalization, tens of thousands of employees, and likely hundreds of thousands of stockholders.").

<sup>26</sup> See comments of Thompson & Knight (Jan. 4, 2005); comments of American Capital Strategies (Jan. 7, 2006).

## **B. Rule 55a-1**

Proposed Rule 55a-1, which virtually all commenters supported, is adopted.<sup>27</sup>

As adopted, Rule 55a-1 permits a BDC to include in its 70 percent basket follow-on investments in a company that met the definition of eligible portfolio company under Rule 2a-46 at the time of the BDC's initial investment(s) in the company, but subsequently would not meet the definition of eligible portfolio company because the company no longer meets the requirements of that rule (i.e., following the BDC's initial investment(s) in the company, the company listed its securities on an Exchange), subject to certain conditions. These conditions permit a BDC to make a follow-on investment only if the BDC, at the time of the follow-on investment: (1) owns at least 50 percent of (a) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities, and (b) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company; and (2) is one of the twenty largest holders of record of the company's outstanding voting securities.<sup>28</sup> Rule 55a-1 is appropriate in the public interest and consistent with the protection of investors and the purposes and policies fairly intended by the policy and provisions of the Act.

## **III. COST-BENEFIT ANALYSIS**

We are sensitive to the costs and benefits that result from our rules. In the Proposing Release we requested public comment and specific data regarding the costs

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<sup>27</sup> See *supra* note 19.

<sup>28</sup> The rule incorporates the conditions set forth in Section 55(a)(1)(B), the section that permits a BDC to make follow-on investments in a company that was an eligible portfolio company at the time of the BDC's initial investment(s), but that subsequently lost its status as an eligible portfolio company because it issued margin securities.

and benefits of the proposed rules. Several commenters suggested that proposed Rule 2a-46(a) would benefit BDCs by addressing the impact caused by changes in the margin rules.<sup>29</sup> Another commenter argued that the Commission calculated incorrectly the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated.<sup>30</sup> We received no comments on the costs and benefits of proposed Rule 55a-1.

**A. Benefits**

Rules 2a-46 and 55a-1 would more closely align the definition of eligible portfolio company with the purpose that Congress intended when it established BDCs as a source of financing for certain types of companies. These companies often need capital for continued development and growth, but may be unable to borrow money through conventional sources or may not have ready access to the public capital markets. Rules 2a-46 and 55a-1 would also benefit BDCs by recapturing companies that Congress originally intended to make eligible for BDC investment as part of a BDC's 70 percent basket.

A number of companies may have lost their eligible portfolio company status as a result of amendments to the Federal Reserve Board's margin rules. BDCs may be currently required to include in their 30 percent basket - rather than in their 70 percent basket - any investment in these companies, notwithstanding the fact that they may be the type of companies that Congress intended to benefit from BDC financing.

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<sup>29</sup> See, e.g., comment of American Capital Strategies (Jan. 7, 2005); comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005).

<sup>30</sup> Comments of Williams & Jensen (Jan. 7, 2005). In addition, most commenters urged the Commission to modify the proposed rule to capture more small companies whose securities are listed on an Exchange. The Commission is reproposing Rule 2a-46(b) to address this concern. See *supra* note 1.

Rule 2a-46 defines an eligible portfolio company to include all private companies and those public companies whose securities are not listed on an Exchange. The Commission's Office of Economic Analysis ("OEA") estimates that, as of June 2006, there were a total number of 6,041 domestic operating companies with securities that were traded on the OTCBB and through Pink Sheets, and therefore would qualify as eligible portfolio companies under the rule. OEA reached this conclusion by first calculating the number of companies whose securities are trading on the OTCBB (3,295 companies) and through Pink Sheets (4,794 companies), and then removing from these figures estimates of all foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c) of the Investment Company Act (e.g., REITS, banks, insurance companies) because both Section 2(a)(46) of the Investment Company Act and Rule 2a-46 exclude these types of companies from the definition of eligible portfolio company (a deduction of 776 companies from OTCBB and 1,273 companies from Pink Sheets). OEA thus concluded that, as of June 2006, there were a total of 6,041 domestic operating companies (2,519 OTCBB companies and 3,522 Pink Sheets companies) that would qualify as eligible portfolio companies. OEA estimates that these 6,041 companies represent approximately 61.4 percent ( $6,041/9,845^{31}$ ) of all public domestic operating companies that could qualify as eligible portfolio companies under Rule 2a-46.

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<sup>31</sup> OEA concluded that, as of June 2006, there were 9,845 public domestic operating companies by calculating the number of companies whose securities are listed on Nasdaq, NYSE and Amex, in addition to those companies whose securities are trading on the OTCBB and through Pink Sheets, corrected for cases where individual companies had multiple classes of securities listed (60 companies), and then removing from this number foreign companies, investment companies, and companies that are excluded from the definition of investment company by Section 3(c). See Sections 2(a)(46)(A) and (B), *supra* note 7.

In the Proposing Release, we explained that OEA estimated that 60 percent of public domestic operating companies do not have securities that trade on an Exchange, and thus would meet the definition of eligible portfolio company under proposed Rule 2a-46(a). We further explained that even more public companies should qualify as eligible portfolio companies by virtue of meeting the requirements of proposed paragraph (b) of that rule (which, as noted previously, is being repropose<sup>32</sup>).

We note that one commenter argued that the Commission calculated incorrectly the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated. The commenter argued that proposed Rule 2a-46(a) (which we are adopting today as Rule 2a-46) would capture only 52.4 percent of public companies.<sup>33</sup>

The commenter's figure is lower than the figure calculated by OEA. It appears that the commenter did not remove from its data foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c). As discussed previously, because Section 2(a)(46) excludes these companies from the definition of eligible portfolio company, we believe that they should be excluded from the total number of companies trading on U.S. markets when quantifying the benefits of the rule.

Rule 55a-1 provides additional benefits to certain companies that met the definition of eligible portfolio company under Rule 2a-46 at the time of the BDC's initial investment(s) in them but that subsequently lost their eligible portfolio company status

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<sup>32</sup> See 2004 Proposing Release, supra note 1 at n.49 and accompanying text.

<sup>33</sup> Comments of Williams & Jensen (Jan. 7, 2005).

under Rule 2a-46, by allowing BDCs to make follow-on investments in such companies under certain conditions.

Finally, we note that both Rule 2a-46 and Rule 55a-1 would benefit BDCs by expanding the universe of investments that may be included in their 70 percent baskets. It also benefits BDCs by addressing the uncertainty caused by changes in the margin rules in the operation of BDCs. As one commenter noted, a “technical flaw” in the definition of eligible portfolio company arose as a result of changes to the margin rules which imposed substantial constraints on BDC investments. The commenter expressed its view that proposed Rule 2a-46(a) had corrected this flaw.<sup>34</sup>

#### **B. Costs**

While Rules 2a-46 and 55a-1 might impose certain administrative compliance costs on BDCs, we expect such costs to be minimal and commenters provided no data as requested in the 2004 Proposing Release. Under Rule 2a-46, a BDC would need to determine, prior to investing in a company, whether the company has a class of securities listed on an Exchange. Such information is easily obtainable through reliable third-party sources. Furthermore, Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions. Thus, this information would also be readily available to a BDC from the company during the course of these negotiations.

We also expect that a BDC’s costs relating to the requirements of Rule 55a-1 will be minimal. Rule 55a-1 permits a BDC to include in its 70 percent basket follow-on investments in a company that met the definition of eligible portfolio company under

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<sup>34</sup> See, e.g., comment of American Capital Strategies (Jan. 7, 2005). See also comments of Capital Southwest Corp. (Dec. 28, 2004).

Rule 2a-46 when the BDC made its initial investment(s), but that does not meet that definition at the time of the follow-on investment. A BDC generally may make follow-on investments under the rule only if, at the time of the follow-on investment, the BDC owns at least 50 percent of (1) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company. In addition, the rule requires a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the company's outstanding voting securities at the time of that investment.

These requirements mirror the requirements set forth in Section 55(a)(1)(B) of the Investment Company Act, the provision that permits a BDC to include in its 70 percent basket certain follow-on investments in companies that were eligible portfolio companies at the time of the BDC's initial investment(s), but that subsequently lost that status because they issued marginable securities. Accordingly, BDCs already make similar types of determinations when considering whether to make follow-on investments in a company that had lost their eligible portfolio company status because they had issued marginable securities. We anticipate that the rule will impose only minimal, if any, costs on companies.

#### **IV. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION**

Section 2(c) of the Investment Company Act mandates that the Commission, when engaging in rulemaking that requires it 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.<sup>35</sup> In the Proposing Release, we requested comment on our analysis of the impact of the proposed rules on efficiency, competition and capital formation. Although we did not receive any comments that specifically addressed proposed Rule 2a-46(a), which is the provision that we are adopting today, we did receive comments about the entire rule.

Specifically, some commenters argued that proposed Rule 2a-46 was too narrow and did not capture all of the very small public companies that could benefit from BDC financing.<sup>36</sup> We interpreted this comment to suggest that capital formation may have been limited under the proposed rule. We are sensitive to this concern and therefore are seeking comment on repropose Rule 2a-46(b) in a separate release.<sup>37</sup>

Some commenters also expressed a concern that proposed Rule 2a-46(a), when coupled with the definition set forth in proposed paragraph (b), would cause BDCs to focus their investment activities on companies that are in financial distress because of their view that most public companies that are quoted on the OTCBB or through Pink Sheets are financially troubled.<sup>38</sup> We interpret this comment to suggest that the rule does not promote efficiency and would impede capital formation. Rule 2a-46 as adopted, however, does not require BDCs to focus their investment activities in financially troubled companies. Rather, Rule 2a-46 allows BDCs to invest in all companies whose securities are traded on the OTCBB and through Pink Sheets, including small,

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<sup>35</sup> 15 U.S.C. 80a-2(c).

<sup>36</sup> See supra note 16 and accompanying text.

<sup>37</sup> See supra note 1.

<sup>38</sup> See supra note 24 and accompanying text.

developing, financially stable public companies, which are among the types of companies that Congress intended to benefit from BDC financing.<sup>39</sup>

As discussed, the new rules more closely align the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose that Congress intended. Rule 2a-46 defines eligible portfolio company to include all private companies and approximately 61.4 percent of public domestic operating companies. Rule 55a-1 permits a BDC to include in its 70 percent basket follow-on investments in a company that met the definition of eligible portfolio company under Rule 2a-46 when the BDC made its initial investment(s), but that does not meet that definition at the time of the follow-on investment. Both rules will promote efficiency, competition and capital formation.

Specifically, both rules promote efficiency by more closely aligning the definition of eligible portfolio company with the purpose of SBIIA. To the extent that BDC investments represent additional capital to certain small companies, these rules enhance efficiency. Efficiency will be enhanced because the rules address the unintended adverse impact that the amendments to the margin rules have had on the ability of BDCs to provide financing to these companies. Rule 2a-46 in our view also promotes efficiency by providing a workable and appropriate test for determining whether a company is an eligible portfolio company. Rule 55a-1 will further enhance efficiency by making it easier for BDCs to make follow-on investments in companies that no longer meet the definition of eligible portfolio company under Rule 2a-46.

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<sup>39</sup> See *supra* note 25 and accompanying text.

We also anticipate that these rules will promote competition. The market for private equity and debt investments can be highly competitive. Since their establishment, BDCs have competed with various sources of capital, including private equity funds, hedge funds, investment banks and other BDCs, to provide financing to certain small businesses. We expect that the rules will encourage competition by addressing the impact and uncertainty caused by changes in the margin rules on BDC investment. Under the rules, BDCs will be able to compete with other entities that provide capital to small, developing and financially troubled companies in a manner that is consistent with the statutory requirement that at least 70 percent of a BDC's assets must be invested in those businesses at the time of any new investment. We further note that shareholders of companies that had lost their status as eligible portfolio companies will benefit under the rules because such companies may now more readily consider BDCs as a source of financing.

