

SECURITIES AND EXCHANGE COMMISSION

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

CHRISTOPHER COX, CHAIRMAN

PAUL S. ATKINS, COMMISSIONER

ROEL C. CAMPOS, COMMISSIONER

ANNETTE L. NAZARETH, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

46 Documents

Chairman Cox
Not Participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55848 / June 1, 2007

Admin. Proc. File No. 3-12559

In the Matter of

TRAUTMAN WASSERMAN & COMPANY, INC.,
GREGORY O. TRAUTMAN,
SAMUEL M. WASSERMAN,
MARK BARBERA,
JAMES A. WILSON, JR.,
JEROME SNYDER,
and
FORDE H. PRIGOT

ORDER DISMISSING
CEASE-AND-DESIST
PROCEEDINGS AGAINST
BARBERA

On February 5, 2007, the Commission filed an Order Instituting Proceedings ("OIP") against Trautman Wasserman & Company, Inc., Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder, and Forde H. Prigot (together, "Respondents"). The OIP alleged that Respondents engaged in late trading and deceptive market timing practices that resulted in numerous violations of the securities laws. The OIP authorized public administrative proceedings against Respondents pursuant to Section 15(b) of the Securities Exchange Act of 1934, Section 9(b) of the Investment Company Act of 1940, and Section 203(f) of the Investment Advisers Act of 1940. 1/ The OIP also authorized cease-and-desist proceedings against Respondents, which included cease-and-desist proceedings against respondent Barbera under Section 8A of the Securities Act of 1933, Section 21C of the Exchange Act, and Section 9(f) of the Investment Company Act. 2/

1/ 15 U.S.C. §§ 78q(b), 80a-9(b), 80b-3(f).

2/ 15 U.S.C. §§ 77h-1, 78u-3, 80a-9(f). The OIP seeks cease-and-desist relief under Securities Act Section 8A and Exchange Act Section 21C against Trautman Wasserman & Company, Inc.; under Securities Act Section 8A, Exchange Act Section 21C, and Investment Company Act Section 9(f) against Trautman, Wasserman, and Wilson; and under Exchange Act Section 21C against Snyder and Prigot.

Respondent Wilson is a defendant in parallel criminal proceedings in New York. Wilson was indicted by a New York grand jury on two counts of fraud and nine counts of falsifying business records, based on essentially the same conduct at issue in this administrative proceeding. On March 13, 2007, the law judge granted an application by the Attorney General of the State of New York ("NYAG"), made pursuant to Rule of Practice 210(c)(3), 3/ to stay the proceeding until the conclusion of the criminal proceeding against Wilson.

However, the law judge lifted the stay by order dated March 23, 2007 in response to an argument by respondent Barbera that Exchange Act Section 21C(b) provides that "[t]he notice instituting proceedings . . . shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or later date is set by the Commission with the consent of any respondent so served." 4/ In her March 23 order, the law judge set a hearing date for all respondents of April 13, 2007, a date sixty days after Barbera was served with the OIP.

On March 28, 2007, the Division of Enforcement ("Division") notified the law judge by letter that it intended to file a motion with the Commission to withdraw those portions of the OIP that seek cease-and-desist relief against Barbera. On March 30, 2007, the law judge issued an order following a prehearing conference. 5/ The law judge stated that, during this conference, all Respondents except Barbera objected to commencing the hearing within sixty days and voiced concerns that the April 13 hearing date would not allow them sufficient time to review the large number of documents they expected to receive eventually from the NYAG and to prepare their defenses.

After a series of motions before the law judge, on April 10, 2007, the Division filed a motion before the Commission seeking to withdraw the cease-and-desist proceedings against Barbera, arguing that withdrawal of those proceedings would permit the Division to proceed against all respondents at one hearing, thereby avoiding substantial prejudice to the Division's

3/ 17 C.F.R. § 201.210(c)(3). Rule 210(c)(3) provides that the Commission or hearing officer may grant criminal prosecutorial authorities leave to participate in a proceeding on a limited basis for the purpose of requesting a stay during the pendency of a criminal investigation or prosecution arising out of the same or similar facts at issue in the administrative proceeding, upon a showing that such a stay is "in the public interest or for the protection of investors."

4/ 15 U.S.C. § 78u-3(b). Securities Act Section 8A(b), 15 U.S.C. § 77h-1(b), and Investment Company Act Section 9(f)(2), 15 U.S.C. § 80a-9(f)(2), contain identical requirements.

5/ Pursuant to Rule 161(c)(2), 17 C.F.R. § 201.161(c)(2), the law judge also granted a joint motion by the Division and respondent Snyder to stay the proceedings as to Snyder to permit the Commission time to consider Snyder's recent settlement offer.

case-in-chief. The same day, the law judge issued an order cancelling Barbera's April 13 hearing and confirming that a hearing as to all respondents would commence on June 4, 2007.

On April 17, 2007, we issued an interim stay of these proceedings to preserve the status quo ante while we awaited the filing of any opposing and reply briefs. On April 20, 2007, Barbera filed a timely opposition to the Division's motion to withdraw the cease-and-desist proceedings against him; in that submission, Barbera also moved to dismiss the entire proceeding against him. We now grant the Division's motion to dismiss the cease-and-desist proceedings against Barbera for the reasons detailed below. Barbera's motion to dismiss the entire proceeding will be addressed in a separate order.

In its April 10 motion, the Division argues that withdrawal of the cease-and-desist proceedings is necessary to prevent prejudice to the Division's case that would result if the Division were forced to conduct a bifurcated hearing because the two hearings would involve common witnesses and documents. The other statutory provisions under which the Division is proceeding against Barbera do not contain a requirement to commence a hearing within thirty to sixty days of service of the OIP; therefore, the Division notes, the dismissal of the cease-and-desist proceedings against Barbera would eliminate the need for a bifurcated hearing. Moreover, the Division points out that, although the result of dismissal of the cease-and-desist proceedings would be that the Division could not obtain a cease-and-desist order as relief from Barbera's alleged misconduct, "[a]ll other remedies would remain available, including revocation of registrations, bars or suspensions, civil penalties and disgorgement."

We agree that it is appropriate in this case to dismiss those provisions of the OIP that authorize the institution of cease-and-desist proceedings against Barbera. Barbera urges, however, that the failure to comply with the sixty-day hearing requirement under the cease-and-desist provisions also mandates dismissal of the rest of the proceedings against him. Barbera offers no explanation or support for this position. The remaining statutes under which the OIP was authorized, namely, Exchange Act Section 15(b), Investment Company Act Section 9(b), and Advisers Act Section 203(f), do not require that Barbera receive a hearing within a specified time. As courts have long recognized, an agency's decision whether to prosecute or enforce is generally within its absolute discretion. ^{6/}

Barbera contends that the Division has abused its discretion by making false representations to the law judge about its intent to withdraw the cease-and-desist proceedings. However, the record of prehearing proceedings in this case offers no support for Barbera's allegations. The Division was consistent in its statements to the law judge that it would move the Commission to withdraw the cease-and-desist proceedings against Barbera if the law judge believed the authorizing statutes compelled a hearing within sixty days. The law judge issued an order on March 30, 2007, in which she postponed the hearing to June 4 despite Barbera's

^{6/} See Board of Trade v. SEC, 883 F.2d 525, 530 (7th Cir. 1989) (citing Heckler v. Chaney, 470 U.S. 821, 831 (1985)).

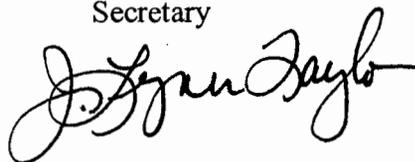
protests. The order mentions that the Division stated its intent to withdraw cease-and-desist proceedings against Barbera; however, that order does not clearly state that the law judge's decision was premised on the Division doing so. The law judge herself recognized that her order may have lacked clarity on this point, noting in her April 9, 2007 order, "I apologize to the Division because my March 30, 2007 order was not clear that the cease-and-desist provisions must be stricken at least as to Barbera." The Division promptly filed its motion to withdraw the cease-and-desist proceedings after the law judge clarified her position.

Therefore, under the circumstances of this case, it is appropriate to grant the Division's motion and dismiss the cease-and-desist proceedings against Barbera.

Accordingly, it is ORDERED that the cease-and-desist proceedings against Mark Barbera, as instituted by order dated February 5, 2007 and as authorized under Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 9(f) of the Investment Company Act, be, and they hereby are, dismissed.

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

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

Chairman Cox
Not Participating

ADMINISTRATIVE PROCEEDING
FILE NO. 3-12559

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
June 1, 2007

In the Matter of

TRAUTMAN WASSERMAN & COMPANY, INC.,
GREGORY O. TRAUTMAN,
SAMUEL M. WASSERMAN,
MARK BARBERA,
JAMES A. WILSON, JR.,
JEROME SNYDER,
and
FORDE H. PRIGOT

ORDER
GRANTING
STAY

On February 5, 2007, the Commission filed an Order Instituting Proceedings ("OIP") against Trautman Wasserman & Company, Inc., Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder, and Forde H. Prigot (together, "Respondents"). The OIP alleged that Respondents engaged in late trading and deceptive market timing that resulted in numerous violations of the securities laws. The OIP authorized public administrative proceedings against Respondents pursuant to Section 15(b) of the Securities Exchange Act of 1934, Section 9(b) of the Investment Company Act of 1940, and Section 203(f) of the Investment Advisers Act of 1940. 1/ The OIP also authorized cease-and-desist proceedings against Respondents under Section 8A of the Securities Act of 1933, Section 21C of the Exchange Act, and Section 9(f) of the Investment Company Act. 2/

1/ 15 U.S.C. §§ 78o(b), 80a-9(b), 80b-3(f).

2/ 15 U.S.C. §§ 77h-1, 78u-3, 80a-9(f). The OIP seeks cease-and-desist relief under Securities Act Section 8A and Exchange Act Section 21C against Trautman Wasserman & Company, Inc.; under Securities Act Section 8A, Exchange Act Section 21C, and Investment Company Act Section 9(f) against Trautman, Wasserman, Wilson, and Barbera; and under Exchange Act Section 21C against Snyder and Prigot.

Document 2 of 46

Respondent Wilson is a defendant in parallel criminal proceedings in New York. ^{3/} Wilson was indicted by a New York grand jury on two counts of fraud and nine counts of falsifying business records, based on essentially the same conduct at issue in this administrative proceeding. On March 13, 2007, the law judge granted an application by the Attorney General of the State of New York ("NYAG"), made pursuant to Rule of Practice 210(c)(3), ^{4/} to stay the proceeding until the conclusion of the criminal proceeding against Wilson.

On April 5, 2007, following a series of motions and orders, the NYAG notified the law judge by letter that Wilson had pleaded guilty to one felony charge in New York State Supreme Court and that sentencing was scheduled for June 7, 2007. The NYAG also noted that Scott A. Christian, another criminal defendant related to the current proceeding as an anticipated witness for the Division, had not yet been scheduled for sentencing. ^{5/} The NYAG represented that it would attempt to schedule Christian's sentencing "soon after defendant Wilson is sentenced" and suggested a hearing date of June 25, 2007, "so that the NYAG can be sure that the criminal proceedings will be completed in [their] entirety before the above matter is heard." ^{6/}

On April 9, 2007, the law judge issued an order denying a request by the NYAG to adjourn the administrative proceeding until June 25, 2007, when Wilson and Christian will likely have been sentenced. In denying the NYAG's request, the law judge noted that, under Rule 210(c)(3), the NYAG had standing only to request a stay of the proceeding, not an adjournment of a hearing date. The law judge also required that the Division make its complete investigative file available to Respondents, reasoning that, because Wilson had already pleaded guilty, revelation of the Division's entire investigative file no longer posed a danger to the NYAG's criminal case.

On April 10, 2007, the NYAG filed a motion with the Commission requesting that these proceedings be stayed pending the outcome of its criminal cases against Wilson and Christian.

^{3/} See People v. James A. Wilson, Jr., Indictment No. 1488/2006 (N.Y. Sup. Ct., N.Y. County, Crim. Term).

^{4/} 17 C.F.R. § 201.210(c)(3). Rule 210(c)(3) provides that the Commission or hearing officer may grant criminal prosecutorial authorities leave to participate in a proceeding on a limited basis for the purpose of requesting a stay during the pendency of a criminal investigation or prosecution arising out of the same or similar facts at issue in the administrative proceeding, upon a showing that such a stay is "in the public interest or for the protection of investors."

^{5/} See People v. Scott A. Christian, No. 03409-2005 (N.Y. Sup. Ct., N.Y. County, Crim. Term).

^{6/} Court records indicate that Christian has now been scheduled for sentencing on June 21, 2007. See People v. Scott A. Christian, *supra* note 5.

On April 17, 2007, we issued an interim stay of these proceedings to preserve the status quo ante while we awaited the filing of any opposing and reply briefs. 7/

It then came to our attention that another case, Warren Lammert et al., 8/ was pending before a different law judge. In the Lammert proceeding, Warren Lammert, Lars Soderberg, and Lance Newcomb ("Lammert Respondents"), who worked for the mutual fund manager Janus Capital Management, are alleged to have facilitated improper market timing and frequent trading in certain Janus mutual funds by the broker-dealer Trautman Wasserman & Company. In that administrative proceeding, the Lammert Respondents sought access to documents in the Trautman Wasserman investigative file. Party filings in Lammert suggested that the NYAG, who had requested and received a stay of the Lammert case pending resolution of the criminal proceedings against Wilson, may have already acquiesced to the release of at least some Trautman Wasserman documents to the Lammert Respondents. To determine whether there was any inconsistency between the NYAG's position with respect to disclosure of documents from the Trautman Wasserman investigative file in the two proceedings, we issued an order on April 27, 2007 requiring clarification. 9/

In response to our order, the Division represented that it was "making available the same documents to the Lammert Respondents and to the Trautman Respondents." The NYAG clarified that it "does not object to the Commission's making available the majority of the Trautman Wasserman investigative file" to both the Trautman Wasserman Respondents and the Lammert Respondents. However, the NYAG stated, it wishes to protect temporarily from production to either set of respondents a "small segment of documents that have not yet been disclosed in the criminal proceeding or in either administrative proceeding," which "includes statements by witnesses and other similar documents that have been identified and separated by the NYAG and the Division."

Our understanding, therefore, is that the NYAG seeks a stay of these administrative proceedings pending the final disposition of its criminal cases against respondent Wilson and witness Christian. The NYAG, however, does not seek to stay the production to Respondents of the Trautman Wasserman file except for the "small segment of documents" not yet made available to any respondent, the revelation of which would prejudice its criminal cases.

Although the NYAG has styled its filing as a "Motion for an Emergency Stay and a Petition for Review of Initial Decisions by the Hearing Officer" pursuant to Rules of Practice

7/ See Trautman Wasserman & Co. et al., Order Granting Interim Stay, Admin. Proc. File No. 3-12559 (April 17, 2007).

8/ Administrative Proceeding File No. 3-12386 (OIP filed July 31, 2006).

9/ See Warren Lammert, et al. and Trautman Wasserman & Co. et al., Order Directing Additional Briefing, Admin. Proc. File Nos. 3-12386, 3-12559 (April 27, 2007).

400, 401, and 410, 10/ the NYAG bases its argument exclusively on the standards set forth in Rule 210(c)(3), which permits criminal prosecutorial authorities to seek leave from either the Commission or the law judge to participate in an administrative proceeding for the purpose of requesting a stay. 11/ We therefore consider the NYAG's motion to be a request for a stay made to the Commission under Rule 210(c)(3). We grant the NYAG's motion for the reasons detailed below.

Under Rule of Practice 210(c)(3), we may grant leave to the NYAG to participate in this proceeding "[u]pon a showing that such a stay is in the public interest or for the protection of investors." A request for a stay shall be evaluated considering the status of the administrative hearing and shall be "based on a showing of good cause and be limited to a reasonable period of time, balancing the need for delay against the need to bring the proceeding to timely resolution, consistent with the public interest." 12/ The Commission promulgated Rule 210(c)(3) in order to encourage "efforts to bring criminal prosecutions arising out of securities violations" and to address concerns that the criminal prosecutions may suffer "substantial prejudice" if the administrative action were not postponed. 13/

We find that good cause exists to postpone this administrative proceeding and that a stay is in the public interest. "Federal courts and the Commission have repeatedly recognized that civil or administrative proceedings may be stayed pending resolution of parallel criminal proceedings where justice requires." 14/ The NYAG represents that "the criminal prosecution at

10/ 17 C.F.R. §§ 201.400, 401, 410. These Rules govern Commission review of interlocutory appeals, consideration of stays generally, and review of initial decisions.

11/ Barbera argues that the Commission should refuse to consider the NYAG's stay request because the request "appears as if the NYAG has taken exception with the ALJ's decision to 'adjourn the hearing,'" noting that "the Rules of Practice reflect that petitions for interlocutory review are disfavored." However, as noted above, the NYAG bases its motion on Rule of Practice 210(c)(3), which permits the NYAG to seek a stay directly from the Commission without necessitating review of prior decisions by the law judge. The NYAG therefore has standing to seek our leave to participate for the limited purpose of requesting a stay.

12/ Securities and Exchange Commission, Rules of Practice, 63 Fed. Reg. 63,404, 63,405 (Nov. 13, 1998).

13/ Id.

14/ Pryor, McClendon, Counts & Co., Order Postponing Proceedings, 54 S.E.C. 382, 386 (1999) (citing A.S. Goldmen, Order Postponing Proceedings, Admin. Proc. File No. 3-9933 (Sept. 1, 1998) p. 6 & n.7). See, e.g., United States v. Kordel, 397 U.S. 1, 12 n.27

issue here depends upon testimony and exhibits not yet disclosed to the respondents," and expresses concern that "testimony of administrative hearing witnesses would be available for impeachment purposes at a subsequent criminal trial." It appears that substantial prejudice could result to the NYAG's prosecution of Wilson and Christian if the administrative proceeding against Respondents were not postponed.

We also note that the duration of the stay should be brief and is not expected to unduly delay the proceeding or prejudice the Respondents. Because the NYAG bases its stay request on the need to complete the sentencing of Wilson and Christian, we anticipate that the stay will no longer be necessary after June 25, 2007, when both defendants will likely have been sentenced.

Barbera argues that, because Wilson and Christian have entered guilty pleas, the NYAG "has no need to present evidence or have witnesses testify; it has guilty pleas and there will be no trial." However, as the NYAG has pointed out, a criminal defendant may withdraw his plea at any time prior to sentencing, leaving open the possibility that Wilson and Christian could change their minds and force the NYAG to go to trial. Barbera argues that this possibility is exceedingly remote because both defendants have been promised that, in exchange for their guilty pleas, they will serve no prison terms. ^{15/} The NYAG points out in its reply that pleading guilty to a felony bears serious consequences even if no jail time is served.

The Commission has no basis upon which to judge the intentions of Wilson or Christian, and we decline to premise our decision here on speculation about whether they are likely or unlikely to withdraw their guilty pleas. Rather, our decision is based on our authority under Rule 210(c)(3), which permits us to prevent possible prejudice to criminal cases by imposing a stay when that stay is in the public interest or for the protection of investors.

^{14/} (...continued)
 (1970) (noting that civil proceedings may be deferred pending resolution of parallel criminal prosecutions when justice requires); SEC v. Chestman, 861 F.2d 49, 50 (2d Cir. 1988) (per curiam) ("The government had a discernable interest . . . to prevent discovery in the civil case from being used to circumvent the more limited scope of discovery in the criminal matter."); In re Ivan F. Boesky Securities Litigation, 128 F.R.D. 47 (S.D.N.Y. 1989) (deferring certain civil discovery where there was a parallel criminal prosecution involving the same subject matter); Kedar Gupta, Admin. Proc. File No. 3-9435 (Feb. 4, 1998) (postponing a Commission administrative proceeding under Rule 161 until disposition of a pending parallel criminal prosecution).

^{15/} Barbera theorizes that the NYAG seeks a stay in order to prevent revelation of documents that show how flimsy is its case against Wilson and Christian, or, in the alternative, to "buy more time for the Division to prepare for its hearing." Barbera admits his theories as to the NYAG's motivations for requesting the stay are unsupported conjecture.

Barbera has also renewed his argument that, under the statutes authorizing institution of the cease-and-desist proceedings against him, he is entitled to receive a hearing within thirty to sixty days of service of the OIP (*i.e.*, by April 13, 2007). This issue has been resolved and more fully addressed in our separate order dismissing the cease-and-desist proceedings against Barbera. 16/

Respondents Wasserman and Prigot filed untimely oppositions to the NYAG's motion in which they state no basis for their opposition except to note that they joined with Barbera in opposing the motion in its entirety – a position they espouse despite having taken contrary positions previously. Both Wasserman and Prigot represented to the law judge that they objected to holding the hearing on April 13 because they required additional time to review discovery. 17/ A short delay in these proceedings appears to comport with the wishes of the majority of respondents in this case who have sought more time to prepare for the hearing. To the extent Wasserman and Prigot purport to join Barbera's objection to the impact of the stay on Barbera's right to a hearing within sixty days, they have no standing to assert such a position.

Respondent Trautman also filed an untimely opposition, in which he argued that "[n]o specific documents, testimony or other evidence is tendered or cited to support" the NYAG's contention that its prosecutions would be jeopardized without a stay. However, requiring the NYAG to support its argument by disclosing the very documents it seeks to protect with a stay would be counterproductive. Trautman also argues that he and his family will suffer from the "lingering threat" of this proceeding if a stay of indefinite duration is granted. However, it is not our practice to impose stays of indefinite duration, 18/ and we will again, in this case, limit the duration of the stay.

Therefore, under these circumstances, we find that it is consistent with the public interest to impose a stay upon all proceedings in this case – including any motions practice – while criminal proceedings against Wilson and Christian are pending. We believe that granting a stay in this case will prevent possible prejudice to the NYAG's case without introducing significant delay to the administrative proceeding and without causing harm to Respondents. However, we are sensitive to the desire to conclude these proceedings expeditiously. As noted above, we have

16/ See Trautman Wasserman, Order Dismissing Cease-and-Desist Proceedings Against Barbera, Securities Exchange Act Rel. No. 55848 (June 1, 2007), ___ SEC Docket ___.

17/ During a March 29 prehearing teleconference before the law judge, Prigot's attorney specifically noted that "the short period of time that's been allotted us, not only for supplying an answer to the OIP, but also for the hearing, would be prejudicial to my client." Wasserman's attorney agreed, arguing that "substantive due process rights . . . would be obliterated if we were required to go to a hearing in two weeks having not even received any discovery."

18/ See A.S. Goldmen, Order Postponing Proceedings, Admin. Proc. File No. 3-9933 (Sept. 1, 1999).

made clear in prior cases that such postponements cannot be open-ended, and we will therefore order that the stay expire on June 25, 2007. 19/ The NYAG may file a motion under Rule 210(c)(3) to continue the stay beyond that date if it believes circumstances so require. Further, in order to permit Respondents to continue preparing their defenses during the pendency of the stay, we will require the Division during the pendency of the stay to continue to make its investigative file available to Respondents, with the exception of the "small segment of documents" identified by the NYAG that have not yet been disclosed and whose revelation may cause prejudice to its pending criminal cases.

Accordingly, it is ORDERED that the New York Attorney General's motion for leave to participate in this proceeding on a limited basis for the purpose of requesting a stay pending the completion of parallel criminal proceedings is granted; and it is further

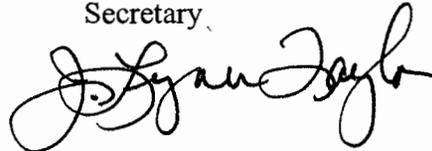
ORDERED that the administrative proceedings authorized by order dated February 5, 2007 be, and they hereby are, stayed until June 25, 2007; and it is further

ORDERED that discovery of those documents in the Division's investigative file already segregated and identified as potentially prejudicial to the New York Attorney General's criminal cases against Wilson and/or Christian is hereby stayed until June 25, 2007; and it is further

ORDERED that the Division otherwise continue to make its entire Trautman Wasserman investigative file available to Respondents, with the exception of any documents in the Division's investigative file that may be properly withheld from Respondents under Rule of Practice 230. 20/

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

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

19/ We note that Rule of Practice 360(a)(2) provides, "If a stay is granted pursuant to Rule 210(c)(3), the time period specified in the order instituting proceedings in which the hearing officer's initial decision must be filed with the Secretary, as well as any other time limits established in orders issued by the hearing officer in the proceeding, shall be automatically tolled during the period while the stay is in effect."

20/ 17 C.F.R. § 201.230.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
June 1, 2007

In the Matter of

WARREN LAMMERT,
LARS SODERBERG,
and
LANCE NEWCOMB

ORDER IMPOSING
PARTIAL STAY

Currently pending before an administrative law judge are proceedings instituted against Warren Lammert, Lars Soderberg, and Lance Newcomb by order of July 31, 2006. On February 15, 2007, the law judge granted a motion made by the New York Attorney General ("NYAG") seeking a stay of the proceedings pending the resolution of certain ongoing criminal proceedings in New York state court. 1/ In her order, the law judge stayed the proceedings but directed the Division of Enforcement to assist the Lammert respondents in obtaining access to documents in the investigative file of a factually related case, Trautman Wasserman & Co. ("Trautman Wasserman"). 2/

On April 10, 2007, the NYAG moved the Commission for a stay of the Trautman Wasserman case pending resolution of related criminal proceedings. To determine whether there was any inconsistency between the NYAG's position with respect to disclosure of documents from the Trautman Wasserman investigative file in the two proceedings, we issued an order on April 27, 2007 requiring clarification as to, among other things, which documents the NYAG sought to protect from premature revelation. 3/ In response to our order, the NYAG clarified that it "does not object to the Commission's making available the majority of the Trautman

1/ Warren Lammert, Stay Order, Admin. Proc. File No. 3-12386 (Feb. 15, 2007).

2/ Trautman Wasserman & Co., Admin. Proc. File No. 3-12559 (Order Instituting Proceedings filed Feb. 5, 2007).

3/ See Warren Lammert and Trautman Wasserman & Co., Order Directing Additional Briefing, Admin. Proc. File Nos. 3-12386, 3-12559 (April 27, 2007).

Wasserman investigative file" to both the Trautman Wasserman respondents and the Lammert respondents. However, the NYAG stated, it wishes to protect temporarily from production to either set of respondents a "small segment of documents that have not yet been disclosed in the criminal proceeding or in either administrative proceeding," which "includes statements by witnesses and other similar documents that have been identified and separated by the NYAG and the Division."

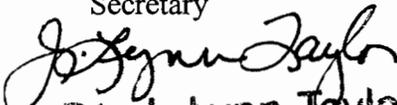
On June 1, 2007, we granted the NYAG's motion for a stay of the proceedings against the Trautman Wasserman respondents until June 25, 2007, but directed the Division to continue to make the Trautman Wasserman investigative file available to the Trautman respondents. 4/ We specifically excepted from disclosure, until June 25, 2007, the "small segment" of documents in the Division's investigative file already segregated and identified as potentially prejudicial to the New York Attorney General's criminal cases.

In order to ensure the effectiveness of that order, it is necessary to protect that "small segment" of documents from premature disclosure to the Lammert respondents. We are therefore issuing this order to stay temporarily the discovery of those documents in the Trautman Wasserman investigative file that the NYAG has identified as potentially prejudicial to its criminal cases. 5/

Accordingly, it is ORDERED that discovery of those documents in the Division's investigative file already segregated and identified as potentially prejudicial to the New York Attorney General's criminal cases against criminal defendants James A. Wilson, Jr. and/or Scott Christian is hereby stayed until such time as the stay on the discovery of those documents is lifted in the proceeding against the Trautman Wasserman respondents.

By the Commission.

Nancy M. Morris
Secretary


By: J. Lynn Taylor

Assistant Secretary

4/ See Trautman Wasserman & Co., Order Granting Stay, Admin. Proc. File No. 3-12559 (June 1, 2007).

5/ To the extent that the law judge's order of February 15, 2007 contemplated the use of confidentiality agreements to protect certain documents from inappropriate disclosure, we intend this order to make clear that only a complete stay on any revelation of those prejudicial documents will prevent harm to the NYAG's cases.

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, 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. Szeliga, age 46, of Littleton, Colorado, was employed with Qwest Communications International Inc. ("Qwest") from approximately 1997 to August 2003. Szeliga was Qwest's chief financial officer and executive vice president of finance from March 2001 to July 2002. Prior to that, she was Qwest's senior vice president of financial planning and analysis and reporting. Szeliga was a certified public accountant ("CPA") licensed in Colorado at the time of her misconduct.

2. Qwest, based in Denver, Colorado, is a telecommunications and Internet services company. At all relevant times, Qwest's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Qwest's common stock trades on the New York Stock Exchange.