Finally, we anticipate that the new rules will promote capital formation. As mentioned above, eligible portfolio company is broadly defined to include all private companies and a significant portion of public domestic operating companies. The definition, however, is designed to ensure that the investment activities of BDCs remain focused primarily on the types of companies that Congress intended BDCs to assist.

#### **V. PAPERWORK REDUCTION ACT**

The Commission has determined that these rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act [44 U.S.C. 3501 et seq.].

## VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 604, which relates to new Rules 2a-46 and 55a-1 under the Investment Company Act. An Initial Regulatory Flexibility Analysis (“IRFA”) was prepared in accordance with 5 U.S.C. 603 and was published in the Proposing Release.<sup>40</sup>

### A. Reasons and Objectives of the New Rules

As described more fully in Sections I. and II. of this Release, the objectives of the new rules are to more closely align the definition of eligible portfolio company set forth under the Investment Company Act, and the investment activities of BDCs, with the purpose intended by Congress when it established BDCs in 1980. The rules are designed to recapture in the definition of eligible portfolio company companies that Congress originally intended to include within the definition, but that may have lost their eligible portfolio company status as a result of the 1998 amendment to the Federal Reserve Board’s margin rules.

### B. Significant Issues Raised by Public Comment

When the Commission proposed the rules that are being adopted today, comment was requested on the proposal and the accompanying IRFA. We received thirty-six comment letters that addressed the proposed rules. As discussed, some commenters believed that proposed Rule 2a-46 was too narrow and did not include some small public companies that can benefit from BDC financing. In a separate release, we are seeking comment on repropounded Rule 2a-46(b), which would address this concern. None of the comment letters, however, specifically addressed the IRFA.

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<sup>40</sup> 2004 Proposing Release, *supra* note 1 at Section VII.

### C. Small Entities Subject to the Rule

Rules 2a-46 and 55a-1 affect both BDCs and companies that qualify as small entities under the Regulatory Flexibility Act. For purposes of the Regulatory Flexibility Act, a BDC is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>41</sup> As of December 2005, there were 87 BDCs, of which 66 were small entities. A company other than an investment company is a small entity under the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>42</sup> We estimate that there are approximately 2,500 companies, other than investment companies, that may be considered small entities under the Regulatory Flexibility Act.

As discussed in this Release, the rules are intended to more closely align the definition of eligible portfolio company with the purpose that Congress intended when it established BDCs as a source of financing for certain small companies. These companies often need capital for continued development and growth, but may be unable to borrow money through conventional sources or may not have ready access to the public capital markets. The rules would also benefit BDCs, including those that are small entities, by recapturing the types of companies that Congress originally intended to make eligible for BDC investment as part of a BDC's 70 percent basket. We have no reason to expect that those BDCs and companies that are small entities for purposes of the Regulatory Flexibility Act will be disproportionately affected by the rules.

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<sup>41</sup> 17 CFR 270.0-10.

<sup>42</sup> 17 CFR 230.157; 17 CFR 240.0-10.

#### **D. Reporting, Recordkeeping and Other Compliance Requirements**

The rules do not impose any new reporting or recordkeeping requirements on BDCs or on companies. The rules also do not impose any compliance requirements on companies. They do, however, impose minimal compliance requirements on all BDCs, including small entities. Under Rule 2a-46, a BDC, prior to investing in a company, would need to determine whether the company has a class of securities listed on an Exchange. This information is readily available, and we believe that all BDCs, including those that are small entities, already evaluate similar types of information when considering whether to invest in a company.

Rule 55a-1 permits a BDC to include in its 70 percent basket follow-on investments in a company that met the definition of eligible portfolio company under Rule 2a-46 when the BDC made its initial investment(s), but that does not meet that definition at the time of the follow-on investment. A BDC generally may make follow-on investments under the rule only if, at the time of the follow-on investment, the BDC owns at least 50 percent of (1) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company. In addition, the rule requires a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the company's outstanding voting securities at the time of investment. These requirements are the same requirements set forth in Section 55(a)(1)(B) of the Investment Company Act, the provision that permits a BDC to include in its 70 percent basket certain follow-on investments in companies that were eligible

portfolio companies at the time of the BDC's initial investment(s), but that subsequently lost that status because they issued marginable securities. Accordingly, BDCs, including those that are small entities, already make similar types of determinations when considering whether to make follow-on investments in companies that had lost their eligible portfolio company status because they had issued marginable securities.

**E. Commission Action to Minimize Adverse Impact on Small Entities**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (1) establishing different compliance or reporting standards that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying the compliance requirements under the proposed rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

Establishing different compliance or reporting requirements for small entities would not be appropriate. As discussed above, the rules do not impose any reporting requirements on BDCs or on companies. In addition, the rules do not impose any compliance requirements on companies. Both Rules 2a-46 and 55a-1, however, do impose some compliance requirements on BDCs that are intended to ensure that BDCs invest primarily in those companies that Congress intended them to invest in when it established BDCs in 1980. These requirements should, however, impose minimum burdens on BDCs. We note that Rule 2a-46 as adopted does not include proposed

paragraph (b) in part because of commenters' concerns that the conditions of that provision are unworkable and burdensome.

We also believe that clarifying, consolidating, or simplifying the compliance requirements under the rules for small entities is inappropriate. As discussed above, neither rule imposes any compliance requirements on companies. Although the rules do impose some compliance requirements on BDCs, as discussed above, these requirements, which we believe will impose minimal burdens on BDCs, are designed to insure that BDCs invest primarily in those companies that Congress intended them to invest in when it established BDCs in 1980.

We believe that the use of performance rather than design standards would add unnecessary complexity. The rules are intended to address the impact and the uncertainty as a result of the 1998 amendment to the Federal Reserve Board's margin rules by providing a clear, bright-line, workable test for determining whether a company is an eligible portfolio company. A standard based on performance could be unduly complicated and cause further uncertainty to BDCs, including those that are small entities, when determining whether a company is an eligible portfolio company. Likewise, the use of a performance standard would bring uncertainty to companies, including those that are small entities, in determining whether they meet the definition of eligible portfolio company.

Finally, we believe that it would be inappropriate to exempt small entities from the coverage of the rules. The rules are intended to benefit BDCs and certain companies that qualify as eligible portfolio companies, including those BDCs and other companies that are small entities. These eligible portfolio companies often need capital for

continued development and growth. Exempting small entities from all or part of the rules would be contradictory to the purpose of the rules.

## VII. STATUTORY AUTHORITY

We are adopting Rules 2a-46 and 55a-1 pursuant to our rulemaking authority under Sections 2(a)(46)(C)(iv), 6(c) and 38(a) of the Investment Company Act.

### List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

## TEXT OF RULES

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

### PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

2. Section 270.2a-46 is added to read as follows:

#### § 270.2a-46 Certain issuers as eligible portfolio companies.

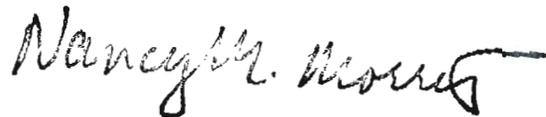
The term eligible portfolio company shall include any issuer that meets the requirements set forth in paragraphs (A) and (B) of section 2(a)(46) of the Act (15 U.S.C. 80a-2(a)(46)(A) and (B)) and that does not have any class of securities listed on a national securities exchange.

3. Section 270.55a-1 is added to read as follows:

**§ 270.55a-1 Investment activities of business development companies.**

Notwithstanding section 55(a) of the Act (15 U.S.C. 80a-54(a)), a business development company may acquire securities purchased in transactions not involving any public offering from an issuer, or from any person who is an officer or employee of the issuer, if the issuer meets the requirements of sections 2(a)(46)(A) and (B) of the Act (15 U.S.C. 80a-2(a)(46)(A) and (B)), but the issuer is not an eligible portfolio company because it does not meet the requirements of §270.2a-46, and the business development company meets the requirements of paragraphs (i) and (ii) of section 55(a)(1)(B) of the Act (15 U.S.C. 80a-54(a)(1)(B)(i) and (ii)).

By the Commission.



Nancy M. Morris  
Secretary

Date: October 25, 2006

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. IA- 2564]

**Approval of Investment Adviser Registration Depository Filing Fees**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Order.

**SUMMARY:** The Securities and Exchange Commission (Commission or SEC) is, for two years, waiving Investment Adviser Registration Depository (IARD) annual and initial filing fees for all advisers.

**EFFECTIVE DATE:** The order will become effective on November 1, 2006.

**FOR FURTHER INFORMATION CONTACT:** Jennifer L. Sawin, Assistant Director, at 202-551-6787, Daniel S. Kahl, Branch Chief, at 202-551-6730, or [Iarules@sec.gov](mailto:Iarules@sec.gov), Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-5041.

**DISCUSSION:**

Section 204(b) of the Investment Advisers Act of 1940 (Advisers Act) authorizes us to require investment advisers to file applications and other documents through an entity designated by the Commission, and to pay reasonable costs associated with such filings.<sup>1</sup> In 2000, we designated the NASD as the IARD system operator and approved filing fees,<sup>2</sup> and later required advisers registered or registering with us to file Form ADV

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<sup>1</sup> 15 U.S.C. 80b-4(b). Prior to enactment in 2006 of the Military Personnel Financial Services Protection Act, Public L. No: 109-290, \_\_\_ Stat. \_\_\_ (Sept. 29, 2006), this provision appeared in section 203A(d) of the Advisers Act.

<sup>2</sup> Designation of NASD Regulation, Inc., to Establish and Maintain the Investment Adviser Registration Depository; Approval of IARD Fees, Investment Advisers Act Release No.

through the IARD.<sup>3</sup> Nearly 10,700 advisers now use the IARD to register with us and make state notice filings electronically through the Internet.

Last year, following discussions among Commission staff, representatives of the North American Securities Administrators Association, Inc. (NASAA) on behalf of the state securities authorities,<sup>4</sup> and NASD, NASD wrote our staff a letter recommending that the annual IARD fee for SEC-registered advisers be waived for a one-year period from November 1, 2005 to October 31, 2006.<sup>5</sup>

We concluded that a one-year waiver of IARD annual filing fees for SEC-registered advisers was appropriate and the one-year waiver period began on November 1, 2005.<sup>6</sup> Advisers registered with us pay these annual fees when they file their annual updating amendment to Form ADV, due within 90 days of their fiscal year end.<sup>7</sup> We made this determination because IARD filing fee revenues from advisers registering or registered with the SEC (SEC-associated IARD revenues) had exceeded projections made in 2000 when the fee schedule was approved, while IARD expenses associated with SEC

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1888 (July 28, 2000) [65 FR 47807 (Aug. 3, 2000)]. In 2003, NASD Regulation, Inc. advised the SEC that it would be operating under the name "NASD."

<sup>3</sup> Electronic Filing by Investment Advisers; Amendments to Form ADV, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)].

<sup>4</sup> The IARD system is used by both advisers registering or registered with the SEC and advisers registered or registering with one or more state securities authorities. NASAA represents the state securities administrators in setting IARD filing fees for state-registered advisers.

<sup>5</sup> A copy of NASD's letter is available on our Web site at <http://www.sec.gov/rules/other/nasdlet090905.pdf>.

<sup>6</sup> Approval of Investment Adviser Registration Depository Filing Fees, Investment Advisers Act Release No. 2439 (Oct. 7, 2005) [70 FR 59789 (Oct. 13, 2005)]. We will address on-going IARD fee levels at a later date, but do not believe it is appropriate to address fee levels at this time as they would not be implemented for two years.

filings (SEC-associated IARD expenses) had been less than was projected in 2000.<sup>8</sup> As a result, a surplus was generated (SEC-associated surplus) that had risen to approximately \$8.5 million as of June 30, 2005. Notwithstanding the one-year fee waiver, the SEC-associated surplus remains significant. It was \$9.1 million as of December 31, 2005, dropped to \$8.7 million as of June 30, 2006 and is projected to drop further, to \$7.9 million, by the end of this year if no further action is taken.

NASD has again written to our staff, recommending that the waiver of annual IARD fees for SEC-registered advisers be extended for an additional two years, to October 31, 2008. To further reduce the SEC-associated surplus, NASD also recommends that initial IARD filing fees, which are intended to cover the costs associated with entitling new registrants on the IARD system, be waived for the same period.<sup>9</sup> Based on current projections of expected SEC-associated IARD revenues and SEC-associated IARD expenses in the next several years, the Commission believes that the current SEC-associated surplus exceeds the amount of surplus needed for operations and system enhancements, and accordingly believes that an extension of the current waiver of IARD annual filing fees through October 31, 2008 is appropriate in order to continue reducing the SEC-associated surplus. We also agree that waiver, from November 1, 2006 through October 31, 2008, of the initial IARD filing fee for advisers

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<sup>7</sup> State-registered advisers pay their annual system renewal fees in December each year, regardless of their fiscal year.

<sup>8</sup> Pursuant to the fee schedule, filing fees vary according to the adviser's assets under management. Revenues have exceeded projections both because the number of SEC-registered advisers has grown (from an estimated 8,100 in 2000 to approximately 9,000 last year, to some 10,700 today), and because advisers' managed assets have increased, which has moved many investment advisers to higher fee categories.

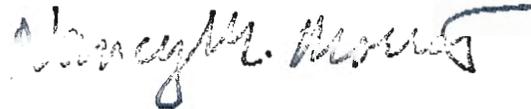
<sup>9</sup> A copy of NASD's letter is available on our Web site.

registering with the Commission is appropriate in order to further reduce the SEC-associated surplus. This action is expected to waive approximately \$9.5 million in IARD system fees. The fee waiver will apply to all annual updating amendments filed by SEC-registered advisers from November 1, 2006 through October 31, 2008 and to all initial applications for registration filed by advisers applying for SEC registration from November 1, 2006 through October 31, 2008.

IT IS THEREFORE ORDERED, pursuant to sections 204(b) and 206(A) of the Investment Advisers Act of 1940, that:

For annual updating amendments to Form ADV filed from November 1, 2006 through October 31, 2008, the fee otherwise due from SEC-registered advisers is waived, and for initial applications to register as an investment adviser with the SEC filed from November 1, 2006 through October 31, 2008, the fee otherwise due from the applicant is waived.

By the Commission.



Nancy M. Morris  
Secretary

Dated: October 26, 2006

Commissioner Campos  
Not Participating

SECURITIES AND EXCHANGE COMMISSION  
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 54660 / October 27, 2006

INVESTMENT ADVISERS ACT OF 1940  
Rel. No. 2565 / October 27, 2006

Admin. Proc. File No. 3-11972

In the Matter of

PHILIP A. LEHMAN  
c/o William B. Fecher, Esq.  
Statman, Harris, Siegel & Eyrich, LLC  
2900 Chemed Center  
255 East Fifth Street  
Cincinnati, OH 45202-2912

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING  
INVESTMENT ADVISER PROCEEDING

Grounds for Remedial Action

Fraudulent Sale of Securities

Former president and sole shareholder of registered broker-dealer and investment adviser engaged in a fraudulent scheme that purported to make high-yield, riskless-principal investments in violation of antifraud provisions of federal securities laws. Held, it is in the public interest to bar respondent from association with any broker, dealer, or investment adviser and to impose a civil money penalty.

APPEARANCES:

William B. Fecher, Esq., for Philip A. Lehman.

Jerrold H. Kohn and Thomas J. Meier, for the Division of Enforcement.

Appeal filed: April 11, 2006  
Last brief received: June 30, 2006

Document 18 of 24

## I.

Philip A. Lehman, formerly associated with Tower Equities, Inc., <sup>1/</sup> a broker-dealer and investment adviser registered with the Commission, appeals from a decision of an administrative law judge that he had not demonstrated an inability to pay a civil money penalty. <sup>2/</sup> Based on an unopposed motion for partial summary disposition, the law judge found that Lehman violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder <sup>3/</sup> by falsely representing to investors in two limited liability companies that they could earn high rates of return in a short period of time with no risk to principal. Also based on that motion, the law judge barred Lehman from association with any broker, dealer, or investment adviser, and determined that a \$55,000 civil penalty was warranted. After a hearing to determine the sole issue of Lehman's ability to pay a penalty, the law judge reiterated his findings of violation, imposition of a bar, and assessment of a penalty. Lehman does not dispute any of these findings or any of the facts supporting the findings of violation. He does not dispute that his misconduct warrants an associational bar. The law judge declined to reduce the amount of the penalty on the basis that Lehman failed "to satisfy his burden of producing a complete and accurate financial disclosure statement" and "to provide credible supporting testimony." That determination is the sole basis for Lehman's appeal. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

## II.

Although the facts underlying the violative conduct are not in dispute, we discuss them to the extent that they are relevant to our determination on appeal.

A. Lehman was associated with Tower Equities from 1984 until September 2000 and from June 2001 until August 2002. <sup>4/</sup> Lehman created, operated, and controlled Ashar Endeavor I,

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<sup>1/</sup> On October 31, 2005, Lehman testified that Tower Equities currently is known as Sior Securities Inc. It is unclear on which date the name change occurred. However, we use the term "Tower Equities" to refer to both entities.

<sup>2/</sup> Philip A. Lehman, Initial Decision Rel. No. 309 (Mar. 20, 2006), 87 SEC Docket 2140.

<sup>3/</sup> 15 U.S.C. §§ 77q, 78j(b); 17 C.F.R. § 240.10b-5.

<sup>4/</sup> From September 2000 through June 2001, Lehman served a nine-month suspension imposed in a separate Commission proceeding against Lehman and Tower Equities involving two alleged fraudulent schemes. Philip A. Lehman, Securities Act Rel. No. 7889 (Sept. 7, 2000), 73 SEC Docket 580 ("2000 settled case"). In that case, without admitting or denying the findings, Lehman consented to the entry of our order that he be

(continued...)

LLC (“Ashar”) and Oberland Endeavor I, LLC (“Oberland”), Ohio limited liability companies, beginning in May 1999 and July 2000, respectively.

Between 1999 and 2002, Lehman sold, or directed others to sell, membership interests in Ashar and Oberland. Beginning in 1999, Stephen E. Cividino, a registered sales representative associated with Tower Equities, sold interests in Ashar to at least four individuals at Lehman’s direction. Also at Lehman’s direction, Cividino represented to potential investors that Ashar would attempt to enter into a “reserved funds transaction” <sup>5/</sup> and told them that these investments would yield high returns of up to 100%, in a very short period with no risk to their principal. The Ashar operating agreement, prepared by Lehman, with the assistance of an attorney named John L. Runft, also indicated that returns would be as high as 100% within sixty days. At Lehman’s direction, Cividino distributed the operating agreement to investors.

Ashar never made any “reserved funds transactions.” Moreover, the record includes a report by the Division’s expert that concluded that investment schemes that predict a return of 100% or more within sixty days without a risk to principal are not economically viable. The report also concluded that “any person experienced in finance would have immediately been aware of [the] fraudulent character [of the representations made in the materials],” that “this fraudulent character would have been readily apparent to any person conducting a minimum amount of diligent research into these investments,” and “so patent is the fraudulent character of these schemes that any person who indicates that they have knowledge of such transactions and their legitimacy is either making a fraudulent statement or acting in reckless disregard of its patently fraudulent character.” Lehman raised a total of approximately \$10 million on behalf of Ashar from twenty-six investors.

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<sup>4/</sup> (...continued)

suspended from associating with any broker, dealer, investment adviser, or investment company, that he cease and desist from future violations of the antifraud provisions (including the provisions at issue here, as well as Sections 206(1) and 206(2) of the Investment Advisers Act of 1940), and that he pay a civil penalty of \$10,000. Tower Equities was censured and ordered to cease and desist from future violations of the antifraud provisions (including the provisions at issue here, as well as Advisers Act Sections 206(1) and 206(2) and Exchange Act Section 15(c)(1) and Rule 15c1-2 thereunder). As a result of our order, the State of Ohio revoked Lehman’s securities sales and investment adviser representative licenses, and the State of Arizona revoked Lehman’s registration as a securities salesman. Philip Allen Lehman, 2002 WL 518622 (Ohio Dept. Comm. Jan. 17, 2002); Philip Allen Lehman, 2002 WL 417265 (Ariz. Corp. Comm. Feb. 22, 2002).

<sup>5/</sup> The term “reserved funds transaction” is referred to, but not defined, in the record. The report filed by the Division’s expert describes the transaction as the purported “trading of medium term notes in the course of which the original investment [*i.e.*, cash] was to be leverage[d] . . . without any encumbrance to the invested funds.”

Beginning in July 2000, at Lehman's direction, Cividino told at least one Ashar investor that "the confidentiality of Ashar had been compromised and that it was necessary to transfer [his] investment to a new entity, known as Oberland . . ." At Lehman's direction, Cividino represented to certain Ashar investors that, as with Ashar, they could earn a large return on their investment in a very short period with no risk to their principal and gave them a copy of Oberland's operating agreement that represented that investors could receive a return of up to 200%. All of the investors in Ashar transferred their funds to Oberland. With respect to at least two investors, Lehman failed to disclose his involvement in the 2000 settled case that resulted in Lehman's nine-month suspension, a cease-and-desist order, and a civil penalty of \$10,000. Like Ashar, Oberland never executed a "reserved funds transaction" or any other investment.

On October 17, 2002, the United States Attorney for the Southern District of Ohio filed a complaint for civil forfeiture against the Oberland account at Key Bank. <sup>6/</sup> The case, which implicated federal antifraud statutes, was dismissed after the parties, including all of the Oberland investors, agreed to a settlement in which all the funds in the account would be disbursed to the investors, resulting in a full refund of their investments.

B. Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder prohibit the making of misleading statements in connection with the purchase, offer, or sale of any security. <sup>7/</sup> Securities Act Section 17(a)(1) and Exchange Act Section 10(b) and Rule 10b-5 thereunder require a showing of scienter. <sup>8/</sup> Scienter may be established by a showing of recklessness. <sup>9/</sup>

Lehman represented orally and in writing that Ashar's and Oberland's investments in "reserved funds transactions" would earn a large return, up to 100% in Ashar and up to 200% in

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<sup>6/</sup> United States v. Contents of Key Bank, N.A., Account Number 353901001365, No. C-3-02-481 (S.D. Ohio Oct. 17, 2002).

<sup>7/</sup> See, e.g., IFG Network Secs., Inc., William Kissinger, and David Ledbetter, Exchange Act Rel. No. 54127 (July 11, 2006), \_\_\_ SEC Docket \_\_\_, \_\_\_ (finding violation of antifraud provisions where misleading statement made regarding recommended investment in certain class shares).

<sup>8/</sup> Robert M. Fuller, Securities Act Rel. No. 8273 (Aug. 25, 2003), 80 SEC Docket 3539, 3545. However, scienter is not necessary to prove a violation of Securities Act Sections 17(a)(2) and 17(a)(3). Id. at 3545-3546 (citing Aaron v. SEC, 446 U.S. 680, 697 (1980)).

<sup>9/</sup> E.g., Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 (11th Cir. 1999). Recklessness is an "extreme departure from the standards of ordinary care . . . present[ing] a danger of misleading buyers and sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it." Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977).