3. On March 15, 2005, the Commission filed a complaint against Szeliga in SEC v. Joseph P. Nacchio, et al. (Civil Action No. 05-cv-00480-MSK-CBS) in the United States District Court for the District of Colorado. On May 30, 2007, the court entered an order permanently enjoining Szeliga, by consent, from future violations of Section 17(a) of the Securities Act of 1933, 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) and 13(b)(2) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder. Szeliga was also ordered to pay \$226,135 in disgorgement of ill-gotten gains, plus \$100,917 in prejudgment interest, and a \$250,000 civil money penalty. The court further ordered that Szeliga be barred permanently from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

4. The Commission's complaint alleged, among other things, that from at least April 1, 1999 through March 31, 2002, Szeliga and others at Qwest engaged in a massive financial fraud that hid from the investing public the true source of the company's revenue and earnings growth. The complaint alleged that to meet aggressive targets for Qwest's revenue and earnings growth, Qwest fraudulently and repeatedly relied on immediate revenue recognition

from one-time sales of assets known as "IRUs" and certain equipment, while falsely claiming to the investing public that the revenue was recurring. The complaint also alleged that Szeliga fraudulently and materially misrepresented Qwest's performance and growth to the investing public, failed properly to account for IRU sales transactions in Qwest's financial statements, and caused the company to report falsely approximately \$3 billion in revenue. The complaint alleged that Szeliga failed to make required accounting disclosures about IRUs to the investing public. In addition, the complaint alleged that, to meet revenue targets, Szeliga caused the manipulation of revenue associated with Qwest Dex, formerly a wholly-owned subsidiary of Qwest. Additionally, the complaint alleged that Szeliga fraudulently lowered liabilities related to employee vacations to increase artificially Qwest's earnings to meet revenue and growth targets. The complaint further alleged that Szeliga sold Qwest stock knowing that Qwest had issued materially false information to the investing public in violation of the insider trading prohibition of the securities laws.

IV.

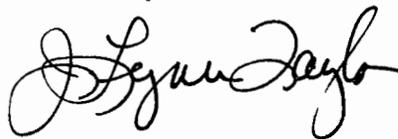
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Szeliga's Offer.

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

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

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. 55844 / June 1, 2007

ADMINISTRATIVE PROCEEDING

File No. 3-12647

In the Matter of

LUIS M. CORNIDE,

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

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III.

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

1. From June 1999 to March 2005, Respondent acted as an unregistered broker-dealer in connection with the offer and sale of Pension Fund of America L.C. ("PFA") securities, for which he received transaction-based compensation. During the relevant time period, he was president of PFA and held a fifty-percent ownership interest.

2. On May 21, 2007, a final judgment was entered by consent against Cornide, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 and Sections 15(a) and 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Pension Fund of America L.C., et al., Civil Action No. 05-20863-CIV-MOORE, in the United States District Court for the Southern District of Florida.

3. The Commission's complaint in the civil action alleged that PFA sold securities in the form of retirement trust plans, raising approximately \$127 million from more than 3,400 investors. The complaint further alleged that PFA, through its offering and marketing materials, made false representations and omissions of material fact to investors relating to, among other things, PFA's failure to disclose it used as much as 90% of investor funds to pay exorbitant commissions to sales agents, administrative fees and other costs, PFA's failure to disclose all pertinent mutual fund fees, and PFA's misrepresentations regarding its relationships with major financial institutions and broker-dealers, falsely holding the institutions out as trustees or custodians for investors' funds. The complaint charged Respondent and others with violations of the broker-dealer registration and antifraud provisions of the federal securities laws in connection with the offer and sale of PFA securities.

IV.

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

Accordingly, it is hereby ORDERED:

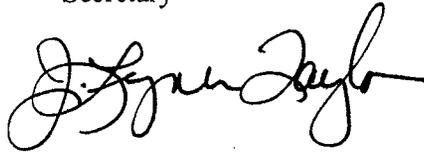
Pursuant to Section 15(b)(6) of the Exchange Act, Respondent Cornide be, and hereby is barred from association with any broker or dealer;

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

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

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. 55845 / June 1, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12648

In the Matter of

ROBERT DE LA RIVA,

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 Robert De la Riva ("De la Riva" 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

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1. From June 1999 to March 2005, Respondent acted as an unregistered broker-dealer in connection with the offer and sale of Pension Fund of America L.C. ("PFA") securities, for which he received transaction-based compensation. During the relevant time period, he was senior vice president of PFA and held a fifty-percent ownership interest.

2. On May 21, 2007, a final judgment was entered by consent against De la Riva, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 and Sections 15(a) and 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Pension Fund of America L.C., et al., Civil Action No. 05-20863-CIV-MOORE, in the United States District Court for the Southern District of Florida.

3. The Commission's complaint in the civil action alleged that PFA sold securities in the form of retirement trust plans, raising approximately \$127 million from more than 3,400 investors. The complaint further alleged that PFA, through its offering and marketing materials, made false representations and omissions of material fact to investors relating to, among other things, PFA's failure to disclose it used as much as 90% of investor funds to pay exorbitant commissions to sales agents, administrative fees and other costs, PFA's failure to disclose all pertinent mutual fund fees, and PFA's misrepresentations regarding its relationships with major financial institutions and broker-dealers, falsely holding the institutions out as trustees or custodians for investors' funds. The complaint charged Respondent and others with violations of the broker-dealer registration and antifraud provisions of the federal securities laws in connection with the offer and sale of PFA securities.

IV.

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

Accordingly, it is hereby ORDERED:

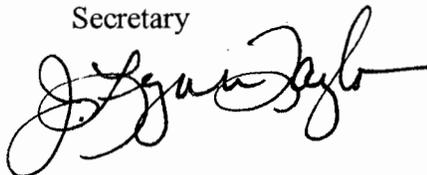
Pursuant to Section 15(b)(6) of the Exchange Act, Respondent De la Riva be, and hereby is barred from association with any broker or dealer;

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

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

INVESTMENT ADVISERS ACT OF 1940
Release No. 2608 / June 4, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12650

In The Matter of	:	ORDER INSTITUTING
JUSTIN SCOTT	:	ADMINISTRATIVE PROCEEDINGS
Respondent.	:	PURSUANT TO SECTION 203(f) OF THE
	:	INVESTMENT ADVISERS ACT OF 1940,
	:	MAKING FINDINGS, AND IMPOSING
	:	REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Justin Scott ("Scott" 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Justin M. Scott, age 49, a resident of Marblehead, Massachusetts, was a portfolio manager, managing director and chief investment officer of Putnam Investments ("Putnam"), a registered investment adviser. Putnam is the investment adviser for the Putnam Family of Funds and is the sub-adviser to certain unaffiliated institutional portfolios. As of

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September 30, 2003, Putnam managed assets of approximately \$272 billion.

2. On June 4, 2007, a final judgment was entered by consent against Scott, permanently enjoining him from future violations of Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled *Securities and Exchange Commission v. Justin Scott and Omid Kamshad*, Civil Action Number 03-12082, in the United States District Court for the District of Massachusetts. The final judgment provides that Scott is liable for disgorgement in the amount of \$489,439, plus prejudgment interest thereon in the amount of \$159,475, and a civil penalty in the amount of \$400,000, for a total monetary obligation of \$1,048,914. The final judgment further provides that Scott shall satisfy his monetary obligation by paying \$524,457 to the Securities and Exchange Commission, together with proof of payment of \$524,457 to the Secretary of State of the Commonwealth of Massachusetts in connection with a related action, *In the Matter of Putnam Investment Management, Inc. et al.*, Docket No. E-2003-061.

3. The Commission's complaint alleged that Scott engaged in inappropriate trading of Putnam mutual funds shares in his Putnam-administered deferred compensation and retirement accounts, including trading of shares of funds over which he exercised investment authority, in violation of Sections 206(1) and (2) of the Advisers Act.

IV.

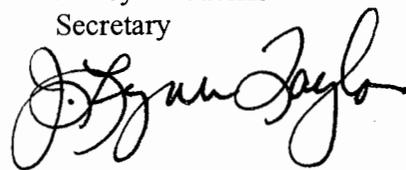
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Scott's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Scott be, and hereby is suspended for a period of twelve months from the date of this Order from association with any investment adviser.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2609 / June 4, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12651

In The Matter of	:	ORDER INSTITUTING
	:	ADMINISTRATIVE PROCEEDINGS
OMID KAMSHAD	:	PURSUANT TO SECTION 203(f) OF THE
	:	INVESTMENT ADVISERS ACT OF 1940,
Respondent.	:	MAKING FINDINGS, AND IMPOSING
	:	REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Omid Kamshad ("Kamshad" 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 him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Kamshad, 44 years old, a resident of London, England, was a portfolio manager, managing director and chief investment officer of Putnam Investments ("Putnam"), a registered investment adviser. Putnam is the investment adviser for the Putnam Family of Funds and is the sub-adviser to certain unaffiliated institutional portfolios. As of September 30, 2003,

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Putnam managed assets of approximately \$272 billion.

2. On June 4, 2007, a final judgment was entered by consent against Kamshad, permanently enjoining him from future violations of Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled *Securities and Exchange Commission v. Justin Scott and Omid Kamshad*, Civil Action Number 03-12082, in the United States District Court for the District of Massachusetts. The final judgment provides that Kamshad is liable for disgorgement in the amount of \$57,157, plus prejudgment interest thereon in the amount of \$13,709, and a civil penalty in the amount of \$400,000, for a total monetary obligation of \$470,866. The final judgment further provides that Kamshad shall satisfy his monetary obligation by paying \$235,433 to the Securities and Exchange Commission, together with proof of payment of \$235,433 to the Secretary of State of the Commonwealth of Massachusetts in connection with a related action, *In the Matter of Putnam Investment Management, Inc. et al.*, Docket No. E-2003-061.

3. The Commission's complaint alleged that Kamshad engaged in inappropriate trading of Putnam mutual funds shares in his Putnam-administered deferred compensation and retirement accounts, including trading of shares of funds over which he exercised investment authority, in violation of Sections 206(1) and (2) of the Advisers Act.

IV.

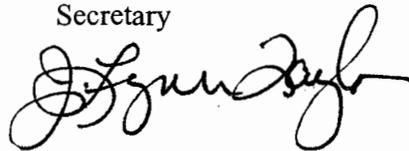
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Kamshad's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Kamshad be, and hereby is suspended for a period of twelve months from the date of this Order from association with any investment adviser.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

*Commissioners Atkins &
Campos Not Participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55858 / June 5, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2616 / June 5, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12652

CORRECTED

In the Matter of

INTERNATIONAL BUSINESS
MACHINES CORPORATION,

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 International Business Machines Corporation ("IBM" 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.

III.

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On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Respondent

IBM, a New York corporation based in Armonk, New York, is a world-wide information technology corporation. IBM's stock is registered pursuant to Section 12(b) of the Exchange Act. IBM stock trades on the New York Stock Exchange, Chicago Stock Exchange, Pacific Stock Exchange, and on other exchanges in the United States and around the world.

Summary

This matter involves a misleading chart presented by IBM during an April 5, 2005 conference call with analysts, which was simultaneously webcast, and included in a Form 8-K filed with the Commission, relating to the impact that the company's decision to expense employee stock options would have on its first quarter 2005 ("1Q05") and fiscal year 2005 ("FY05") earnings results.

During the conference call, IBM announced that beginning in 1Q05 it would report stock options as an expense in its financial statements and advised analysts to adjust their earnings models to account for the change. At the time, IBM expected that its stock options expense for 1Q05 would have a \$0.10 impact on first quarter earnings per share results and estimated a \$0.39 impact on FY05 earnings per share results. IBM did not disclose this information during the conference call or in its subsequently filed Form 8-K. IBM included a misleading chart in its presentation which was understood by many analysts to indicate that the earnings per share impact of the stock options expense would be \$0.14 for 1Q05 and \$0.55 for FY05, thereby causing analysts to lower their 1Q05 and FY05 earnings per share estimates by these amounts. By engaging in this conduct, IBM violated the reporting provisions of the federal securities laws.

Discussion

On April 5, 2005, one week after the SEC staff issued SAB 107 (regarding the reporting of employee stock options as an expense), and less than two weeks before IBM released its 1Q05 financial results, IBM announced that it would begin to report employee stock options as an expense in its financial statements for 1Q05. During the presentation (the text of which was filed with the Commission in a Form 8-K), IBM also advised analysts to update their 2004 models, for comparability, and their 2005 models to reflect the change. IBM explained to analysts that they should reduce their 2004 earnings per share figures by \$0.14 for the first quarter and by \$0.55 for the year, which were the actual amounts of stock options expense that IBM had disclosed in its 2004 pro-forma disclosures. IBM also said "(t)his is an accounting change and does not impact underlying business dynamics. Therefore, for purposes of your models, updated 2005 expectations should reflect the same level of year-to-year profit improvement as current estimates."

Furthermore, IBM said that it had taken steps that would result in lower stock options expense for 2005 compared to their 2004 pro-forma expense and that any savings would be used to offset a previously announced \$1 billion year-to-year increase in pension expense for 2005.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

During IBM's January 2005 earnings announcement, IBM had said that for 2005 it expected a \$1 billion year-to-year increase in its pension expense. This was approximately \$200 million more than the \$800 million year-to-year increase IBM had anticipated for 2005 and had announced in October 2004. IBM had also said in January that it would take steps over the course of 2005 to overcome the \$1 billion year-to-year increase in its pension expense. IBM identified "divesting the PC business," "redesigning (its) equity program with premium priced options," and "globalizing (its) business" as actions it would take to help overcome the increased pension expense.

During the April 5, 2005 conference call, IBM's management did not make any statements about the amount by which analysts should reduce their 2005 estimates to account for options expensing. IBM did present a chart which many analysts read to indicate that the stock option expense would reduce 1Q05 and FY05 earnings per share estimates by \$0.14 and \$0.55, respectively. At the time, IBM expected that its stock options expense would have only a \$0.10 impact on 1Q05 earnings per share results, or \$0.04 less than the first quarter 2004 pro-forma expense, and IBM estimated that its stock option expense would have only a \$0.39 impact on FY05 earnings per share results, or \$0.16 less than the pro-forma amount for the full year 2004. IBM did not disclose this information during the April 5 announcement or in its Form 8-K.

Although IBM considered disclosing that its 1Q05 stock options expense would be \$0.03 to \$0.04 less than the first quarter 2004 pro-forma expense, management rejected the idea due, at least in part, to concern that analysts would add back the year-to-year reduction to their earnings per share estimates instead of using the reduction to offset the increase in pension expense. Management wanted to avoid this because it would have increased the expected growth rate that analysts had set for IBM, which would have been difficult for the company to achieve because of the year-to-year increase in pension expense. However, as discussed above, the amount of the increase in IBM's pension expense for 2005 had been disclosed in October 2004 and updated in January 2005 and, therefore, had been available for analysts to factor into their 2005 models.