Oberland, in a short period of time with no risk to principal. We have stated repeatedly that promises of a high return on an investment in a short period of time with little or no risk to principal are inherently misleading. 10/ With respect to at least two investors, Lehman failed to disclose his involvement in the antifraud proceeding that resulted in his nine-month suspension, a cease-and-desist order, and a civil penalty of \$10,000. These omissions were material 11/ because a reasonable investor would want to know about recent disciplinary history involving fraud of someone managing his or her investments. 12/

As demonstrated by the Division's expert, any securities professional could be expected to know that making promises of risk-free, rapid, high returns on investments is inherently misleading. 13/ Lehman, who had more than twenty years of experience in the securities industry, was at least reckless in his disregard for the risk of misleading investors that was created by his promises of high returns. 14/ Moreover, the 2000 settled case involved similar allegations that Lehman fraudulently represented to investors that they would receive high returns on their investments in a short period of time with minimal risk to principal. Hence, by at least

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10/ See Dane E. Faber, Exchange Act Rel. No. 49216 (Feb. 10, 2004), 82 SEC Docket 530, 539 (“We have held that it is inherently fraudulent to predict specific and substantial increases in the price of a speculative security.”); Brian Prendergast, 55 S.E.C. 289, 306 (2001) (“The June 6 letter’s prediction that investors would recover their losses was (like guarantees of profit and predictions of sharp increases in the price of speculative stocks) inherently fraudulent.”); John Montelbano, Exchange Act Rel. No. 47227 (Jan. 22, 2003), 79 SEC Docket 1474, 1482 (“[A]pplicants energized Monitor’s sales force with . . . inherently fraudulent price predictions.” (citing C. James Padgett, 52 S.E.C. 1257, 1265 (1997), petition denied sub nom. Sullivan v. SEC, 159 F.3d 637 (D.C. Cir. 1998) (Table), cert. denied, 525 U.S. 1070 (1999)); Lester Kuznetz, 48 S.E.C. 551, 553 (1986), aff’d, 828 F.2d 844 (D.C. Cir. 1987) (Table))).

11/ See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in determining how to act.

12/ See SEC v. Bolla, 401 F. Supp. 2d 43, 68 (D.D.C. 2005) (finding that failure to disclose to investors disciplinary history of investment adviser was material omission); Michael Batterman and Randall B. Batterman III, Investment Advisers Act Rel. No. 2334 (Dec. 3, 2004), 84 SEC Docket 1349, 1353 (noting that district court, in underlying injunctive proceeding, found that disclosure of disciplinary record of investment adviser “undoubtedly would have been material to an investor”), aff’d, No. 05-0404 (2d Cir. 2005).

13/ See supra note 10.

14/ E.g., Sundstrand Corp., 553 F.2d at 1045. See also supra note 10.

2000, Lehman knew that making similar representations was materially misleading and yet continued to do so. We therefore find that Lehman acted at least recklessly in making the material misrepresentations and omissions described above, and that after the 2000 settled case, he acted knowingly.

Based on the record described above, we find that Lehman willfully violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder.

### III.

We have broad discretion to set sanctions in administrative proceedings. <sup>15/</sup> Exchange Act Section 15(b)(6)(A) and Advisers Act Section 203(f) authorize the Commission to bar a person from association with a broker, dealer, or investment adviser if the person willfully violated federal securities laws while associated with a broker, dealer, or investment adviser, and the bar is in the public interest. <sup>16/</sup> In determining whether a sanction is in the public interest, we consider the factors articulated in Steadman v. SEC. <sup>17/</sup> These factors include the egregiousness of the respondent's actions, the isolated or recurrent nature of the violation, the degree of scienter involved, the sincerity of any assurances against future violations, the respondent's recognition that the conduct was wrongful, and the likelihood of recurring violations. <sup>18/</sup> Lehman is a recidivist whose egregious actions evidence a high degree of scienter. Because Lehman's misconduct is so similar to that for which he was recently sanctioned, we can only conclude that the sanctions imposed on him in the earlier proceeding failed to imbue him with any appreciation for the wrongfulness of his actions or to deter him from future violations. <sup>19/</sup> Lehman did not below, and does not here, challenge the bar imposed on him by the law judge. Based on these considerations, we find that a bar is in the public interest.

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<sup>15/</sup> See e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 188-189 (1973) ("The fashioning of an appropriate and reasonable remedy is for the Secretary [of Agriculture], not the court. The court may decide only whether under the pertinent statute and relevant facts, the secretary made 'an allowable judgement in [his] choice of remedy.'") (quoting Jacob Siegel Co. v. FTC, 327 U.S. 608, 612 (1946)).

<sup>16/</sup> 15 U.S.C. §§ 78o(b)(6)(A), 80b-3(f).

<sup>17/</sup> 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

<sup>18/</sup> Steadman, 603 F.2d at 1140.

<sup>19/</sup> Cf. First Secs. Transfer Systems, Inc. and Steven Telsey, 52 S.E.C. 392, 397 (1995) (determining that a more severe sanction was necessary because "[t]he past sanctions . . . have proven ineffective to induce Telsey to comply with the law").

Exchange Act Section 21B and Advisers Act Section 203(i) authorize the Commission to impose a first-tier civil money penalty where a respondent has willfully violated any provision of the Securities Act, the Exchange Act, or the rules and regulations thereunder, and where such civil penalty is in the public interest. 20/ A first-tier penalty of up to \$5,500 for each act or omission may be elevated to a second-tier penalty of up to \$55,000 if the act or omission “involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.” 21/

The factors we may consider in determining whether a penalty is in the public interest include whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and the harm to other persons resulting from the conduct. 22/ We also may consider the extent to which any person was unjustly enriched and whether the respondent previously has been found by the Commission or other regulatory agency to have violated the securities laws. 23/ Further, we may consider the need to deter the respondent and other persons from committing such acts and other matters as justice may require. 24/

Lehman’s representations regarding purported high-yield, riskless-principal investments and his omission regarding his involvement in an earlier antifraud proceeding that resulted in sanctions were fraudulent, thus triggering the second-tier penalty option. His recidivism occurred almost coincident with the imposition of sanctions in the earlier Commission proceeding for violations based on similar misconduct. Because of the bar we impose today, Lehman will no longer be active in the securities industry. However, we find that his actions are egregious enough that a penalty will assist in impressing on Lehman the seriousness of his obligation to comply with the law. We further find that the need to deter other persons from committing similar acts is high. Based on all these factors, we find that a second-tier penalty in the amount of \$55,000 is warranted.

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20/ 15 U.S.C. §§ 78u-2(b), 80b-3(i).

21/ 15 U.S.C. § 78u-2(b); see also 17 C.F.R. §§ 201.1001, 1002. A third-tier civil penalty of \$110,000 may be warranted if the act or omission also “directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission.” 15 U.S.C. § 78u-2(b). Lehman’s fraudulent misconduct was followed by a full refund to all Oberland investors of their investments. See supra note 6 and accompanying text.

22/ 15 U.S.C. § 78u-2(c).

23/ Id.

24/ Id.

Lehman does not contest the finding that a second-tier penalty is warranted but has maintained throughout this proceeding that he is unable to pay the amount imposed. We may, in our discretion, consider evidence of the respondent's ability to pay. 25/ The evidence "may relate to the extent of such person's ability to continue in business and the collectability of a penalty." 26/ Even when a respondent demonstrates an inability to pay, we have discretion not to waive the penalty, particularly when the misconduct is sufficiently egregious. 27/

Lehman argues that the law judge should not have imposed the penalty because the Division has the "burden of proof with respect to his inability to pay" but did not meet its burden. Lehman is not correct that the Division has the burden of proof on his ability to pay. The statute states that "a respondent may present evidence of the respondent's ability to pay such penalty." 28/ Our decisions have consistently interpreted this to mean that the respondent has the burden of demonstrating an inability to pay. 29/ This allocation makes sense given a respondent's superior knowledge of his or her own financial situation. 30/

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25/ 15 U.S.C. § 78u-2(d).

26/ Id.

27/ See Charles Trento, Securities Act Rel. No. 8391 (Feb. 23, 2004), 82 SEC Docket 785, 793 (finding that respondent's fraudulent misconduct "far outweigh[ed] any consideration of his present ability to pay a penalty").

28/ 15 U.S.C. § 78u-2(d).

29/ Vladlen "Larry" Vindman, Securities Act Rel. No. 8679 (Apr. 14, 2006), \_\_\_ SEC Docket \_\_\_, \_\_\_ ("As the respondent, Vindman had the burden of demonstrating inability to pay."); Brian A. Schmidt, 55 S.E.C. 576, 597 (2002) ("[T]he respondent carries the burden of demonstrating inability to pay."); Terry T. Steen, 53 S.E.C. 618, 627 (1998) ("The burden of proving financial inability to pay disgorgement falls upon the respondent.").

30/ See H.R. Rep. No. 101-616, at 39 (1990), reprinted in 1990 U.S.C.C.A.N. 1379, 1402 ("It is appropriate for respondents to have the burden of proof as to their ability to pay because they have better knowledge concerning their financial condition and access to their financial records than does the Commission."). Even where an agency, by statute, is required to consider the ability to pay and to produce evidence of respondent's financial condition, the respondent still bears some of the burden of proving an inability to pay. See Stanley v. Bd. of Gov. of Fed. Reserve Sys., 940 F.2d 267, 274 (7th Cir. 1991) ("An awkward state of affairs would arise if the [agency] was required to bear full responsibility for proving the financial condition of the individual Directors who

(continued...)

At the hearing, Lehman submitted a sworn financial statement dated October 24, 2005 ("2005 SFS") and eight exhibits. The 2005 SFS listed assets of approximately \$192,537 and liabilities of approximately \$135,715 for a net worth of \$56,822. Lehman was the sole witness and testified under oath about his financial circumstances. The Division cross-examined him on that subject and submitted fourteen exhibits. On appeal, Lehman submitted a revised SFS dated April 10, 2006 ("2006 SFS") and two affidavits. The 2006 SFS listed assets of approximately \$789,752 and liabilities of approximately \$900,501 for a net worth of (\$110,749), which is \$167,571 less than the net worth given in the 2005 SFS.

We discuss the items whose values are in dispute below.

Real Estate. Lehman is a member of Cundiff Investments LLC ("Cundiff"), a limited liability company that owns two properties on North Main Street in Dayton, Ohio ("Cundiff Properties"). In the 2005 SFS, Lehman did not include any information about Cundiff. In the 2006 SFS, Lehman included Cundiff as an asset worth \$612,800 and a liability worth \$765,256. 31/ The values in the 2006 SFS that are associated with the Cundiff Properties thus account for \$152,459 of the \$167,571 difference in Lehman's claimed net worth as compared to the 2005 SFS. 32/ Lehman and his wife listed rental income and depreciation expenses from the properties on their 2003 and 2004 federal income tax returns. Lehman did not, however, list the Cundiff Properties as an asset in his 2005 SFS. At the hearing, the Division submitted an undated local county property summary that lists the combined tax-assessed value of the Cundiff Properties as \$655,690. 33/ Lehman objected to the Division's proffered fair market value, stating that "Cundiff does not have any net value." He offered no evidence, such as an appraisal or an appeal of the assessed valuations, to support his assertion. Rather, Lehman contends that

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30/ (...continued)

obviously oppose higher penalties and whose self-interest is served by painting as grim a picture as possible of their respective financial conditions.").

31/ The record is unclear as to whether Lehman was the sole member of Cundiff during the period at issue. Division Exhibit 9 includes a document dated May 1, 1999 that appoints Lehman as Cundiff's agent to receive service. The document requires the signators to comprise at least a majority of the members of Cundiff. Lehman is the sole signator on the document. Lehman has not indicated at any time during the proceeding that any of the values associated with Cundiff do not accurately reflect his ownership interest.

32/ The remaining difference of \$15,115 is accounted for by undisputed updates to other assets and liabilities.

33/ The undated local county property summary offered by the Division also shows that the combined taxes owed on the Cundiff Properties as of 2005 are delinquent in the amount of \$29,444. Lehman does not list this amount of taxes owed in his 2006 SFS.

his testimony on this point was sufficient to establish the net value of the properties and that the law judge, "by impermissibly making adverse credibility findings, rejected [his] testimony."

For the first time on appeal, Lehman claims that the Cundiff Properties are encumbered by mortgages. Lehman's motion to adduce additional evidence, filed in connection with this appeal, claimed that the Cundiff Properties "have negative equity," based on "the indebtedness secured by mortgages on [the properties.]" Specifically, Lehman's 2006 SFS estimated the Cundiff Properties to be an asset worth \$612,800 with a corresponding liability worth \$765,256, for a net value of (\$152,456).

We granted Lehman's motion to adduce evidence pursuant to Rule 452 of our Rules of Practice. <sup>34/</sup> Lehman's evidence included two affidavits. His own affidavit, which did not contain any supporting documentation, stated that the Cundiff Properties have "a value of \$613,700.00" and are "encumbered by mortgages totaling \$627,464.91," not \$765,256. The affidavit also stated that "Cundiff has been unable to make the required payments on the mortgages and is delinquent on the real estate taxes," but does not specify the amounts or duration of these alleged delinquencies. The second affidavit, by his counsel, William B. Fecher, attached three exhibits. One exhibit purportedly is a May 26, 2006 local county recorder summary of instruments recorded in the name of Cundiff. Two of the five entries appear to be for mortgages on land described only in legal terms and not by address. <sup>35/</sup> The second exhibit purportedly is a promissory note for \$145,136.32, entered into by Cundiff on April 1, 2002, that is secured by "a second-priority mortgage granting [the lender] a security interest in [the Cundiff Properties]." The third exhibit purportedly is a promissory note for \$340,153.43, entered into by Cundiff on April 1, 2002, that is secured by "a first-priority mortgage granting [the lender] a security interest in [the Cundiff Properties]." These original principal amounts total \$485,289.75. None of the exhibits includes any information about the current balance owed on the mortgages purportedly associated with the Cundiff Properties.

Lehman has not provided adequate or credible evidence that the Cundiff Properties have no net value or a negative net value. His various assertions about the values of Cundiff as an asset and the corresponding liabilities are inconsistent, conflict with the values set forth in the supporting documentation provided by his own attorney, and are therefore unsupported. Even if we accept Fecher's documentation regarding the combined value of the mortgages, we are left with an asset of \$655,690 less a liability of \$485,289.75 for a net value of \$170,400.25. However, even Fecher's documentation regarding the combined value of the mortgages is incomplete and unpersuasive because it fails to indicate how much of the original principal amount of the mortgages has been paid down in the four years since the mortgages were entered into. The record provides no information about whether taxes or interest are owed on the

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<sup>34/</sup> 17 C.F.R. § 201.452.

<sup>35/</sup> The other three entries appear to be for two deeds and one easement related to these properties.

mortgages. Our conclusion, therefore, is that the Cundiff Properties should be considered at a net value of \$170,400.25.

Lehman owns two buildings on Lexington Avenue in Dayton, Ohio (the "Lexington Avenue Properties"). A local county property summary, submitted by Lehman at the hearing and dated October 24, 2005, lists the combined tax-assessed value of the Lexington Avenue Properties as \$121,900. Lehman did not submit an appraisal nor did he ever appeal the assessed valuations on the Lexington Avenue Properties. However, Lehman testified, and claimed in both the 2005 SFS and 2006 SFS, that the combined fair market value of the Lexington Properties is \$60,000. Lehman offered no evidence to substantiate his personal opinion or to refute his own contradictory evidence of the county's valuations. He contends that his testimony on this point was sufficient to establish the fair market value of the properties and that the law judge impermissibly rejected it.

Lehman argues that the local county property valuations cannot be relied upon to establish actual value because "[a] tax valuation is not an appraisal or a determination of actual value." However, under Ohio law, the tax-assessed value of real estate is intended to represent fair market value. <sup>36/</sup> Lehman offered no evidence to indicate that the Lexington Avenue Properties are an exception to this principle regarding Ohio property. We find that Lehman has not presented any credible evidence to counter his own submission showing that the value of the Lexington Avenue Properties is \$121,900. We therefore reject his contentions.

The credible evidence in the record regarding the net value of the Cundiff Properties (an asset worth \$655,690 less a liability worth at most \$485,289.75 for a net value of \$170,400.25) and the value of the Lexington Avenue Properties (an asset worth \$121,900) establishes that Lehman's net worth is at least \$274,007.25 on the basis of these adjustments alone (total assets worth \$894,542 less total liabilities worth \$620,534.75), rather than the (\$110,749) he claims in his 2006 SFS.

Byers Note. Lehman, doing business as Byers Acquisition Group, Inc. ("Byers"), is the creditor with respect to a promissory note ("Byers Note"). BriMic, LLC, a limited liability company that purchased the assets of a tavern in connection with the Byers Note, is the debtor on that note. The Byers Note lists an original balance of \$170,000 as of May 1999. Lehman testified that the actual original amount was only \$160,000, but he provided no evidence to substantiate this claim.

Lehman claims that the Byers Note is worthless. In one section of his 2005 SFS, Lehman lists the value of the Byers Note as "To Be Determined." In another section of the 2005 SFS, Lehman indicates that he received "\$950 - subject to change" per month as income on the Byers

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<sup>36/</sup> See Ohio Rev. Code §§ 5713.01, 5713.03; Estate of Thomas L. Kaplin v. Commissioner of Internal Revenue, 815 F.2d 32, 33 (6th Cir. 1987) (finding that Tax Court erred in rejecting the tax-assessed value of Ohio property as probative of fair market value).

Note. At the hearing, Lehman testified that he was concerned about the collectability of the note because he “had several people go down there and tell [him] that they’re not doing very well.” He testified that he verbally agreed with BriMic, LLC that the balance on the Byers Note currently is \$112,000, although he had no signed agreement to that effect, and nothing else in the record supports this amount. He further testified that, although he previously received monthly payments of \$1,600, he currently received \$700 less. There is no substantiation in the record concerning monthly payments. In his 2006 SFS, Lehman listed the value of the Byers Note as “0” and, unlike his 2005 SFS, did not indicate that he received any income on the note.

Pursuant to our May 2006 order granting Lehman’s motion to adduce additional evidence, Lehman submitted evidence that he claimed would establish “the true value of the Byers Note,” including “notice that [BriMic, LLC] was being evicted from the business premises and, if evicted, that [BriMic, LLC] would be unable to make payments on the [Byers] Note.” Lehman’s affidavit, previously mentioned in our discussion of the Cundiff Properties, states that BriMic, LLC informed him that “the landlord for the premises at which the Byers Inn operates has terminated their lease and expects them to vacate the premises on or before May 15, 2006 . . . [and] that, if the lease is terminated, BriMic, LLC will be forced to cease operations and be unable to make any further payments on the Note.”

Fecher’s affidavit, also previously mentioned in our discussion of the Cundiff Properties, attaches a purported notice of BriMic, LLC’s lease termination sent to Fecher by facsimile. The transmittal sheet is from a Dayton law firm and includes “Bri-Mic, LLC” in the subject line. The “lease termination,” dated May 21, 2006, but showing a machine-generated transmittal date of May 19, 2006, is a one-paragraph, unsigned letter purportedly from BriMic, LLC to Lehman that states, among other things, that BriMic, LLC was notified of “the termination of possessory rights” to the tavern. The document is silent as to whether payments to Byers will continue.

According to the Byers Note, “the entire unpaid principal balance of [the] Note, together with any accrued interest thereon, any late fees and any expenses, shall become due and payable in full, at [Lehman’s] sole option, upon the occurrence of,” among other things, BriMic, LLC’s failure to make timely payments to Lehman following the termination of BriMic, LLC’s lease. Other provisions of the Byers Note state that (1) the note is secured by “all of [BriMic, LLC’s] property and assets,” (2) the note is guaranteed by the principals of BriMic, LLC, and (3) the obligations of BriMic, LLC to any “member, shareholder, and/or insider of BriMic, LLC” are subordinated to the obligations to Lehman.

Lehman’s adduced evidence concerning the purported termination of the tavern lease is vague and of questionable authenticity. At best, it fails to substantiate his claim that payments from BriMic, LLC would cease, or that Lehman would have no recourse to recover the balance owed on the note if payments did cease. We find that it adds little, if anything, to Lehman’s burden of proving that he is unable to pay the penalty, and as a discretionary matter do not consider it.

IRS Letter. Lehman argues that he owes the IRS certain tax amounts and that the law judge should have considered these amounts in determining whether Lehman had the ability to pay the civil penalty. 37/ The record contains a letter from the IRS to Lehman and his wife dated October 24, 2005 that shows proposed deficient amounts on their joint income tax returns for the periods ending December 31, 2002, 2001, and 2000, which, together with further penalties for alleged tax fraud, total approximately \$325,536. This amount was not included in the calculation of Lehman's net worth in either the 2005 or 2006 SFS. The 76-page letter contains a detailed explanation about why the IRS preliminarily determined that certain information in the tax returns was inaccurate, disclosed fraudulently, and warranted repayment and penalties. Lehman concedes that the IRS Letter is a preliminary report that Lehman may challenge, and, in fact, Lehman claims he has challenged. 38/ However, there is no evidence that would indicate when his challenge to the IRS Letter will be resolved. Under the circumstances, in our discretion, we are not considering this information in considering Lehman's ability to pay the civil penalty.

\* \* \*

Lehman also claims that the law judge "improperly criticized the Respondent for not supplying information related to his wife[, Sarah Merrick] . . ." Lehman claims that "her financial condition cannot be the subject of any determination of the appropriate financial penalty" because it amounts to a "denial of her due process rights . . ." Lehman does not explain how the law judge's observations about the lack of financial information regarding Ms. Merrick might impact our assessment of his ability to pay the \$55,000 penalty. Nor does he explain how it is a denial of his wife's due process rights to include her assets when he readily admits that she shares the liabilities listed on his 2005 and 2006 SFSs. However, we note that, throughout the proceeding, the law judge repeatedly informed Lehman of his obligation to "provide the full range of supporting evidence addressed in Rule 630 of [our] Rules of Practice[,]" including the sworn financial statement, which explicitly requires disclosure of a spouse's information, including both assets and liabilities. 39/ Disclosure of a spouse's

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37/ Exchange Act Section 21B(d) states, among other things, that evidence of "any other claims of the United States . . . upon such person's assets" may be taken into account when considering a respondent's ability to pay a civil penalty. 15 U.S.C. § 78u-2(d).

38/ Lehman testified that he disputed the proposed findings of the IRS and that, although he had met with IRS staff, nothing had been finalized.

39/ Lehman testified that his wife did not receive Social Security, a pension, alimony, any annuities, or interest or dividends, but did share the monthly expenses listed on his 2005 SFS and 2006 SFS. Regarding any other financial circumstances of his wife, Lehman testified that he had "no clue." The record suggests otherwise. The two promissory notes that Lehman's attorney submitted in support of Lehman's argument that Cundiff is encumbered by mortgages were signed by Sarah Merrick. Further, the law judge found

(continued...)

information may be useful in determining whether, and to what extent, such spouse's assets or liabilities offset the assets and liabilities of the individual submitting the sworn financial statement. Thus, we reject Lehman's claims.