After IBM's April 5 announcement, many analysts reduced their earnings per share estimates for 2005 by the same amount as the 2004 pro-forma expense, \$0.14 for 1Q05 and \$0.55 for FY05. The average of analysts' earnings per share estimates was reduced to \$0.90 for 1Q05 and to \$5.07 for FY05. Many analysts' reports reflected that IBM's earnings per share estimates were lowered by \$0.14 and \$0.55 per share for 1Q05 and FY05, respectively, to account for stock options expenses.

On April 14, 2005, after the market's close, IBM announced its 1Q05 financial results. The announcement of 1Q05 results was formerly scheduled for April 18, 2005. IBM disclosed earnings of \$0.85 per share, which was \$0.05 less than the amount that many analysts were expecting following the April 5 presentation. IBM also disclosed that its equity compensation expense was \$0.10 per share for 1Q05, or \$0.04 lower than what many analysts had understood IBM's April 5 misleading chart to have indicated it would be. IBM's stock price dropped \$6.94 the next day, or over 8%, closing at \$76.33.

Violations

Section 13(a) of the Exchange Act and Rule 13a-11 thereunder require issuers of registered securities to file certain reports. 15 U.S.C. § 78m(a); 17 C.F.R. § 240.13a-11. Under Rule 13a-11, issuers are required to file current reports on material corporate developments on Form 8-K. 17 C.F.R. § 240.13a-11. In addition, issuers may choose to file certain reports on Form 8-K, as was done in this matter. Exchange Act Rule 12b-20 requires, in addition to information required to be in a report, any material information “necessary to make the required statements, in the light of the circumstances under which they are made not misleading.” 17 C.F.R. § 240.12b-20. Information is material if there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). Information regarding a company’s earnings is one of the most important considerations in making an investment decision.

IBM violated the above reporting provisions by filing with the Commission a materially misleading Form 8-K. The filing contained materially misleading information about the amount of IBM’s stock options expense and the impact it would have on IBM’s earnings per share. The Form 8-K created the impression that IBM’s stock options expense would be greater than what IBM actually expected it to be for 1Q05 and FY05. In light of the statements made in the Form 8-K, IBM should have also included in its Form 8-K additional information it knew at the time relating to its stock options expense for 1Q05 and FY05, (i.e., that it expected the expense to have a \$0.10 impact on earnings per share in 1Q05, and that it estimated the expense to have a \$0.39 impact on earnings per share for FY05). By failing to include this information in its disclosure, IBM violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-11 thereunder.

IV.

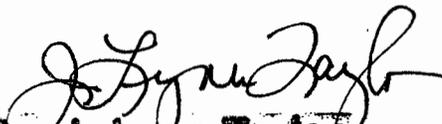
In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent IBM’s Offer.

Accordingly, it is hereby ORDERED that:

Respondent IBM cease and desist from committing or causing any violations and any future violations of Sections 13(a) of the Exchange Act and Rules 12b-20 and 13a-11 thereunder.

By the Commission.

Nancy M. Morris
Secretary


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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249b

[Release No. 34-55857; File No. S7-04-07]

RIN 3235-AJ78

Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations

AGENCY: Securities and Exchange Commission (“Commission”).

ACTION: Final rule.

SUMMARY: The Commission is adopting rules to implement provisions of the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”), enacted on September 29, 2006. The Rating Agency Act defines the term “nationally recognized statistical rating organization,” provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies, and directs the Commission to issue final implementing rules no later than 270 days after its enactment (or by June 26, 2007). The rule and form prescribing the process for a credit rating agency to apply for registration are immediately effective. The remaining rules are effective on June 26, 2007.

EFFECTIVE DATES: [Insert date of publication in Federal Register] except that §§ 240.17g-2, 240.17g-3, 240.17g-4, 240.17g-5, and 240.17g-6 are effective on June 26, 2007.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Assistant Director, at (202) 551-5521; Randall W. Roy, Branch Chief, at (202) 551-5522; Rose Russo Wells, Attorney, at (202) 551-5527; Sheila D. Swartz, Attorney, at (202) 551-5545, Division of Market

Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC
20549-6628.

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

The term nationally recognized statistical rating organization ("NRSRO") is used in federal and state statutes and regulations to confer regulatory benefits or prescribe requirements based on credit ratings issued by credit rating agencies identified as NRSROs.¹ The process of identifying NRSROs has historically been undertaken by the Commission staff through the issuance of no-action letters where the staff has determined, among other things, that the credit rating agency is recognized nationally by the predominant users of credit ratings as issuing credible and reliable ratings.² The

¹ See, e.g., federal statutes: 15 U.S.C. 78c(a)(41) (defining the term "mortgage related security"); 15 U.S.C. 78c(a)(53)(A) (defining the term "small business related security"); 15 U.S.C. 80a-6(a)(5)(A)(iv)(I) (exempting certain companies from the provisions of the Investment Company Act of 1940"); Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (1999); Transportation Equity Act for the 21st Century, Pub. L. No. 105-178 (1998); Reigle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325 (1994); Department of Commerce, Justice, and State, The Judiciary, and Related Agencies Appropriations Act, FY2001, Pub. L. No. 106-553 (2000); Higher Education Amendments of 1992, Pub. L. No. 102-325 (1992); Housing and Community Development Act of 1992, Pub. L. No. 102-550 (1992); Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242 (1991); and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-72 (1989); Commission rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.13, 239.32, 239.33, 240.3a1-1(b)(3), 240.10b-10(a)(8), 240.15c3-1(c)(2)(vi)(E), (F), and (H), 240.15c3-1a(b)(1)(i)(C), 240.15c3-1f(d), 240.15c3-3a, Item 14, Note G, 242.101(c)(2), 242.102(d), 242.300(k)(3) and (l)(3), 270.2a-7(a)(10), 270.3a-7(a)(2), 270.5b-3(c), and 270.10f-3(a)(3); and state rule: Cal. Ins. Code 1192.10.

² See letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, Commission, to John T. Anderson, Esquire, of Lord, Bissell & Brook, on behalf of Duff & Phelps, Inc. (February 24, 1982); letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Paul McCarthy, President, McCarthy, Crisanti & Maffei, Inc. (September 13, 1983); letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Robin Monro-Davies, President, IBCA Limited (November 27, 1990); letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to David

Rating Agency Act replaces the no-action letter process – which has been criticized as lacking transparency – with a registration program and Commission oversight of credit rating agencies that choose to be treated as NRSROs.

The Rating Agency Act implements the program for NRSRO registration and oversight by adding definitions to Section 3 of the Securities Exchange Act of 1934 (“Exchange Act”),³ creating a new Section 15E of the Exchange Act,⁴ and amending Section 17 of the Exchange Act.⁵ Under these new statutory provisions, a credit rating agency seeking to be treated as an NRSRO must apply for, and be granted, registration with the Commission, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. In addition, the Rating Agency Act provides the Commission with rulemaking authority to prescribe: the form of the application (including requiring the furnishing of additional information); the records an NRSRO must make and retain; the financial reports an NRSRO must furnish to the

L. Lloyd, Jr., Dewey Ballentine, Bushby, Palmer & Wood (October 1, 1990); letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Gregory A. Root, President, Thomson BankWatch, Inc. (August 6, 1991); letter from Michael A. Macchiaroli Assistant Director, Division of Market Regulation, Commission, to Lee Pickard, Pickard and Djinis LLP (January 25, 1999); letter from Annette L. Nazareth, Director, Division of Market Regulation, Commission, to Mari-Anne Pisarri, Pickard and Djinis LLP (February 24, 2003); letter from Mark M. Attar, Special Counsel, Division of Market Regulation, Commission, to Arthur Snyder, President, A.M. Best Company, Inc. (March 3, 2005); letter from Erik R. Sirri, Director, Division of Market Regulation, Commission, to Neal E. Sullivan, Bingham McCutchen LLP (May 21, 2007); letter from Erik R. Sirri, Director, Division of Market Regulation, Commission, to Yoshihiro Saito, Perkins Coie LLP (May 23, 2007).

³ 15 U.S.C. 78c.

⁴ 15 U.S.C. 78o-7.

⁵ 15 U.S.C. 78q.

Commission on a periodic basis; the specific procedures an NRSRO must implement to manage the handling of material nonpublic information; the conflicts of interest an NRSRO must manage or avoid altogether; and the practices that an NRSRO must not engage in if the Commission determines they are unfair, coercive, or abusive.

II. TIMING OF FINAL RULES

On February 2, 2007, the Commission proposed a package of rules pursuant to these grants of rulemaking authority.⁶ The rules published today incorporate many of the proposed provisions but also include significant revisions based on the comments received.⁷ The Commission, in adopting these rules today, intends that Rule 17g-1 (17 CFR 240.17g-1), Form NRSRO, and 17 CFR 249b.300 be issued in final form and be effective on the date of their publication in the Federal Register. The Commission further intends that Rules 17g-2 (17 CFR 240.17g-2), 17g-3 (17 CFR 240.17g-3), 17g-4 (17 CFR 240.17g-4), 17g-5 (17 CFR 240.17g-5), and 17g-6 (17 CFR 240.17g-6) be issued in final form on June 26, 2007 and become effective on that date.

III. EFFECTIVE DATE

Section 553(d) of the Administrative Procedure Act generally provides that, unless an exception applies, a substantive rule may not be made effective less than 30 days after notice of the rule has been published in the Federal Register.⁸ One exception

⁶ See Exchange Act Release No. 55231 (February 2, 2007), 72 FR 6378 (February 9, 2007) ("Proposing Release").

⁷ These comments are available on the Commission's Internet Web site, located at <http://www.sec.gov/comments/s7-04-07/s70407.shtml>, and in the Commission's Public Reference Room in its Washington, DC headquarters.

⁸ 5 U.S.C. 553(d).

to the 30-day requirement is an agency's finding of good cause for providing a shorter effective date.⁹

The Rating Agency Act provides that the new program for NRSRO registration and oversight shall apply on the earlier of the date on which regulations are issued in final form under Section 15E(n) of the Exchange Act, or 270 days after the enactment of the Rating Agency Act, which will be June 26, 2007.¹⁰ The Rating Agency Act voids existing Commission staff no-action letters on and after the effective date of the new program for NRSRO registration and oversight, but creates a transitional measure allowing credit rating agencies with existing no-action letters to continue to act as NRSROs “during Commission consideration of the application, if such entity has furnished an application for registration.”¹¹ Consequently, as noted above, the Commission intends that Rule 17g-1 and Form NRSRO be effective immediately upon publication. Further, the Commission intends that the remaining rules, Rule 17g-2 through Rule 17g-6, be effective on June 26, 2007, the statutory deadline.

Immediate effectiveness of Form NRSRO and Rule 17g-1 is necessary to allow credit rating agencies that are currently the subject of staff no-action letters identifying them as NRSROs to have a period of time to submit applications for registration as NRSROs before the provisions of the Rating Agency Act and the recordkeeping, reporting, and conduct rules issued under the Rating Agency Act become effective, and

⁹ Id.

¹⁰ 15 U.S.C. 78o-7(p).

¹¹ 15 U.S.C. 78o-7(l).

thus before the no-action letters become void. This will avoid a gap in time when no NRSROs exist, which would disrupt the regulatory use of that term in applicable statutes and regulations, resulting in uncertainty in the marketplace for all persons that rely upon credit ratings issued by NRSROs. Further, this result would be inconsistent with Congressional intent in creating the transitional measure. Finally, the accelerated effectiveness for the remaining rules, Rule 17g-2 through Rule 17g-6, is necessary to meet the statutory deadline.

The primary purpose of the 30-day delayed effectiveness requirement is to give affected parties a reasonable period of time to adjust to the new rules. Here, the existing NRSROs would not be harmed by immediate effectiveness, and would in fact benefit from the opportunity to utilize the transitional measure Congress provided. Further, an entity would not be required to comply with Rule 17g-2 through Rule 17g-6 until its voluntary registration has been approved.

The Commission acted expeditiously in proposing and adopting these rules under a very tight, statutorily-imposed deadline. The Rating Agency Act was enacted on September 29, 2006. Just over four months later, on February 2, 2007, the Commission voted to propose the new rules and form, which were designed to comply with the statutory mandate to establish an entirely new regulatory regime for NRSROs. The Commission voted to adopt these rules and Form NRSRO on May 23, 2007, over a month before the statutory deadline. In doing so, the Commission carefully responded to industry, user, and investor perspectives to ease the transition to a new, Congressionally-created registration and regulatory scheme.

Failure to accelerate effectiveness of Rule 17g-1 through Rule 17g-6 and Form NRSRO could interfere with the goals of the Rating Agency Act. For these reasons, the Commission finds that good cause exists for Rule 17g-1 and Form NRSRO to be immediately effective upon publication, and for Rule 17g-2 through Rule 17g-6 to be effective on June 26, 2007.

IV. REVIEW OF COMMISSION RULES

Section 15E(n)(2) of the Exchange Act requires the Commission to review its existing rules using the term “NRSRO” within 270 days of its enactment.¹² The statute further provides that the Commission shall amend or revise the rules in accordance with Section 15E(n)(2) of the Exchange Act.¹³ The Commission has reviewed all of its rules using the term “NRSRO.” The Commission does not believe these rules need to be amended at this time. The term “NRSRO” in each rule will refer to an “NRSRO” as that term is defined in the Rating Agency Act when the statutory provisions become effective.¹⁴ For example, Commission Rule 15c3-1 (the broker-dealer net capital rule) uses the term “nationally recognized statistical rating organization” to prescribe the amount a broker-dealer must haircut proprietary corporate debt securities when computing its regulatory capital.¹⁵ The rule does not otherwise define the term “nationally recognized statistical rating organization.” Consequently, after the effective date of the NRSRO regulatory program, the term, as used in this rule, will refer to a

¹² 15 U.S.C. 78o-7(n)(2).

¹³ Id.

¹⁴ See Sections 3(a)(62) and 15E(1)(2) of the Exchange Act (15 U.S.C. 78c(a)(62) and 15 U.S.C. 78o-7(1)(2)).