\* \* \*

We conclude that Lehman has not demonstrated that he is unable to pay a second-tier penalty of \$55,000. The credible, reliable record evidence suggests that his net worth is well in excess of that amount. We recognize that the record as presented creates some uncertainty about the collectibility of the penalty, and we are "cognizant of the inadvisability of assessing penalties so heavy that the persons against whom they are assessed are unable to pay them. Such a situation results in the expenditure of agency resources in unsuccessful attempts to collect the penalties. Moreover, the imposition of a [penalty] that cannot be enforced may ultimately render the deterrent message intended to be communicated by the [penalty] less meaningful. For these reasons, consideration of adequate, credible evidence of inability to pay is appropriate for us to consider as a discretionary matter." 40/

Lehman's evidence of inability to pay, however, does not meet this standard. The evidence he presents with respect to the value, or lack thereof, of the disputed items is neither adequate nor credible because his assertions variously are vague, unsubstantiated, inconsistent, or contradicted by reliable evidence, some of which Lehman himself provides. Indeed, to the extent there are uncertainties as to Lehman's true net worth, they exist because of the confusion created by Lehman's submission of deficient documentation in support of his claim.

Further considerations affecting our decision not to reduce or waive the penalty include his recidivism and our view that his misconduct is egregious. Lehman directs our attention to three disciplinary actions involving violations of purportedly greater egregiousness that resulted in waivers or significant reductions in civil penalties. 41/ Appropriate remedial action depends

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39/ (...continued)  
that cross-examination revealed that Lehman knew, but failed to disclose, that his wife had an ownership interest in S & P Business Trust, which owns the holding company that owns at least 75% of Tower Equities. Based on the record, however, we are unable to determine the value of Ms. Merrick's assets, and we therefore do not consider such information in our determination of Lehman's claimed inability to pay.

40/ First Secs. Transfer Systems, Inc., 52 S.E.C. at 397 (finding evidence not adequate or credible where current financial situation was neither documented nor substantiated).

41/ See SEC v. Frank Bergonzi, Martin L. Grass, and Franklin C. Brown, Lit. Rel. No. 19409 (Sept. 30, 2005); Uniprime Capital Acceptance, Inc. and Alfred J. Flores, Lit. Rel. No. (continued...)

on the facts and circumstances of each particular case, and cannot be precisely determined by comparison with the actions taken in other proceedings. <sup>42/</sup> We note that the matters to which Lehman refers are settled cases whose sanctions may understate the sanctions that would be imposed in litigated cases because settled sanctions reflect pragmatic considerations such as the avoidance of time-and-manpower-consuming adversarial litigation. <sup>43/</sup> In any event, the cases are easily distinguishable. Unlike Lehman, none of those respondents was found to be a recidivist, let alone one who engaged in the fraudulent misconduct at issue almost coincident with the imposition of sanctions in an earlier proceeding for violations based on similar misconduct. Lehman's recidivism, which we are explicitly entitled to consider under the relevant statutory scheme, weighs heavily in our determination that a civil penalty is in the public interest and that reduction or waiver of the penalty is not appropriate. <sup>44/</sup> Further, all of the respondents in the cases to which Lehman cites were found to have demonstrated an inability to pay. We make no such finding here.

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<sup>41/</sup> (...continued)

19371 (Sept. 12, 2005), 86 SEC Docket 698; and Marketxt, Inc. and Irfan Mohammed Amanat, Exchange Act Rel. No. 51864 (June 17, 2005), 85 SEC Docket 2665.

<sup>42/</sup> See Mark F. Mizenko, Exchange Act Rel. No. 52600 (Oct. 13, 2005), 86 SEC Docket 1515, 1523 n.23; Davrey Financial Services, Inc., Exchange Act Rel. No. 51780 (June 2, 2005), 85 SEC Docket 2057, 2068 n.27 (citing Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973)).

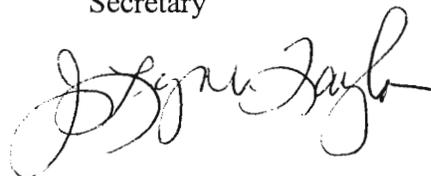
<sup>43/</sup> See, e.g., Anthony A. Adonnino, Exchange Act Rel. No. 48618 (Oct. 9, 2003), 81 SEC Docket 981, 999 (noting that settled cases may result in lesser sanctions), aff'd, 111 Fed. Appx. 46 (2d Cir. 2004) (unpublished); Richard J. Puccio, 52 S.E.C. 1041, 1045 (Oct. 22, 1996) (noting that "respondents who offer to settle may properly receive lesser sanctions than they otherwise might have received based on pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings").

<sup>44/</sup> 15 U.S.C. § 78u-2(c).

For all of these reasons, we find it in the public interest that the penalty remain at \$55,000. An appropriate order will issue. 45/

By the Commission (Chairman COX and Commissioners ATKINS, NAZARETH, and CASEY; Commissioner CAMPOS not participating).

Nancy M. Morris  
Secretary

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

By: J. Lynn Taylor  
Assistant Secretary

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45/ 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. 54660 / October 27, 2006

INVESTMENT ADVISERS ACT OF 1940  
Rel. No. 2565 / October 27, 2006

Admin. Proc. File No. 3-11972

In the Matter of

PHILIP A. LEHMAN  
c/o William B. Fecher, Esq.  
Statman, Harris, Siegel & Eyrich, LLC  
2900 Chemed Center  
255 East Fifth Street  
Cincinnati, OH 45202-2912

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Philip A. Lehman be, and he hereby is, barred from association with any broker, dealer, or investment adviser; and it is further

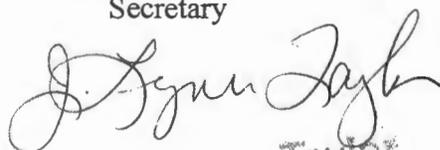
ORDERED that Lehman pay a civil money penalty of \$55,000.

Payment of the civil money penalty shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed or delivered by hand to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding.

A copy of the cover letter and check shall be sent to Jerrold H. Kohn, Division of Enforcement, Securities and Exchange Commission, Midwest Regional Office, 175 W. Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

By the Commission.

Nancy M. Morris  
Secretary



By: J. Lynn Taylor  
Assistant Secretary

*Commissioner Nazareth  
Not Participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54669 / October 30, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12467

In the Matter of  
  
GREGORY A. APPLGATE,  
  
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 Gregory A. Applegate ("Gregory Applegate" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent 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, and the findings contained in Sections III.1, 4, and 5. 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.

*Document 19 of 24*

### III.

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

1. Gregory A. Applegate ("Applegate") was a registered representative associated with Tempo Securities, a broker-dealer, from April 1994 through December 2004, and with Regis Securities, also a broker-dealer, from January 2005 until August 2005.

2. On October 7, 2005, the Commission filed a complaint in the Northern District of Ohio, in SEC v. Gregory Applegate, No. 1:05CV2363, alleging that from about 2001 through August 2005, Applegate solicited at least 140 investors to invest at least \$5.8 million in a supposed "hedge fund." Applegate guaranteed an annual rate of return to these investors and promised to make up any losses out of his own pocket.

3. The complaint also alleged that in reality, Applegate's hedge fund was a Ponzi scheme: Applegate misappropriated investor funds, using them to finance an unrelated personal business, pay personal expenses, and reimburse or pay "investment returns" to earlier investors. To perpetrate this Ponzi scheme, Applegate provided investors with false monthly client statements reflecting securities holdings and returns that did not exist and monthly "dividend checks."

4. On January 9, 2006, in the case of U.S. v. Gregory Applegate, No. 1:05-cr-00577-PAG in the Northern District of Ohio, Applegate plead guilty to mail fraud, Title 18, U.S. Code, Section 1341, for conduct related to that alleged in the Commission's Complaint. On April 26, 2006, U.S. District Judge Patricia A. Gaughan sentenced Applegate to 5 years in prison.

5. On October 17, 2006, in the Commission's case, U.S. District Judge Daniel Polster for the Northern District of Ohio entered a Final Judgment and Order of Permanent Injunction against Applegate, pursuant to his consent and without Applegate admitting or denying the allegations in the Commission's Complaint, except as to personal and subject matter jurisdiction which he admitted, enjoining Applegate from violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

### 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, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act that Gregory Applegate, 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.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
**By: Jill M. Peterson**  
**Assistant Secretary**

Commissioner Campos  
Not participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54667 / October 30, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2502 / October 30, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12465

In the Matter of

LAURA MARION,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST  
PROCEEDINGS, MAKING FINDINGS, AND  
IMPOSING A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission (the "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 (the "Exchange Act"), against Laura Marion ("Marion" or the "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 her and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.<sup>1</sup>

<sup>1</sup> In a separate civil action filed simultaneously with this proceeding, Marion has separately consented to the entry of a judgment by the U.S. District Court for the Eastern District of Michigan pursuant to Section 21(d) of the Exchange Act ordering her to pay a civil penalty of \$40,000. *SEC v. Delphi Corporation, et al.*, Civil Action No. 2:06-cv-14891 (AC) (E.D. Mich. Oct. 30, 2006).

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### III.

On the basis of this Order and Respondent's Offer, the Commission finds that:<sup>2</sup>

#### A. Respondent and Delphi Corporation

##### 1. Respondent

Marion, 34, is a resident of Rochester Hills, Michigan. Marion is an accountant and, at all relevant times, was Director of Financial Accounting and Reporting of Delphi Corporation ("Delphi").

##### 2. Delphi

Delphi is an auto parts supplier headquartered in Troy, Michigan. At all relevant times, Delphi's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange ("NYSE") under the symbol "DPH." On October 8, 2005, Delphi filed for bankruptcy in the Southern District of New York. On November 11, 2005, Delphi was delisted from the NYSE. Delphi's common stock is now registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades in the over the counter market and is quoted in the pink sheets under the symbol "DPHIQ."

#### B. Facts

##### 1. Introduction

This case involves Marion's involvement in Delphi's reporting and books-and-records violations related to two inventory transactions in the fourth quarter of 2000. The transactions involved Delphi's purported sales of inventory to a financial institution (the "Financial Institution") and a Michigan consulting company (the "Consulting Company"), and Delphi's simultaneous agreement to repurchase the inventory in the first quarter of 2001, at the original purchase prices plus fees. Delphi improperly accounted for the transactions as sales, rather than as financing transactions.

##### 2. Delphi's inventory transactions

In the fourth quarter of 2000, Delphi personnel conceived of a scheme to temporarily move precious metals, automotive batteries and generator cores off of Delphi's balance sheet in order to generate income and operating cash flow. On or about December 5, 2000, these Delphi employees wrote a handwritten note, addressed to Marion, stating that they had been instructed by a member of senior management to "maximize the financial engineering relating to [precious metals], cores and batteries."

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<sup>2</sup> 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.

In December 2000, Delphi entered into an arrangement whereby Delphi sold precious metals inventories to the Financial Institution for approximately \$199 million and simultaneously entered a forward agreement, by which Delphi agreed to repurchase the metals from the Financial Institution in January 2001, for approximately \$202.5 million. Consistent with the agreement, Delphi did, in fact, repurchase the inventory from the Financial Institution in January 2001 for approximately \$202.5 million. As Director of Financial Accounting and Reporting, Marion reviewed the transaction documents and transmitted a document to Delphi's auditors, prepared by another Delphi employee and edited by Marion, that purported to support the \$202.5 million purchase price through an analysis of the future price of metals.

Also in December 2000, Delphi entered into an arrangement whereby it sold automotive battery and generator core inventory to the Consulting Company for \$70 million. Marion understood that Delphi had described this transaction to Delphi's auditors as a sales transaction and had told the auditors that there was no agreement to repurchase the battery and core inventory from the Consulting Company. In fact, outside of Marion's presence, a Delphi executive had entered an oral agreement with the Consulting Company to repurchase the inventory for \$70 million plus a \$350,000 fee. Prior to Delphi filing its Form 10-K for the period ended December 31, 2000, Marion became aware that Delphi had repurchased the inventory in January 2001 for the original \$70 million purchase price and had paid the Consulting Company a fee.