¹⁵ See 17 CFR 240.15c3-1(c)(2)(vi)(F).

credit rating agency that is an NRSRO as determined by the provisions of the Rating Agency Act.¹⁶

The Commission notes that several commenters raised potential concerns about how other Commission rules may operate after the NRSRO registration and oversight program takes effect.¹⁷ These commenters suggested that requirements in Rule 2a-7¹⁸ under the Investment Company Act of 1940,¹⁹ which regulates the operation of money market funds, may need to be modified depending on the number of credit rating agencies that become registered as NRSROs.²⁰ For example, one commenter noted that Rule 2a-7(c)(6)(i)(A)(2) requires a money market fund to re-assess the minimal credit risk of its portfolio whenever it becomes aware that any unrated or second tier security held by the fund has been given a credit rating by any NRSRO below the NRSRO's second highest category.²¹ Another commenter noted that Rule 2a-7 prescribes that money market funds determine whether a security is eligible for purchase based on whether it has received a credit rating in one of the two highest categories from any

¹⁶ See Sections 3(a)(62) and 15E(1)(2) of the Exchange Act (15 U.S.C. 78c(a)(62) and 15 U.S.C. 78o-7(1)(2)).

¹⁷ See letter dated March 12, 2007 from Elizabeth Krentzman, General Counsel, Investment Company Institute ("ICI Letter"); letter dated March 12, 2007 from Stephen A. Keen, Attorney, on behalf of Federated Investors, Inc. ("FI Letter"); letter dated April 4, 2007 from Charles S. Morrison, Senior Vice President and Money Market Group Leader, Fidelity Management and Research Company ("FMRC Letter").

¹⁸ 17 CFR 270.2a-7.

¹⁹ 15 U.S.C. 80a-1 *et seq.*

²⁰ See ICI Letter; FI Letter; FMRC Letter.

²¹ See FI Letter.

NRSRO.²² This commenter was concerned that this might lead to money market funds filling portfolios that most NRSROs consider third tier.²³ One of these commenters also expressed concern that the proposal did not require that an NRSRO have a particular number of credit rating categories or that the categories of one NRSRO might not correspond to those of another NRSRO.²⁴ Based on the uncertainty of how many credit rating agencies ultimately will register as NRSROs, the Commission intends to monitor for now how the NRSRO regulatory program impacts Rule 2a-7 and the Commission's other rules using the term "NRSRO." As the program develops, the Commission will evaluate whether modifications to these rules would be appropriate.

V. THE FINAL RULES

A. Rule 17g-1 – Registration Requirements

The Rating Agency Act, through the enactment of new Section 15E of the Exchange Act, provides the Commission with rulemaking authority with respect to the process for applying for registration as an NRSRO, keeping an NRSRO registration current, and withdrawing an NRSRO registration.²⁵ The Commission proposed to implement its rulemaking authority in these areas through a new rule, Rule 17g-1. The provisions of proposed Rule 17g-1 would have prescribed: how a credit rating agency must apply to be registered as an NRSRO; the form of the application; how an NRSRO must make non-confidential information in the application public; how an NRSRO must

²² See FMRC Letter.

²³ Id.

²⁴ See FI Letter.

²⁵ 15 U.S.C. 78o-7.

apply to be registered in an additional class of credit ratings; how an NRSRO must update its application; how an NRSRO must annually certify that the information and documents in its registration continue to be accurate; and how an NRSRO must provide notice of the withdrawal of its registration.

As discussed below, the Commission is adopting Rule 17g-1 with certain modifications that address issues raised by commenters, restructure the order of the paragraphs, and remove text that was unnecessary. Any textual changes not specifically discussed are non-substantive and designed to make the rule text more cohesive and consistent both within the rule and across the other the NRSRO rules published today.

1. **Paragraph (a) of Rule 17g-1**

As adopted, paragraph (a) of Rule 17g-1 provides that a credit rating agency applying to register with the Commission as an NRSRO must furnish an application on Form NRSRO. Section 15E(a)(1)(A) of the Exchange Act provides that a credit rating agency applying for registration must furnish the Commission with an application in a form prescribed by Commission rule.²⁶ Paragraph (a) of Rule 17g-1, as proposed, similarly provided that a credit rating agency applying to be registered with the Commission as an NRSRO must furnish the Commission with an application on Form NRSRO that follows all instructions for the Form. The Commission did not receive any comments on the proposed rule text of this paragraph and is adopting it substantially as proposed with one modification. Specifically, there is no longer a reference in the text to the “credit ratings described in section 3(a)(62)(B) of the [Exchange] Act (15 U.S.C. 78c(a)(62)).” This reference to a component of the statutory definition of “NRSRO” in

²⁶ 15 U.S.C. 78o-7(a)(1)(A).

the proposed rule was redundant and unnecessary. A credit rating agency, by statutory definition, must apply to be registered in one or more of the classes of credit ratings identified in section 3(a)(62)(B) of the Exchange Act.²⁷

2. Paragraph (b) of Rule 17g-1

As adopted, paragraph (b) of Rule 17g-1 provides a mechanism for an NRSRO registered for fewer than the five classes of credit ratings identified in the definition of NRSRO to apply to be registered in an additional class.²⁸ Specifically, the NRSRO must apply by furnishing an amendment on Form NRSRO.²⁹ This provision was proposed in paragraph (e) of Rule 17g-1.

Section 15E(a)(1)(B) of the Exchange Act, prescribes certain minimum information the credit rating agency must provide in its application for registration as an NRSRO.³⁰ This includes information regarding the classes of credit ratings set forth in the definition of “NRSRO” in Section 3(a)(62)(B) of the Exchange Act with respect to which the credit rating agency “intends to apply for registration.”³¹ A credit rating agency may apply to be registered for fewer than all five classes of credit ratings

²⁷ See 15 U.S.C. 78c(a)(62).

²⁸ See 15 U.S.C. 78c(3)(a)(62)(B).

²⁹ This provision further implements Section 15E(a)(1) of the Exchange Act, which requires the Commission, by rule, to prescribe the form of an application for registration (15 U.S.C. 78o-7(a)(1)).

³⁰ 15 U.S.C. 78o-7(a)(1)(B).

³¹ See Section 15E(a)(1)(B)(vii) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(vii)).

described in Section 3(a)(62)(B) of the Exchange Act.³² Accordingly, this provision provides a mechanism for an NRSRO to apply to be registered in an additional class.³³

The application to register for an additional class will be subject to the requirements in Section 15E of the Exchange Act³⁴ applicable to an application to be registered as an NRSRO. This means the time periods for the Commission to act on the application set forth in Sections 15E(a)(2)(A) and (B) of the Exchange Act also will apply to an application to be registered in an additional class of credit ratings.³⁵

Finally, the provisions of paragraphs (c) and (h) respectively, regarding the requirement to notify the Commission and amend the application prior to final Commission action and when an application is deemed to have been furnished to the Commission also apply to these applications.

The Commission did not receive any comments on these provisions. The Commission is adopting them substantially as proposed with several technical modifications. The rule text is modified to delete language instructing the NRSRO to indicate where appropriate on the form the additional class of credit ratings for which it is applying for registration. In its place, the rule text provides that the NRSRO must follow all applicable instructions for the Form, which include an instruction to indicate where appropriate on the Form the additional class of credit ratings for which

³² 15 U.S.C. 78c(a)(62)(B).

³³ This provision further implements Section 15E(a)(1) of the Exchange Act, which requires the Commission, by rule, to prescribe the form of an application for registration (15 U.S.C. 78o-7(a)(1)).

³⁴ 15 U.S.C. 78o-7.

³⁵ 15 U.S.C. 78o-7(a)(2)(A) and (B).

registration is sought. The Commission is adopting the provision with the modifications discussed above.

3. Paragraph (c) of Rule 17g-1

As adopted, paragraph (c) of Rule 17g-1 provides that an applicant for registration and an NRSRO applying to be registered in an additional class of credit ratings must promptly furnish the Commission with a notice if information in the application becomes, or is found to be, materially inaccurate before the Commission has granted or denied the application. Thereafter, the applicant will be required to update the application with complete and accurate information by submitting an amended application on Form NRSRO.³⁶

These provisions were proposed in paragraphs (c) and (e) of Rule 17g-1 for initial applicants and for NRSROs applying to be registered in an additional class of credit ratings, respectively. The notification provision is designed to alert the Commission as soon as possible that the application under consideration is materially inaccurate. The intent is to avoid situations where the Commission continues to review an application that is no longer materially accurate. The Commission has modified Form NRSRO to further clarify how a pending application should be updated using Form NRSRO. Specifically, the Form now has a check box for "Application Supplement" and specific instructions about how to complete the Form in this instance. The Commission did not receive any comments on these provisions and is adopting them with the modifications discussed above.

³⁶ This provision is being implemented under the Commission's authority in Section 15E(a)(1)(A) of the Exchange Act to prescribe the form of the application (15 U.S.C. 78o-7(a)(1)(A)).

4. Paragraph (d) of Rule 17g-1

As adopted, paragraph (d) of Rule 17g-1 provides a mechanism for an entity that has applied to be registered as an NRSRO, or an NRSRO that has applied to be registered in an additional class of credit ratings, to withdraw the registration application before the Commission takes final action on the application.³⁷ Specifically, it requires the applicant to furnish the Commission with a written notice of withdrawal executed by a duly authorized person.

The application provisions were proposed in paragraphs (b)(2) and (e) of Rule 17g-1 for initial applicants and for applications to be registered in an additional class of credit ratings, respectively. The requirement for execution by a duly authorized person is designed to ensure that the withdrawal notice reflects the intent of the credit rating agency. The Commission did not receive any comments on these provisions and is adopting them substantially as proposed.

5. Paragraph (e) of Rule 17g-1

As adopted, paragraph (e) of Rule 17g-1 provides that an NRSRO updating its application for registration pursuant to Section 15E(b)(1) of the Exchange Act³⁸ must promptly furnish the amendment to the Commission on Form NRSRO.³⁹ Section 15E(b)(1) of the Exchange Act requires an NRSRO to promptly update its application for registration if, after registration, any information or document provided as part of the

³⁷ The withdrawal of a granted registration is discussed separately below.

³⁸ 15 U.S.C. 78o-7(b)(1).

³⁹ The Commission is implementing this provision under Section 15E(a)(1) of the Exchange Act (15 U.S.C. 78o-7(a)(1)), which requires the Commission, by rule, to prescribe the form of an application for registration.

application becomes materially inaccurate.⁴⁰ The statute further provides that the information on credit ratings performance statistics (discussed below) must only be updated on an annual basis and that the certifications from qualified institutional buyers (QIBs), discussed below, are not required to be updated.⁴¹ This provision was proposed in paragraph (f) of Rule 17g-1.

The Commission has added in the instructions to Form NRSRO a description of this statutory requirement as a means to alert NRSROs that they must promptly update information or a document submitted on or with their Form NRSRO that has become materially inaccurate.

The Commission is not defining the term “promptly” as used in Section 15E(b)(1) of the Exchange Act.⁴² The Commission, however, did express its view in the proposing release that meeting the statutory requirement to update a registration when information becomes materially inaccurate should not take more than two days. In response, five commenters stated that it would be unreasonable to expect an NRSRO to submit an amendment in two days.⁴³ Three commenters proposed that the Commission

⁴⁰ 15 U.S.C. 78o-7(b)(1).

⁴¹ Id.

⁴² Id.

⁴³ See letter dated March 12, 2007 from William G. Connolly, on behalf of A.M. Best Company, Inc. (“A.M. Best Letter”); letter dated March 12, 2007 from Yasuhiro Harada, President, Ratings & Investment Information (“R&I Letter”); letter dated March 12, 2007 from Jeanne M. Dering, Executive Vice President, Moody’s Investors Services (“Moody’s Letter”); letter dated March 12, 2007 from Kent Wideman, Group Managing Director, and Mary Keogh, Managing Director, Dominion Bond Rating Service (“DBRS Letter”); letter dated March 12, 2007 from Charles D. Brown, General Counsel, Fitch Ratings (“Fitch Letter”).

define the term “promptly” to mean 10 days.⁴⁴ One commenter suggested 20 days.⁴⁵ Another commenter suggested the Commission use a facts and circumstances standard for determining whether an amendment was “promptly” furnished.⁴⁶ The Commission agrees that the analysis of whether an amendment is furnished promptly will depend on the facts and circumstances. For example, if an NRSRO changes its principal business address, it should not take more than a few days to complete Form NRSRO (inputting the new information), have the Form executed, and furnish the Form to the Commission. On the other hand, it may take a few days longer to complete the Form if the information or documents in an Exhibit become materially inaccurate.

One commenter also stated that the rule should require an update of the registration application only when the information in the current registration application becomes “materially inaccurate.”⁴⁷ In response, the Commission notes that the requirement to update an application arises from Section 15E(b)(1) of the Exchange Act, which provides, in pertinent part, that an NRSRO shall promptly update its application for registration “if any information or document provided therein becomes materially inaccurate.”⁴⁸ As noted above, the instructions to Form NRSRO have been modified to include a description of this statutory provision.

⁴⁴ See R&I Letter; A.M. Best Letter; and Fitch Letter.

⁴⁵ See Moody’s Letter.

⁴⁶ See DBRS Letter.

⁴⁷ See Moody’s Letter.

⁴⁸ 15 U.S.C. 78o-7(b)(1).

In all other respects, the Commission is adopting the provision substantially as proposed.

6. Paragraph (f) of Rule 17g-1

As adopted, paragraph (f) of Rule 17g-1 provides that an NRSRO updating its application for registration pursuant to Section 15E(b)(2) of the Exchange Act⁴⁹ (the annual certification) must furnish the amendment to the Commission on Form NRSRO.⁵⁰ Section 15E(b)(2) of the Exchange Act requires an NRSRO to furnish the Commission with an amendment to its registration not later than 90 days after the end of each calendar year.⁵¹ This section further provides that the amendment must (1) certify that the information and documents provided in the application for registration (except the QIB certifications) continue to be accurate and (2) list any material change to the information and documents during the previous calendar year.⁵²

This provision was proposed in paragraph (g) of Rule 17g-1. A commenter suggested that the proposed provision should be revised to permit the filing of the annual certification within 90 days after the end of an NRSRO's fiscal year (if different than the end of the calendar year).⁵³ However, as noted, the calendar year requirement is statutory. The instructions to Form NRSRO have been modified from those proposed to

⁴⁹ 15 U.S.C. 78o-7(b)(2).

⁵⁰ The Commission is implementing this provision under Section 15E(b)(2) of the Exchange Act (15 U.S.C. 78o-7(b)(2)), which requires the Commission, by rule, to prescribe the form of the annual certification.

⁵¹ 15 U.S.C. 78o-7(b)(2).

⁵² Id.

⁵³ See Fitch Letter.

include a description of this statutory provision. In all other respects, the Commission is adopting the provision substantially as proposed.

7. Paragraph (g) of Rule 17g-1

As adopted, paragraph (g) of Rule 17g-1 provides that an NRSRO withdrawing its registration pursuant to Section 15E(e)(1) of the Exchange Act⁵⁴ must furnish the Commission with a notice of withdrawal on Form NRSRO. The rule further provides that the withdrawal becomes effective 45 calendar days after the furnishing of the form. Section 15E(e)(1) of the Exchange Act⁵⁵ provides that an NRSRO may withdraw from registration, subject to such terms and conditions the Commission may establish as necessary in the public interest or for the protection of investors, by furnishing the Commission with a written notice of withdrawal.⁵⁶ The rule text references this statutory standard.

This provision was proposed in paragraph (h) of Rule 17g-1 without specifying the form of the notice or the conditions for withdrawal. A commenter suggested that the withdrawal provision be modified to provide that the withdrawal of the registration becomes effective within 90 days of the notice and that the notice be provided through an amendment to registration furnished on Form NRSRO.⁵⁷ The Commission did note in the proposing release that the conditions for withdrawal potentially could include a

⁵⁴ 15 U.S.C. 78o-7(e)(1).

⁵⁵ Id.

⁵⁶ Id.

⁵⁷ See Moody's Letter.

requirement that the NRSRO provide public notice that its credit ratings will cease to be eligible for regulatory use.

The Commission agrees with the commenter that the notice should be furnished on Form NRSRO. This provides for public notice of the withdrawal, since the current Form NRSRO must be made publicly available pursuant to Section 15E(a)(3) of the Exchange Act⁵⁸ and Rule 17g-1(i) discussed below. The Commission also agrees with the commenter that in the normal course an NRSRO's withdrawal of registration should become effective within a prescribed time period. This will provide a degree of certainty to the NRSRO as to when it will no longer be subject to the Commission's regulatory program. It also will be consistent with withdrawal requests by certain other regulated entities. For example, a broker-dealer's request for withdrawal of its registration becomes effective within 60 days of the filing of the appropriate form.⁵⁹ The Commission also believes users of credit ratings should have adequate prior notice of an NRSRO's intent to withdraw its application. This will give them notice that they will no longer be able to rely on the entity's credit ratings to meet statutory or regulatory requirements using the term "NRSRO." It also will provide them with notice that the entity will no longer be subject to the Commission's oversight, including requirements to disclose information about its performance, methodologies, procedures, and organization.

The Commission believes the 45 calendar day time period for the withdrawal to become effective is necessary in the public interest or for the protection of investors for

⁵⁸ 15 U.S.C. 78o-7(a)(3).

⁵⁹ See 17 CFR 240.15b6-1.

several reasons. First, as discussed below, pursuant to paragraph (i) of Rule 17g-1, an NRSRO must make its current Form NRSRO publicly available within 10 business days of being furnished to the Commission. Consequently, notice of an NRSRO's withdrawal will be made publicly available at least 30 calendar days before becoming effective. This notice will provide users of credit ratings with time to prepare for the NRSRO's withdrawal. Second, subject to certain limited exceptions, an entity acting as a "broker" or "dealer" as defined in Sections 3(a)(4) and (5) of the Exchange Act⁶⁰ respectively must register with the Commission.⁶¹ Conversely, an entity may act as a "credit rating agency" as defined in Section 3(a)(61) of the Exchange Act⁶² without being required to register with the Commission. In this sense, registration as an NRSRO is more voluntary than registration as a broker-dealer. Therefore, a shorter time period to withdraw an NRSRO registration is appropriate.

Form NRSRO has been modified to include a checkbox to indicate when the Form is being furnished to withdraw a registration and the instructions for the Form have been modified from those proposed to include an explanation of how to complete the Form in this case. Specifically, an NRSRO would complete each Item on the Form, except Item 6, and have the Form executed.

For these reasons, the Commission is adopting the provision in Rule 17g-1 concerning a withdrawal of registration with the modifications described above.

8. Paragraph (h) of Rule 17g-1

⁶⁰ 15 U.S.C. 78c(a)(4) and (5).

⁶¹ See Section 15 of the Exchange Act (15 U.S.C. 78o).

⁶² 15 U.S.C. 78c(a)(61).

As adopted, paragraph (h) of Rule 17g-1 provides that a Form NRSRO submitted to the Commission pursuant to any provision in Rule 17g-1 will be deemed furnished to the Commission on the date that the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the form.⁶³ The requirement for completeness comports with the requirements imposed on other types of registrants under the Exchange Act.⁶⁴ In addition, Section 15E(a)(2)(A) of the Exchange Act requires the Commission to grant an application for registration as an NRSRO or commence proceedings on whether to deny the application within 90 days from the date the application is furnished to the Commission or a longer period if the applicant consents.⁶⁵ Further, if proceedings are commenced, Section 15E(a)(2)(B) of the Exchange Act⁶⁶ requires the Commission to conclude them within 120 days of the date the application is furnished to the Commission.⁶⁷ These statutory requirements make it necessary for the Commission to receive a complete initial application before the 90-day and 120-day periods begin to run.

⁶³ This provision is adopted under the Commission's authority in Section 15E(a)(1)(A) of the Exchange Act to prescribe the form of the application (15 U.S.C. 78o-7(a)(1)(A)).

⁶⁴ See, e.g., 17 CFR 240.15b1-1 and 17 CFR 240.15b3-1 (broker-dealers); 17 CFR 240.15Ba2-1 (municipal securities dealers); 17 CFR 240.17Ab2-1 (clearing agencies); and 17 CFR 240.17Ac2-1 (transfer agents).

⁶⁵ 15 U.S.C. 78o-7(a)(2)(A).

⁶⁶ 15 U.S.C. 78o-7(a)(2)(B).

⁶⁷ Under Section 15E(a)(2)(B)(iii) of the Exchange Act, the Commission can extend this period for an additional 90 days for good cause or for such other period as the applicant consents (15 U.S.C. 78o-7(a)(2)(B)(iii)). An applicant will be required to consent to extend both the period for the Commission to make the initial determination and the 120-day period to conclude proceedings; since the 120-day period begins when the application is furnished to the Commission, not when the Commission determines to commence proceedings.

Rule 17g-1, as proposed, explicitly applied the standard described above for when a Form NRSRO would be deemed “furnished” for submissions of the Form to apply for registration and to add a class of credit ratings to an existing registration. The Commission did not receive any comments on these provisions as proposed.

Rule 17g-1, as adopted, clarifies that the “when furnished” standard also applies to furnishings of Form NRSRO to update a registration, make the annual certification, and withdraw a registration. As discussed above, amendments to update materially inaccurate information must be furnished promptly, annual certifications must be furnished within 90 days of the end of the calendar year, and withdrawals of registration become effective in 45 calendar days. Therefore, a Form NRSRO submitted for these purposes will be deemed “furnished” upon the submission of a complete and properly executed form.

Rule 17g-1(h), as adopted, contains a provision stating that the Commission will, to the extent permitted by law, keep confidential information that is furnished on a confidential basis and requested to be kept confidential. As in any situation where a person wishes to obtain confidential treatment for information provided to the Commission, an applicant and NRSRO must comply with the requirements of the Exchange Act governing confidential treatment.⁶⁸ This provision has been added to highlight for credit rating agencies and NRSROs the fact that information required by Form NRSRO includes information that will be furnished “on a confidential basis.”⁶⁹ Some of the information to be furnished to the Commission “on a confidential basis” in

⁶⁸ See, e.g., Section 24 of the Exchange Act (15 U.S.C. 78x), 17 CFR 240.24b-2, 17 CFR 200.80 and 17 CFR 200.83.

⁶⁹ See, e.g., Section 15E(a)(1)(B)(viii) of the Exchange Act.

the Form is required by Section 15E(a)(1)(B) of the Exchange Act,⁷⁰ and the Commission will consider requests for confidential treatment for that information. In addition, certain other information also is required in the Form and it may be appropriate for the Commission to provide confidential treatment to some of this information. The Commission will evaluate all requests for confidential treatment under the existing rules governing confidential treatment for information furnished to the Commission.⁷¹

For these reasons, the Commission is adopting the provision in Rule 17g-1 concerning when a Form NRSRO will be deemed to have been furnished with the modifications described above.

9. Paragraph (i) of Rule 17g-1

As modified, paragraph (i) of Rule 17g-1 requires that an NRSRO make its current Form NRSRO and information and documents submitted in Exhibits 1 through 9 publicly available within 10 business days of being granted an initial registration or registration in an additional class of credit ratings and within 10 business days of furnishing an update to amend information on the form, to provide the annual certification, and to withdraw a registration. Section 15E(a)(3) of the Exchange Act provides that the Commission, by rule, shall require an NRSRO, after registration, to make the information submitted in its application and any amendments publicly available on its Web site or through another comparable, readily accessible means.⁷²

The 10 business day period is intended to provide the NRSRO with sufficient time to

⁷⁰ See Sections 15E(a)(1)(B)(viii) and (ix) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(viii) and (ix)).

⁷¹ See 17 CFR 200.80 and 17 CFR 200.83.

⁷² 15 U.S.C. 78o-7(a)(3).

make the information public and designed to ensure that users of credit ratings have access to the information within a reasonably short timeframe.

This provision was proposed in paragraph (d) of Rule 17g-1, except that the time period to make the information publicly available was proposed to be five business days. The Commission received three comments on the five business day time period. Two commenters stated that five business days was not enough time to make their application information publicly available, given the volume of information.⁷³ They commented that the time period should be 15 and 20 business days, respectively.⁷⁴ The third commenter stated that the five business day time period should not be lengthened as the information is an important way for users of credit ratings to become familiar with a new NRSRO.⁷⁵

The Commission agrees with the third commenter that making the information publicly available as soon as possible will be an important means for users of credit ratings to understand the methodologies, procedures, and business models of new NRSROs. At the same time, the Commission agrees with the two other commenters that larger more complex NRSROs could have substantial amounts of information in their applications, which may make it difficult to provide all this information in a publicly available format in five business days. Therefore, the Commission is lengthening the time period to ten business days. This is shorter than the 15 and 20 day periods advocated by the two commenters. However, as discussed below, Form NRSRO has

⁷³ See DBRS Letter; Fitch Letter.

⁷⁴ See Fitch Letter and DBRS Letter, respectively.

⁷⁵ See ICI Letter.

been modified in ways that reduce the volume of information that must be made publicly available. Consequently, the Commission believes 10 business days will be a sufficient amount of time.

Finally, while Section 15E(a)(3) of the Exchange Act⁷⁶ does not address whether an application to register as an NRSRO shall be made publicly available prior to registration, this type of information typically would be made available by the Commission to members of the public before the application is acted on by the Commission.⁷⁷ Two commenters, both current NRSROs, stated that the Commission should not make information in the application available to the public until after registration was granted.⁷⁸ The Commission notes that an applicant can seek confidential treatment for information in the application under existing laws and rules governing confidential treatment.⁷⁹ The Commission will accord this information confidential treatment to the extent permitted by law. This is consistent with how the Commission treats applications of other entities.

B. Form NRSRO

The Commission proposed Form NRSRO to serve four functions: for a credit rating agency to apply for registration as an NRSRO; for an NRSRO to apply to be

⁷⁶ 15 U.S.C. 78o-7(a)(3).

⁷⁷ See 17 CFR 200.80(b)(4) and 17 CFR 200.80a. 17 CFR 200.80a contains a compilation of records generally available at the public reference room in the principal office of the Commission, including, for example, applications for registration as a broker-dealer or investment adviser.

⁷⁸ See DBRS Letter; A.M. Best Letter.

⁷⁹ See 17 CFR 200.80 and 17 CFR 200.83.

registered in an additional class of credit ratings; for an NRSRO to update public information required to be disclosed and kept accurate on the Form; and for an NRSRO to make an annual certification. Proposed instructions for the Form described how an applicant, and after registration, an NRSRO, should complete the Form in each of these circumstances.

The Commission believes that having just one form (and one set of instructions) will reduce the burden on applicants, NRSROs, and Commission staff. For example, it will reduce the complexity of having different forms for the application, amendments, and annual certification. Using one form also will allow NRSROs to more quickly become familiar with the Form and its instructions, which will reduce the potential for making mistakes in completing the Form. It also will assist users of credit ratings in understanding the Form and public Exhibits and where to look on the Form for specific information.

As discussed below, the Commission is adopting Form NRSRO with substantial modifications that address issues commenters raised and allow the Form to be used to furnish a notice of withdrawal of registration. Much of the information elicited in the Form is required to be submitted to the Commission pursuant to Section 15E(a)(1)(B) of the Exchange Act.⁸⁰ The Commission, under authority in Section 15E(a)(1)(B)(x), is requiring certain additional information.⁸¹ The Commission believes this additional information elicited in the Form is necessary or appropriate in the public interest or for the protection of investors because, as discussed below, it will: (1) assist the Commission

⁸⁰ 15 U.S.C. 78o-7(a)(1)(B).

⁸¹ 15 U.S.C. 78o-7(a)(1)(B)(x).

in making the findings required in Section 15E(a)(2)(C) of the Exchange Act with respect to whether an applicant should be granted registration as an NRSRO;⁸² (2) assist the Commission in making the findings required in Section 15E(d) of the Exchange Act with respect to whether the Commission should censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO;⁸³ (3) assist the Commission in reviewing whether an NRSRO is complying with Section 15E of the Exchange Act⁸⁴ and the Commission's rules thereunder; and (4) provide users of credit ratings with information that will assist them in comparing NRSROs and understanding how a given NRSRO conducts its activities.

1. Checkboxes indicating nature of submission

The first entry an applicant or NRSRO must make on Form NRSRO is to indicate, by checking the appropriate box, the reason the form is being furnished: to apply for registration as an NRSRO; to apply to be registered in an additional class of credit ratings; to supplement either type of application while the application is pending; to update public information on the Form that has become materially inaccurate; to make the annual certification; and to provide notice of a withdrawal of registration. If the Form is furnished to supplement an application or update a registration, the NRSRO also must identify by number the specific items or Exhibits on the form that are being supplemented or amended. For example, if the NRSRO is furnishing an update to its registration because its address and organizational structure have changed, the NRSRO

⁸² 15 U.S.C. 78o-7(a)(2)(C).

⁸³ 15 U.S.C. 78o-7(d).

⁸⁴ 15 U.S.C. 78o-7.

is required to enter “Item 1C” and “Exhibit 4” in the appropriate field on the Form. The Form, as proposed, required a brief description of the nature of the amendment. This requirement has been eliminated to simplify the process of completing the Form.