**3. Marion receives a document characterizing the inventory transactions as structured finance transactions.**

On February 5, 2001, prior to Delphi filing its Form 10-K for the period ended December 31, 2000, Marion was asked by Delphi's then controller and chief accounting officer to obtain a "spec[ific] breakout of costs" for the December inventory transactions, including detail of the structuring fees and financing costs. Within a day, Marion received a document with those details (the "February 2001 Document"). The February 2001 Document provided several pieces of information that indicated that the December 2000 transactions were not sales of inventory, but instead were financing transactions. First, the February 2001 Document was titled "4<sup>th</sup> Quarter 2000 Structured Finance Initiatives Cost Breakdown." In addition, the February 2001 Document showed that Delphi had paid the Financial Institution a \$2 million structuring fee and approximately \$1.5 million in interest and other costs. The total of these fees and costs was equal to the difference between the \$199 million price at which the Financial Institution purchased the precious metals from Delphi and the \$202.5 million price reflected in the forward contract. Finally, the February 2001 Document showed that Delphi had paid the Consulting Company a Structuring Fee of \$350,000. Marion reviewed and annotated the document. Her annotations indicated that she understood that Delphi had repurchased the inventory for the original sales price, plus the structuring fees and associated interest and other costs. On February 6, 2001, Marion forwarded the document, with her annotations, to Delphi's controller and chief accounting officer.

4. **Marion assists in preparation of financial statements and disclosures that improperly report inventory transactions.**

On February 8, 2001, Delphi issued its 2000 Form 10-K. Marion had a substantial role in preparing and reviewing the filing. The Form 10-K reflected Delphi's improper accounting for the inventory transactions as sales rather than as financing transactions. As a result of Delphi's improper accounting, Delphi improperly recognized approximately \$200 million in cash flow from operations and overstated its earnings per share by approximately 13 cents or 36% of the originally reported earnings for the quarter and 7% of the originally reported earnings for the full year. Also in the filing, Delphi reported year-end reductions in inventory and associated costs, and improperly attributed those reductions to Delphi's "aggressive inventory management." In fact, the majority of Delphi's purported inventory improvements were the result of the temporary "structured finance" transactions with the Financial Institution and Consulting Company. Moreover, these transactions resulted in approximately \$4 million in cost *increases* to Delphi.

5. **Marion's role in Delphi's books and records and reporting violations**

As a senior accountant and Director of Financial Accounting and Reporting at Delphi, Marion was one of several Delphi officers and employees who was responsible for ensuring that Delphi's financial statements and related disclosures in its periodic reports, and well as its other books and records, accurately reflected the true substance of the inventory transactions. Based on the February 2001 Document, Marion knew or should have known that Delphi had not engaged in sales transactions with the Financial Institution and Consulting Company, but instead had engaged in financing transactions. Nevertheless, Marion took no steps to follow up on the information contained in the February 2001 Document, to consider how it might impact Delphi's accounting for the transactions or to share the information in the document with Delphi's auditors. Marion also did not correct language in Delphi's Form 10-K that falsely attributed Delphi's inventory reductions to "aggressive inventory management."

C. **Conclusion**

As a result of the conduct described above, Marion was a cause of Delphi's violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder, which require reporting companies to file accurate annual reports with the Commission.

Also as a result of the conduct described above, Marion was a cause of Delphi's violations of 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.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Marion's Offer.

Accordingly, it is hereby ORDERED that Respondent Marion cease and desist from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder.

By the Commission.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
**Assistant Secretary**

Commissioner Campos  
Not Participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54665 / October 30, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2500 / October 30, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12463

In the Matter of

**B.N. BAHADUR,**

Respondent.

**ORDER INSTITUTING CEASE-AND-DESIST  
PROCEEDINGS, MAKING FINDINGS, AND  
IMPOSING A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**I.**

The Securities and Exchange Commission (the "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 (the "Exchange Act"), against B.N. Bahadur ("Bahadur" or the "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 Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.<sup>1</sup>

<sup>1</sup> In a separate civil action filed simultaneously with this proceeding, Bahadur has separately consented to the entry of a judgment by the U.S. District Court for the Eastern District of Michigan pursuant to Section 21(d) of the Exchange Act ordering him to disgorge \$350,000, pay prejudgment interest of \$139,257 on the disgorgement amount and pay a civil penalty of \$80,000. *SEC v. Delphi Corporation, et al.*, Civil Action No. 2:06-cv-14891 (AC) (E.D. Mich. Oct. 30, 2006).

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### III.

On the basis of this Order and Respondent's Offer, the Commission finds that:<sup>2</sup>

#### A. Respondent and Delphi Corporation

##### 1. Respondent

Bahadur, 61, is a resident of West Bloomfield, Michigan. At all relevant times, he was the sole owner and principal of a private management consulting company based in Southfield, Michigan (the "Consulting Company").

##### 2. Delphi Corporation

Delphi Corporation ("Delphi") is an auto parts supplier headquartered in Troy, Michigan. At all relevant times, Delphi's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange ("NYSE") under the symbol "DPH." On October 8, 2005, Delphi filed for bankruptcy in the Southern District of New York. On November 11, 2005, Delphi was delisted from the NYSE. Delphi's common stock is now registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades in the over the counter market and is quoted in the pink sheets under the symbol "DPHIQ."

#### B. Facts

##### 1. Introduction

In December 2000, Delphi entered into two separate inventory schemes involving transactions with third parties. In one of those transactions, Delphi purported to sell \$70 million worth of inventory to the Consulting Company at the end of December 2000, while simultaneously promising Bahadur that Delphi would repurchase the inventory from the Consulting Company in early 2001. In return for Bahadur's participation, he negotiated for the Consulting Company to receive a \$350,000 fee. Delphi accounted for the transaction as a sale of inventory, but should have accounted for it as a financing.

##### 2. Bahadur assists Delphi by entering into oral repurchase agreement.

In December 2000, a Delphi executive ("Executive X") asked Bahadur if, as an accommodation, his Consulting Company would buy automotive battery and generator core inventory from Delphi for \$70 million and resell it back to Delphi within 90 days, again, for \$70 million. Executive X agreed that the Consulting Company would earn a 0.5% fee in connection with the transaction. When Bahadur was unable to secure financing for the

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<sup>2</sup> 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.

transaction, Executive X suggested the parties close the transaction before the end of 2000, but seek to finalize the financing early in January.

Although the Consulting Company had been engaged by Delphi on multiple occasions to provide consulting services, it had never purchased inventory from an automotive manufacturer or supply company and had no need or use for automotive batteries or generator cores. Nevertheless, after consulting outside counsel and participating in telephone conference calls with counsel and Executive X, Bahadur agreed to enter into the transaction with Delphi. Bahadur's counsel, who drafted the contract, proposed to Executive X and recommended to Bahadur that Delphi's repurchase obligation be put in writing. Executive X rejected that proposal, however, and Bahadur agreed to go forward with the transaction without a written repurchase agreement.

The final agreement was executed in December 2000 and, pursuant to Delphi's specific request, made no mention of Delphi's agreement to repurchase of the inventory or of any fee the Consulting Company would earn in connection with the transaction. However, Executive X had repeatedly assured Bahadur and his counsel that Delphi would repurchase the inventory and that the Consulting Company would earn a fee.

**3. Delphi self-finances Bahadur's inventory purchase by making improper use of supplier financing program.**

In January 2001, while Bahadur was working on securing financing, Executive X suggested that Delphi finance the transaction through a third party entity's supplier financing program. In the normal course, Delphi enrolled its suppliers in the third party supplier financing program so that suppliers could receive early, but reduced, payment on invoices issued for material purchased by Delphi. Under the program, as soon as the supplier's invoice was received and approved by Delphi, the third party supplier financier would pay the supplier at a discount. Delphi would then pay the third party supplier financier the full amount of the invoice on its actual due date.

In connection with the batteries and cores transaction, however, Delphi used the third party supplier finance program for a different and improper purpose. Delphi first arranged with Bahadur for the Consulting Company to be enrolled in the supplier financier program. Delphi then arranged with Bahadur to have the Consulting Company issue an invoice to Delphi for \$70,840,214.28. This amount was calculated by Delphi so that, after the third party supplier financier took its fee, the Consulting Company would receive the net proceeds of \$70,350,000. Upon receipt of the invoice, Delphi approved it and submitted it to the third party supplier financier. The Consulting Company received the \$70,350,000 on or about January 12, 2001 and immediately paid \$70 million to Delphi as payment for its purchase of the inventory. The Consulting Company retained \$350,000 as its fee. A month later, Delphi paid \$70,840,214.28 to the third party supplier financier.

When the transaction was complete, Delphi had paid the Consulting Company \$350,000 and had paid the third party supplier financier \$538,385.63 to move inventory off of Delphi's books for approximately two weeks. No inventory ever left Delphi's premises.

#### 4. **Bahadur's knowledge**

Bahadur knew that by representing the transaction as a "purchase," without any mention of the repurchase agreement or the Consulting Company's fee, the inventory purchase agreement he signed in December 2000 did not accurately represent all of the terms of the transaction, including the oral agreement by Executive X. He further knew that under the actual terms of his arrangement with Delphi, the Consulting Company was not in fact purchasing inventory from Delphi, but instead was agreeing to provide Delphi with short-term financing. Moreover, by January 2001, he knew that as a result of Delphi's self-financing program, the only cash Delphi received in connection with the transaction came not from the Consulting Company, but from Delphi itself, via the third party supplier financier.

#### 5. **Delphi's fraudulent accounting**

Delphi fraudulently accounted for the December 2000 transaction with the Consulting Company as a sale. As the result of its fraudulent accounting, on its Form 10-K for the period ended December 31, 2000, Delphi improperly overstated its earnings per share by approximately 3 cents or 9% for the fourth quarter of 2000.

#### C. **Conclusion**

As a result of the conduct described above, Bahadur was a cause of Delphi's violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

Also as a result of the conduct described above, Bahadur was a cause of Delphi's violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder, which require reporting companies to file accurate annual reports with the Commission.

Lastly, as a result of the conduct described above, Bahadur was a cause of Delphi's violations of 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.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Bahadur's Offer.

Accordingly, it is hereby ORDERED that Respondent Bahadur 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 promulgated thereunder and cease and desist from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder.

By the Commission.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
**Assistant Secretary**

Commissioner Campos  
Not Participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54668 / October 30, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2503 / October 30, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12466

In the Matter of

KEVIN CURRY,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST  
PROCEEDINGS, MAKING FINDINGS, AND  
IMPOSING A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission (the "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 (the "Exchange Act"), against Kevin Curry ("Curry" or the "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 Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.<sup>1</sup>

<sup>1</sup> In a separate civil action filed simultaneously with this proceeding, Curry has separately consented to the entry of a judgment by the U.S. District Court for the Eastern District of Michigan pursuant to Section 21(d) of the Exchange Act ordering him to pay a civil penalty of \$25,000. *SEC v. Delphi Corporation, et al.*, Civil Action No. 2:06-cv-14891 (AC) (E.D. Mich. Oct. 30, 2006).

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### III.

On the basis of this Order and Respondent's Offer, the Commission finds that;<sup>2</sup>

#### A. Respondent and Delphi Corporation ("Delphi")

##### 1. Respondent

Curry, 58, is a resident of Hilton Head, South Carolina. At all relevant times, he was a client executive at a Texas information technology company (the "IT Company") supporting the IT Company's relationship with Delphi.