The Commission also has added two checkboxes that were not on the proposed version of the Form. The first new checkbox – “Application Supplement” – is for when a credit rating agency applying for registration as an NRSRO or an NRSRO applying to be registered in an additional class of credit ratings must furnish an amendment to its application because information submitted in the application is or has become materially inaccurate. As proposed, an NRSRO would have checked the more generic “Amendment” checkbox. The Commission added a separate checkbox to distinguish amendments relating to a pending application from other amendments, which will make the reason for the furnishing of the Form more transparent.

Second, the Commission added a checkbox to indicate when the Form is being furnished to withdraw a registration in light of the change to Rule 17g-1 requiring the notice of withdrawal to be furnished on Form NRSRO.

2. Item 1 (Identifying information)

As adopted, Item 1 requires an applicant and NRSRO to enter on to Form NRSRO identifying information about itself and its contact person. The instructions for Form NRSRO provide that the individual listed as the contact person must be authorized to receive all communications and papers from the Commission and will be responsible for their dissemination within the NRSRO. One commenter suggested that Item 1 require the telephone number, fax, and email address of the contact person.⁸⁵ The

⁸⁵ See DBRS Letter.

Commission elicits the telephone number for broker-dealer contact persons.⁸⁶ The number of NRSROs will be substantially smaller than the number of registered broker-dealers. The Commission believes at this time it will be able to easily obtain the contact information for the contact person without the necessity of having the information disclosed on the Form.

The instructions to Item 1 of Form NRSRO indicate that the name entered on Line A of Item 1 must be the “person” that is applying for registration or registered as the NRSRO. The instructions further clarify through the definition of “person” that a separately identifiable department or division of a corporation or company may be registered as an NRSRO. This clarification had been made because certain credit rating agencies provide their credit rating services through operating divisions that may be a part of a larger legal entity or encompass several different legal entities located throughout the world.⁸⁷ In an effort to more narrowly tailor the requirements for registration, the Commission believes it is appropriate in these circumstances to permit the operating division to register as the NRSRO as opposed to the larger legal entity that may engage in activities not intended to be regulated under the Rating Agency Act. Similarly, the Commission believes it is appropriate that the registered operating division include each separate legal entity that provides credit rating services, provided the operating division treats the credit ratings of the separate legal entities as its own and has global procedures, methodologies, policies, and controls that apply to the separate legal entities.

⁸⁶ See Form BD – Uniform Application for Broker-Dealer Registration.

⁸⁷ See, e.g., letter dated March 12, 2007 from Vickie A. Tillman, Executive Vice President, Standard & Poors (“S&P Letter”); DBRS Letter; Fitch Letter; Moody’s Letter.

The instructions to Form NRSRO now include a definition of “separately identifiable department or division” that is designed with these goals in mind.⁸⁸ The first component of the definition is that the operating division must be a unit of a corporation or company that is under the direct supervision of an officer or officers designated by the board of directors of the corporation as responsible for the day-to-day conduct of the corporation’s credit rating activities for one or more affiliates, including the supervision of all employees engaged in the performance of such activities. The second component of the definition is that all of the records relating to the operating division’s credit rating activities must be separately created or maintained in or extractable from its own facilities or the facilities of the corporation, and such records must be maintained or otherwise accessible to permit independent examination for, and enforcement by, the Commission of Section 15E of the Exchange Act⁸⁹ and rules and regulations promulgated thereunder.

In all other respects, Item 1 to Form NRSRO is being adopted substantially as proposed.

3. Certification

The applicant or NRSRO must have a duly authorized individual execute a certification that the information and statements furnished in the Form NRSRO are accurate in all significant respects. The Commission added the “in all significant respects” language to the certification in response to comments that the certification, as proposed, could have been construed to hold the certifying individual to an unrealistic

⁸⁸ See 15 U.S.C. 80b-2 for a similar definition of separately identifiable departments or divisions of banks.

⁸⁹ 15 U.S.C. 78o-7.

standard of having to ensure the Form did not include even trivial inaccuracies.⁹⁰ The additional language is intended to allay these concerns. In light of this new language, the instructions for the Form now clarify that the Chief Executive Officer or the President of the applicant or NRSRO, or an individual with similar responsibilities, must execute the certification. This is designed to ensure that the person executing the certification has responsibilities that will make the person aware of the basis for the information being provided in the form.

In all other respects, the language of the certification is being adopted substantially as proposed.

4. Item 2 (Legal status, place of formation, fiscal year end)

As adopted, Item 2 requires an applicant and NRSRO to enter on to Form NRSRO information about its legal status (for example, corporation or partnership), the place and date of its formation, and its fiscal year end. The information with respect to the fiscal year end of the applicant or NRSRO is relevant because Form NRSRO requires applicants to submit audited financial statements with the application and Rule 17g-3 requires NRSROs to annually furnish the Commission with audited financial statements covering the previous fiscal year. The Commission did not receive any comments on this provision and is adopting it substantially as proposed.

5. Item 3 (Credit Rating Affiliates)

As discussed above, commenters with global operations stated that a credit rating agency with separate legal entities in different countries should be able to include them

⁹⁰ See Letter dated March 26, 2007 from Vickie A. Tillman, Executive Vice President, Standard & Poors ("S&P 2nd Letter"); Moody's Letter.

in a single NRSRO registration.⁹¹ The Commission agrees that permitting a single registration is appropriate in that it will lessen the burden of having a parent company register multiple legal entities that make up the parent company's credit rating division. Consequently, an applicant with affiliates that would be, or an NRSRO with affiliates that are, a part of its registered separately identifiable department or division must identify and provide the address of each such affiliate. The instructions to Form NRSRO clarify that any credit rating issued by a credit rating affiliate will be considered a credit rating issued by the NRSRO for purposes of Section 15E of the Exchange Act⁹² and the regulations thereunder. For example, the provisions in Rule 17g-5 with respect to issuing or maintaining credit ratings while having certain conflicts of interest will apply.

The instructions also provide that an applicant and NRSRO in completing Form NRSRO must incorporate information about the credit ratings, methodologies, procedures, policies, financial condition, results of operations, and organizational structure of each credit rating affiliate identified in Item 3 in the other items and Exhibits. For example, the description of the procedures and methodologies for determining credit ratings in Exhibit 2 must include the procedures and methodologies used by the credit rating affiliates.

For these reasons, the Commission is adopting Item 3 to Form NRSRO as described above.

6. Item 4 (Compliance officer)

⁹¹ See DBRS Letter; Fitch Letter.

⁹² 15 U.S.C. 78o-7.

As adopted, Item 4 requires an applicant and NRSRO to provide the name and address of its designated compliance officer required under Section 15E(j) of the Exchange Act.⁹³ This person is responsible for administering the policies and procedures of the credit rating agency to prevent the misuse of nonpublic information, to manage conflicts of interest, and to ensure compliance with the securities laws and the rules and regulations under those laws. The Commission did not receive any comments on this provision and is adopting it substantially as proposed.

7. Item 5 (Method of making Form and Exhibits publicly available)

As adopted, Item 5 requires an applicant and NRSRO to describe how it will make, or makes, its current Form NRSRO and Exhibits 1 through 9 publicly available pursuant to Section 15E(a)(3) of the Exchange Act⁹⁴ and Rule 17g-1(i) thereunder. As discussed above, paragraph (i) of Rule 17g-1 is being adopted under Section 15E(a)(3) of the Exchange Act, which provides that the Commission shall, by rule, require an NRSRO, upon the granting of its registration, to make the information submitted to the Commission in the initial application, amendments, or annual certifications publicly available on the NRSRO's Web site or through another comparable, readily accessible means.⁹⁵ As discussed above, paragraph (i) of Rule 17g-1 requires an NRSRO to make its current Form NRSRO and Exhibits 1 through 9 publicly available within 10 business days after the date of the Commission order granting an initial application and an application to be registered in an additional class of credit ratings and within 10 business

⁹³ 15 U.S.C. 78o-7(j).

⁹⁴ 15 U.S.C. 78o-7(a)(3).

⁹⁵ Id.

days after furnishing the Commission with an amendment on Form NRSRO (including an annual certification and withdrawal of registration). This information elicited in Item 5 will assist the Commission in reviewing whether the NRSRO is complying with this requirement and assist the public in locating the information.

The Commission did not receive any comments on this provision and is adopting it substantially as proposed.

8. Item 6 (Classes of credit ratings for which registration is sought and QIB certifications)

An applicant for registration as an NRSRO or an NRSRO applying to add another class of credit ratings to its registration must complete Item 6 of Form NRSRO. This item elicits information about the classes of credit ratings for which the applicant is applying to be registered. It also requires the applicant to attach the requisite number of QIB certifications (two for each class of credit rating for which registration is sought and at least 10 with an initial application).

Item 6 elicits the approximate number of credit ratings issued in each class as of the application date. Commenters objected to the requirement to provide the number of credit ratings in a particular class because it could make it more difficult for new entrants to obtain business.⁹⁶ The Commission believes that users of credit ratings will find this information useful in understanding an NRSRO. For example, it will provide information as to how broad an NRSRO's coverage is with respect to issuers and obligors within a particular class of credit ratings.

Item 6 also elicits the date the applicant first began issuing credit ratings in that class on a continuous basis without interruption. The Form, as proposed, required the

⁹⁶ See, e.g., A.M. Best Letter.

applicant to provide the number of years it has been issuing credit ratings on a continuous basis. One commenter suggested that an NRSRO be required to provide the date of first issuance, instead of the number of years, to avoid the necessity of having to frequently update the information.⁹⁷ The Commission agrees with the commenter that this will make the information submitted on the Form less subject to change and reduce the requirement to, and burden of, updating the Form. Consequently, the Commission has modified Items 6 and 7 accordingly. The information on how long an NRSRO has issued credit ratings in a particular class will assist users of credit ratings in assessing the NRSRO's level of experience.⁹⁸ Section 15E(a)(1)(C) of the Exchange Act also requires that the QIB certifications include a representation that the QIB has used the credit ratings of the applicant in the class of credit ratings for at least the three years immediately preceding the date of the application. The instructions provide that an applicant cannot tack on periods when a credit rating affiliate issued credit ratings in the particular class if the entity was not an affiliate during that time period. This provision is designed to avoid the submission of misleading information by providing that only credit ratings issued by, or on behalf of, the NRSRO are used in determining the start date.

Item 6 also elicits a brief description of how the credit rating agency issues its credit ratings on the Internet or through another readily accessible means, for free or for

⁹⁷ See letter dated March 8, 2007 from Majorie E. Gross ("Gross Letter").

⁹⁸ Because Item 7, discussed below, will not be filled out when the NRSRO applies for registration, it will remain blank for a period of time between the granting of an initial registration and the time when the NRSRO furnishes a new Form NRSRO either as an amendment or annual certification. Item 6, however, will have been filled out as part of the application for registration. This item requires the same information as Item 7. Therefore, users of credit ratings will have the access to the information through Item 6 until the NRSRO furnishes an annual certification. Thereafter, the information will be located in Item 7 and updated annually with each new annual certification.

a reasonable fee. The Commission will use this information to review whether the applicant is in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee.⁹⁹ The Rating Agency Act does not define “readily accessible.” The information about how an applicant issues credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee also will inform the public about where and, if applicable, the cost to access an NRSRO’s credit ratings.

Further, the Rating Agency Act does not define “reasonable fee.” In the proposing release, the Commission sought comment on whether it should define “reasonable fee.” In response, four commenters stated that the Commission should not in any way regulate the fees an NRSRO charges for its credit ratings.¹⁰⁰ The Commission has determined not to define “reasonable fee” at this time in order to gain experience on the issue. Item 6 is designed to assist the Commission in gaining this experience.

One commenter stated that Item 6, as proposed, does not elicit information that would be helpful in understanding the fees charged for obtaining or accessing credit ratings.¹⁰¹ The Commission notes that, to the extent that several NRSROs indicate that they make their credit ratings available for free, the Commission will have assurance that regulatory users have ready access to NRSRO credit ratings. However, the Commission

⁹⁹ Section 3(a)(61)(A) of the Exchange Act (15 U.S.C. 78c(a)(61)(A)).

¹⁰⁰ See letter dated March 12, 2007 from Cate Long, Multiple Markets (“MM Letter”); letter dated March 12, 2007 from Lawrence J. White, Professor of Economics, Stern School of Business (“White Letter”); Letter dated March 12, 2007 from Alex J. Pollack, Resident Fellow, American Enterprise Institute (“AEI Letter”); Gross Letter.

¹⁰¹ See Gross Letter.

believes the form should elicit more information about fees so that the information will be disclosed to users of credit ratings. This will improve price transparency, which may lead to greater competition. Accordingly, the instructions for Item 6 and Item 7 now provide that an applicant that charges a fee for accessing its credit ratings must describe the fee or include a fee schedule in the form.

Finally, Item 6 requires the applicant to provide the QIB certifications mandated pursuant to Section 15E(a)(1)(B)(ix) of the Exchange Act.¹⁰² Under this provision, an applicant must submit a minimum of ten QIB certifications. An NRSRO will not be required to make the QIB certifications publicly available pursuant to Section 15E(a)(3) of the Exchange Act¹⁰³ and Rule 17g-1(i) thereunder or update them after registration.¹⁰⁴

Sections 15E(a)(1)(C)(i), (ii), and (iii) further provide, respectively, that: (1) the certifying QIB must not be affiliated with the applicant; (2) the certification may address more than one of the categories of obligors identified in the definition of NRSRO; and (3) at least two of the certifications must address each category of obligor.¹⁰⁵ Section 15E(a)(1)(C)(iv) provides that the QIB must state in the certification that it meets the definition of a “QIB” in Section 3(a)(64) of the Exchange Act¹⁰⁶ and that the QIB has used the credit ratings of the applicant for at least three years immediately preceding the

¹⁰² 15 U.S.C. 78o-7(a)(1)(B)(ix).

¹⁰³ 15 U.S.C. 78o-7(a)(3).

¹⁰⁴ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

¹⁰⁵ See 15 U.S.C. 78o-7(a)(1)(C)(i), (ii) and (iii), respectively.

¹⁰⁶ 15 U.S.C. 78c(a)(64).

date of the application in the subject category or categories of obligors.¹⁰⁷ The Senate report (“Senate Report”) accompanying the Rating Agency Act explained that the term “used” was intended to mean the QIB “seriously considered the ratings in some of [its] investment decisions.”¹⁰⁸ The Senate Report further explained that “a QIB whose analysts regularly read and consider [a credit rating agency’s] ratings in the course of making investment decisions would have “used” them under the meaning of the bill.”¹⁰⁹ The required representation for the QIB certification is that the QIB “has seriously considered the credit ratings of [the credit rating agency] in the course of making some of its investment decisions for at least the three years immediately preceding the date of this certification, in the following classes of credit ratings.” In addition, as a measure designed to ensure the impartiality of the QIB’s representation, the QIB must certify that it has not received compensation for providing the certification.