##### 2. Delphi

Delphi is an auto parts supplier headquartered in Troy, Michigan. At all relevant times, Delphi's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange ("NYSE") under the symbol "DPH." On October 8, 2005, Delphi filed for bankruptcy in the Southern District of New York. On November 11, 2005, Delphi was delisted from the NYSE. Delphi's common stock is now registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades in the over the counter market and is quoted in the pink sheets under the symbol "DPHIQ".

#### B. Facts

##### 1. Introduction

Prior to December 2001, Delphi had entered agreements with the IT Company under which the IT Company provided information technology ("IT") services to Delphi (the "Existing IT Agreements"). In December 2001, Delphi and the IT Company entered into a new five-year IT contract, pursuant to which Delphi agreed to pay the IT Company approximately \$207 million over the course of five years in return for IT services (the "New IT Contract"). As additional consideration, the IT Company agreed to pay Delphi \$20 million at the time the New IT Contract was signed. Delphi agreed to repay the \$20 million to the IT Company over five years. Although the \$20 million was to be repaid and related to a new contract, Delphi improperly accounted for the payment as income (reduction of recorded IT expenses) in the fourth quarter of 2001.

Curry was a client executive at the IT Company. In 2001, he assisted in negotiating the terms of the New IT Contract, including the \$20 million payment. He also assisted in negotiating an inaccurate and incomplete side letter between Delphi and the IT Company, that allowed Delphi to mislead its auditors about the true nature of the \$20 million payment. Finally, in 2002, he negotiated and signed two work orders that were used by the companies to facilitate Delphi's repayment of the \$20 million to the IT Company.

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<sup>2</sup> 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. Curry's Understanding of Delphi's Scheme**

From his discussions with Delphi concerning the New IT Contract, Curry understood that Delphi sought a payment of \$20 million that it could book as income in the fourth quarter of 2001. Curry understood that because the payment was to be repaid and tied to the New IT Contract, it would be improper for Delphi to immediately record the \$20 million as income.

## **3. Curry's Role in Negotiating the Inaccurate and Incomplete Side Letter**

Delphi asked the IT Company to enter into a side letter documenting the \$20 million payment. Curry, on behalf of the IT Company, assisted in negotiating a side letter with Delphi that described the terms of the \$20 million payment in an inaccurate and incomplete way. In order to account for the \$20 million as income, Delphi wanted to mislead its auditors into believing that it was receiving the \$20 million as a nonrefundable rebate on payments it had previously made to the IT Company, in connection with the Existing IT Agreements. Conversely, to support its own accounting for the \$20 million payment, the IT Company wanted its own auditors to understand the true terms of the payment: that it was to be repaid over five years and that it was linked directly to the New IT Contract. Curry came to understand, from others, that in order for both companies to accomplish their accounting goals, they would need to draft a vague side letter. The side letter that Curry ultimately assisted in negotiating on behalf of the IT Company deliberately omitted any reference to the New IT Contract. Instead it stated that the payment was related to the companies' "ongoing business relationship." The letter also omitted any reference to the fact that Delphi had to repay the \$20 million.

## **4. Curry's Role in Negotiating and Signing Two Incorrect Work Orders**

In early 2002, the IT Company required that Delphi enter into a written commitment to repay the \$20 million to the IT Company. Because Delphi had accounted for the \$20 million as income, it was unwilling to enter into any document that explicitly stated that it was repaying the \$20 million. Accordingly, the companies agreed to enter into two work orders that incorrectly stated that Delphi was paying the IT Company \$20 million over five years to perform "administrative services" under the New IT Contract. In fact, the work orders were simply a mechanism for Delphi to repay the \$20 million to the IT Company. Curry negotiated and signed the work orders on behalf of the IT Company.

5. **Delphi's improper accounting**

Delphi improperly accounted for the \$20 million payment as a reduction of recorded IT expenses (effectively income) in the fourth quarter of 2001. Based on the intent of the parties and substance of the agreements, GAAP required that Delphi record the transaction as a liability to the IT Company at the time the companies executed the New IT Contract and the side letter.<sup>3</sup> As a result of its improper accounting, Delphi overstated its fourth quarter 2001 earnings per share, as reported in its Form 10-K for the period ended December 31, 2001, by approximately 2 cents or 24%.

C. **Conclusion**

As a result of the conduct described above, Curry was a cause of Delphi's violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder, which require reporting companies to file accurate annual reports with the Commission.

Also, as a result of the conduct described above, Curry was a cause of Delphi's violations of 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.

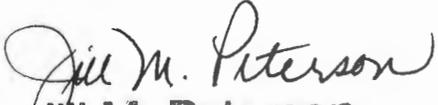
IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Curry's Offer.

Accordingly, it is hereby ORDERED that Respondent Curry cease and desist from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder.

By the Commission.

Nancy M. Morris  
Secretary

  
By: **Jill M. Peterson**  
**Assistant Secretary**

<sup>3</sup> Statement of Financial Accounting Concept Statement No.6 – Elements of Financial Statements, ¶¶ 35 – 40.

Commissioner Campos  
Not Participating

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 54666 / October 30, 2006

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 2501 / October 30, 2006

ADMINISTRATIVE PROCEEDING  
File No. 3-12464

In the Matter of

STUART DOYLE,

Respondent.

**ORDER INSTITUTING CEASE-AND-DESIST  
PROCEEDINGS, MAKING FINDINGS, AND  
IMPOSING A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission (the "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 (the "Exchange Act"), against Stuart Doyle ("Doyle" or the "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 Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.<sup>1</sup>

<sup>1</sup> In a separate civil action filed simultaneously with this proceeding, Doyle has separately consented to the entry of a judgment by the U.S. District Court for the Eastern District of Michigan pursuant to Section 21(d) of the Exchange Act ordering him to pay a civil penalty of \$40,000. *SEC v. Delphi Corporation, et al.*, Civil Action No. 2:06-cv-14891 (AC) (E.D. Mich. Oct. 30, 2006).

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### III.

On the basis of this Order and Respondent's Offer, the Commission finds that:<sup>2</sup>

#### A. Respondent and Delphi Corporation ("Delphi")

##### 1. Respondent

Doyle, 49, is a resident of Rochester Hills, Michigan. At all relevant times, he was a client executive at a Texas information technology company (the "IT Company") supporting the IT Company's relationship with Delphi.

##### 2. Delphi

Delphi is an auto parts supplier headquartered in Troy, Michigan. At all relevant times, Delphi's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange ("NYSE") under the symbol "DPH." On October 8, 2005, Delphi filed for bankruptcy in the Southern District of New York. On November 11, 2005, Delphi was delisted from the NYSE. Delphi's common stock is now registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades in the over the counter market and is quoted in the pink sheets under the symbol "DPHIQ."

#### B. Facts

##### 1. Introduction

Prior to December 2001, Delphi had entered agreements with the IT Company under which the IT Company provided information technology ("IT") services to Delphi (the "Existing IT Agreements"). In December 2001, Delphi and the IT Company entered into a new five-year IT contract, pursuant to which Delphi agreed to pay the IT Company approximately \$207 million over the course of five years in return for IT services (the "New IT Contract"). As additional consideration, the IT Company agreed to pay Delphi \$20 million at the time the New IT Contract was signed. Delphi agreed to repay the \$20 million to the IT Company over five years. Although the \$20 million was to be repaid and related to a new contract, Delphi improperly accounted for the payment as income (reduction of recorded IT expenses) in the fourth quarter of 2001.

Doyle was the lead client executive at the IT Company responsible for negotiating the terms of the New IT Contract, including the \$20 million payment. He also signed an inaccurate and incomplete side letter on behalf of the IT Company, that allowed Delphi to mislead its auditors about the true nature of the \$20 million payment.

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<sup>2</sup> 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. **Doyle's Understanding of Delphi's Scheme**

From early in his discussions with Delphi concerning the New IT Contract, Doyle understood that Delphi sought a payment of \$20 million that it could book as income in the fourth quarter of 2001. Doyle understood that because the payment was to be repaid and tied to the New IT Contract, it would be improper for Delphi to immediately record the \$20 million as income.

## 3. **Doyle's Role in Signing the Inaccurate and Incomplete Side Letter**

Delphi asked the IT Company to enter into a side letter documenting the \$20 million payment. Doyle, on behalf of the IT Company, signed a side letter with Delphi that described the terms of the \$20 million payment in an inaccurate and incomplete way. In order to account for the \$20 million as income, Delphi wanted to mislead its auditors into believing that it was receiving the \$20 million as a nonrefundable rebate on payments it had previously made to the IT Company, in connection with the Existing IT Agreements. Conversely, to support its own accounting for the \$20 million payment, the IT Company wanted its own auditors to understand the true terms of the payment: that it was to be repaid over five years and that it was linked directly to the New IT Contract. Doyle came to understand, from others, that in order for both companies to accomplish their accounting goals, they would need to draft a vague side letter. The side letter that Doyle ultimately signed on behalf of the IT Company deliberately omitted any reference to the New IT Contract. Instead it stated that the payment was related to the companies' "ongoing business relationship." The letter also omitted any reference to the fact that Delphi had to repay the \$20 million.

## 4. **Delphi's improper accounting**

Delphi improperly accounted for the \$20 million payment as a reduction of recorded IT expenses (effectively income) in the fourth quarter of 2001. Based on the intent of the parties and substance of the agreements, GAAP required that Delphi record the transaction as a liability to the IT Company at the time the companies executed the New IT Contract and the side letter.<sup>3</sup> As a result of its improper accounting, Delphi overstated its fourth quarter 2001 earnings per share, as reported in its Form 10-K for the period ended December 31, 2001, by approximately 2 cents or 24%.

### C. **Conclusion**

As a result of the conduct described above, Doyle was a cause of Delphi's violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder, which require reporting companies to file accurate annual reports with the Commission.

Also, as a result of the conduct described above, Doyle was a cause of Delphi's violations of Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and

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<sup>3</sup> Statement of Financial Accounting Concept Statement No.6 – Elements of Financial Statements, ¶¶ 35 – 40.

keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Doyle's Offer.

Accordingly, it is hereby ORDERED that Respondent Doyle cease and desist from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder.

By the Commission.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: **Jill M. Peterson**  
**Assistant Secretary**



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 finding contained in paragraph 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. Marcille, age 49, is and has been a certified public accountant licensed to practice in the State of Massachusetts. He served as Chief Financial Officer of U.S. Gas & Electric, Inc. ("U.S. Gas") from December 2002 until September 2004 when he became the company's Chief Executive Officer, a position he currently holds.

2. U.S. Gas is a Delaware corporation with its principal place of business in North Miami, Florida. U.S. Gas is engaged in the business of retail sales of natural gas. At all relevant times, U.S. Gas's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act").

3. On September 27, 2006 the Commission filed a complaint against Marcille in SEC v. U.S. Gas & Electric, Inc. et al., (Civil Action No. C-06-22440-CIV-LENARD). On October 23, 2006 the court entered an order permanently enjoining Marcille, by consent, from future violations of Sections 5(a), 5(c), 17(a)(2) and 17(a)(3) of the Securities Act of 1933.

4. The Commission's complaint alleged, among other things, that during the time Marcille was its Chief Financial Officer, U.S. Gas, with the participation of its officers, including Marcille, made material misstatements and omissions to investors in several unregistered offerings concerning the use of proceeds. Specifically, the complaint alleges that U.S. Gas, with the participation of its officers, including Marcille, failed to disclose to investors that excessive commissions were being paid to telemarketers out of the offering proceeds, and made misrepresentations to investors in one of the offerings regarding the amount of management fees that would be paid out of investor funds.

### IV.

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

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Marcille is suspended from appearing or practicing before the Commission as an accountant.

B. After three 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.

Nancy M. Morris  
Secretary

*Jill M. Peterson*  
By: Jill M. Peterson  
**Assistant Secretary**