The certification must be executed by a person duly authorized by the QIB to make the certification on behalf of the QIB. This is designed to ensure that the certification is that of the QIB and not an employee of the QIB who may have an interest (distinct from that of the QIB) in providing the certification to the applicant. The form of the certification now requires that the printed name and title of the person be provided

¹⁰⁷ 15 U.S.C. 78o-7(a)(1)(C)(iv).

¹⁰⁸ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”). The Senate Report further explained that a QIB whose employees subscribe to or regularly receive the ratings but do not read them or, if they read them, rarely or never consider them in making their investment decisions would not be deemed to have ‘used’ the ratings.”

¹⁰⁹ Id (emphasis added).

under the signature. This will clarify the identity and level of responsibility of the person executing the certification.

The Commission did not receive any comments on the form of the QIB certification and is adopting it substantially as proposed with the two modifications described above.

Item 6 of proposed Form NRSRO also requires the applicant to indicate whether it is submitting the QIB certifications and, if so, how many certifications are being submitted or that the applicant is exempt from the requirement to provide the certifications. Under Section 15E(a)(1)(D) of the Exchange Act, a credit rating agency is not required to submit the QIB certifications if it was identified as an NRSRO in a Commission staff no-action letter issued before August 2, 2006.¹¹⁰

For these reasons, the Commission is adopting Item 6 with the modifications discussed above.

9. Item 7 (Classes of credit ratings covered by current registration)

As adopted, Item 7, requires an NRSRO to provide information about the classes of credit ratings for which the NRSRO is currently registered, the approximate number of credit ratings issued in each class as of the previous calendar year end, and the date the NRSRO first issued credit ratings in that class on a continuous basis. The NRSRO also must provide information about how the NRSRO makes its credit ratings readily accessible. Item 7 has been modified from the proposed form to make the information provided in the item less subject to change, which will reduce the frequency of having to furnish updated information. Specifically, as discussed above, the number of years the

¹¹⁰ 15 U.S.C. 78o-7(a)(1)(D).

NRSRO has issued credit ratings in a particular class is now indicated by having the NRSRO provide the date it first issued credit ratings in that class. As proposed, the NRSRO would have had to provide the number of years it had issued credit ratings in that class, which would constantly change with the advance of time. Also, the number of credit ratings issued in a particular class is now as of the end of the previous calendar year. Therefore, this information will change once a year and only be required to be updated on an annual basis. The instructions to the Form provide that this update can be made with the annual certification and within the 90 day time period for providing the annual certification.

10. Item 8 (Potential statutory disqualifications)

An applicant and NRSRO will be required to disclose, if applicable, if it or any person within its credit rating organization have been, or are, subject to certain legal judgments or orders, or regulatory findings. As explained in the proposing release, Section 15E(a)(2)(C)(ii)(II) of the Exchange Act¹¹¹ directs the Commission to deny a credit rating agency's application for registration as an NRSRO if the Commission finds that the applicant, if granted registration, would be subject to suspension or revocation of its registration under Section 15E(d) of the Exchange Act.¹¹² Section 15E(d) of the Exchange Act¹¹³ provides that the Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO, if the Commission finds that the

¹¹¹ 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

¹¹² 15 U.S.C. 78o-7(d).

¹¹³ Id.

NRSRO or a person associated with the NRSRO has committed or omitted any act, or is subject to an order or finding enumerated in Sections 15(b)(4)(A), (D), (E), (G), or (H) of the Exchange Act,¹¹⁴ has been convicted of any offense specified in Section 15(b)(4)(B) of the Exchange Act,¹¹⁵ or is enjoined from any action, conduct, or practice specified in Section 15(b)(4)(C) of the Exchange Act.¹¹⁶ The Commission also can take these actions if the NRSRO or a person associated with the NRSRO has been convicted of any crime punishable by imprisonment for 1 or more years that is not described in Section 15(b)(4)(B) of the Exchange Act¹¹⁷ or a substantially equivalent crime in a foreign court of competent jurisdiction, or if a person associated with the NRSRO is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO.¹¹⁸ Item 8 of Form NRSRO requires an applicant or NRSRO to answer whether the applicant or the NRSRO or any person within their credit rating organizations, is subject to these acts, convictions, or orders described in Section 15E(d) of the Exchange Act.¹¹⁹

If an applicant answers “yes” to a question, the credit rating agency is required to provide additional information on a Disclosure Reporting Page (DRP) NRSRO as set forth in the instructions for Form NRSRO. An NRSRO will not be required to make the

¹¹⁴ 15 U.S.C. 78o(b)(4)(A), (D), (E), (G) and (H).

¹¹⁵ 15 U.S.C. 78o(b)(4).

¹¹⁶ 15 U.S.C. 78o(b)(4)(C).

¹¹⁷ 15 U.S.C. 78o(b)(4)(B).

¹¹⁸ 15 U.S.C. 78o-7(d).

¹¹⁹ Id.

disclosure reporting pages publicly available pursuant to Section 15E(a)(3) of the Exchange Act¹²⁰ and Rule 17g-1(i) thereunder.¹²¹ If an applicant answers “yes” to a question in Item 8, the Commission will use the disclosure reporting pages to evaluate whether the applicant’s registration could be granted in light of the disclosure. After registration, if an NRSRO answers “yes” to one of the questions, the Commission will use the disclosure reporting pages to evaluate pursuant to the process under Section 15E(d) of the Exchange Act whether it would be appropriate to issue an order censuring, placing limitations on the activities, functions, or operations of, suspending for a period not exceeding 12 months, or revoking the registration of the NRSRO.¹²²

Two commenters stated that Item 8, as proposed, was overly broad because, in asking about any person “associated” with the applicant and NRSRO, it reached employees in areas of a large conglomerate that performed functions wholly unrelated to credit rating services.¹²³ The Commission notes that its authority under Sections 15E(a)(2)(C)(ii)(II)¹²⁴ and 15E(d)¹²⁵ of the Exchange Act can be triggered by legal judgments and orders, and regulatory findings involving persons “associated” with the applicant and NRSRO. In considering these comments, the Commission evaluated when a disclosure would be more likely to trigger Commission action. The Commission

¹²⁰ 15 U.S.C. 78o-7(a)(3).

¹²¹ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

¹²² 15 U.S.C. 78o-7(d).

¹²³ See S&P Letter; Moody’s Letter.

¹²⁴ 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

¹²⁵ 15 U.S.C. 78o-7(d).

concluded that it would involve disclosures relating to the credit rating agency and the persons directly involved in providing or supporting credit rating services. Therefore, to lessen the burden on applicants and NRSROs, the Commission believes it is appropriate to narrow the scope of the disclosure requirement to “persons within the credit rating agency,” which the instructions define as the credit rating agency, any credit rating affiliates of the credit rating agency identified in Item 3, and any partner, officer, director, branch manager, or employee of the credit rating agency or credit rating affiliates (or any person occupying a similar status or performing similar functions).

One commenter requested that the Commission clarify that the disclosures in Item 8 do not include disclosures relating to accusations or arrests.¹²⁶ The Commission notes that the disclosures are triggered by the provisions of Section 15E(d) of the Exchange Act,¹²⁷ which refers to convictions (not arrests or accusations). A second commenter suggested that the disclosure item not include the name of the individual.¹²⁸ The Commission believes it has reduced this concern, in part, by narrowing the disclosure item to persons within the credit rating agency and by providing that the disclosure reporting pages are not required to be made publicly available pursuant to Section 15E(a)(3) of the Exchange Act¹²⁹ and Rule 17g-1(i).¹³⁰ The Commission believes the disclosure of the name of a person providing or supporting credit ratings

¹²⁶ See R&I Letter.

¹²⁷ 15 U.S.C. 78o-7(d).

¹²⁸ See A.M. Best Letter.

¹²⁹ 15 U.S.C. 78o-7(a)(3).

¹³⁰ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

services will be important as these persons may seek to associate with another NRSRO if they are terminated from or leave the reporting NRSRO. The Commission also notes that the events triggering an Item 8 disclosure generally are matters of public record (e.g., convictions, regulatory orders) and, consequently, there may be a reduced expectation of confidentiality.

Otherwise, Item 8 is being adopted substantially as proposed.

11. Exhibit 1 (Credit Ratings Performance Statistics)

Section 15E(a)(1)(B)(i) of the Exchange Act requires that an application for registration as an NRSRO contain credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable).¹³¹ An applicant and NRSRO will provide this information in Exhibit 1 to Form NRSRO. The Exchange Act does not otherwise define or identify the particular credit rating performance statistics to be provided with the application. Credit rating agencies typically generate statistical reports showing historical default and downgrade rates within each credit rating notch or grade.¹³² These types of statistics are important indicators of the performance of a credit rating agency in terms of its ability to assess the creditworthiness of issuers and obligors and, consequently, will be useful to users of credit ratings in evaluating an NRSRO.

The instructions to Form NRSRO provide that an applicant and NRSRO must

¹³¹ 15 U.S.C. 78o-7(a)(1)(B)(i).

¹³² The credit rating categories of a credit rating agency generally are represented by symbols, numbers or other designations that are used to distinguish the creditworthiness of the obligors, securities and money market instruments the credit rating agency rates. For example, some credit rating agencies use symbols such as AAA, AA, A, BBB, BB, B, CCC, and CC to distinguish the creditworthiness of corporate debt securities. AAA would be the highest rating and CC would be the lowest rating above the default or regulatory supervision of the issuer.

include in the Exhibit definitions of the credit ratings (i.e., an explanation of each category and notch) and explanations of the performance measurement statistics, including the metrics used to derive the statistics. One commenter requested that the Commission clarify the instruction with respect to explaining “the metrics used to derive the statistics.”¹³³ The intent is that the NRSRO explain in general terms how it calculates the default and downgrade rates. The Commission believes that requiring this information is necessary or appropriate in the public interest or for the protection of investors because it will assist users of credit ratings in understanding how the measurements were derived and in making comparisons with the measurement statistics of other NRSROs.¹³⁴

The definitions of the categories and notches will assist the Commission in assessing whether the NRSRO’s credit ratings, as a practical matter, can be used for certain Commission rules. For example, paragraph(c)(2)(vi)(F) of Exchange Act Rule 15c3-1 specifies lower haircuts for debt securities that are rated in one of the “four highest rating categories” of at least two NRSROs.¹³⁵ This provision was designed based on the practice of many credit rating agencies to have at least eight categories for their debt securities with the top four commonly referred to as “investment grade.” If an NRSRO uses less than eight categories, the Commission will be required to evaluate whether, based on the NRSRO’s definitions, securities included in the top four

¹³³ See DBRS Letter.

¹³⁴ Section 15E(a)(1)(B)(x) of the Exchange Act provides that the Commission can require additional information that it finds is necessary or appropriate in the public interest or for the protection of investors (15 U.S.C. 78o-7(a)(1)(B)(x)).

¹³⁵ 17 CFR 240.15c3-1(c)(2)(vi)(F).

categories would be suitable for the lower haircuts specified in paragraph(c)(2)(vi)(F) of Rule 15c3-1.¹³⁶

The Commission requested comment on whether the performance measurement statistics should use standardized inputs, time horizons, and metrics to allow for greater comparability. This request elicited numerous comments.¹³⁷ Three commenters supported the use of standardized measures because it would make it easier to compare NRSROs.¹³⁸ A number of commenters opposed the use of standardized measures for several reasons, including that such measures would be impractical because credit rating agencies use different methodologies to determine credit ratings and different definitions of default and that the use of such measures could interfere with the methodologies for determining credit ratings.¹³⁹ In light of the varying approaches cited in the comments, the Commission is not prepared to prescribe standard metrics at this time. The Commission intends to continue to consider this issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs. As adopted, the Exhibit

¹³⁶ Id.

¹³⁷ See letter dated March 12, 2007 from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable (“FSR Letter”); letter dated March 12, 2007 from Herwig M. Langohr, Professor, INSEAD Business School, Patricia T. Langohr, Professor, ESSEC Business School (“Langohr Letter”); letter dated March 22, 2007 from George P. Miller, Executive Director, American Securitization Forum (“ASF Letter”); letter dated March 16, 2007 from Makoto Utsumi, President & CEO, Ratings & Investment Information (“JCR 2nd Letter”); ICI Letter; Gross Letter; R&I Letter; MM Letter; White Letter; DBRS Letter; A.M. Best Letter; S&P Letter; AEI Letter; Moody’s Letter.

¹³⁸ See Gross Letter; ICI Letter; JCR 2nd Letter.

¹³⁹ See, e.g., R&I Letter; A.M Best Letter; S&P Letter; Moody’s Letter; ASF Letter.

requires NRSROs to describe how they derive their statistics in sufficient detail to allow users of credit ratings to understand the measures. This will provide users with some basis to compare different NRSROs even if the statistics are not derived from similar measures.

The Commission requested comment on whether other performance measurement statistics would be appropriate as an alternative, or in addition, to historical default and downgrade rates. For example, the Commission requested comment on whether Exhibit 1 should require measurement of the performance of a given credit rating by comparing or mapping it to the market value of the rated security or to extreme declines in the market value of the security after the rating. Although the Commission is not taking action in this regard at this time, the Commission intends to study these issues and consider possible future action.

For these reasons, Exhibit 1 to Form NRSRO and the instructions for the Exhibit are being adopted substantially as proposed.

12. Exhibit 2 (Procedures and methodologies for determining credit ratings)

Section 15E(a)(1)(B)(ii) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding the procedures and methodologies used by the credit rating agency to determine credit ratings.¹⁴⁰ An applicant and NRSRO will provide this information in Exhibit 1 to Form NRSRO. The Exchange Act does not otherwise define or identify the procedures and methodologies that must be provided under this section.¹⁴¹ However, the definition of “credit rating

¹⁴⁰ 15 U.S.C. 78o-7(a)(1)(B)(ii).

¹⁴¹ See 15 U.S.C. 78a *et seq.*

agency” in Section 3(a)(61) of the Exchange Act provides that a “credit rating agency” is an entity that, among other things, “employ[s] either a quantitative or qualitative model, or both, to determine credit ratings.”¹⁴²

Credit rating agencies may establish procedures and methodologies for determining credit ratings in the following areas: the determination of whether to initiate a credit rating; the use of public and non-public sources of information to perform credit rating analysis, including information and analysis provided by third-party vendors; the use of quantitative and qualitative models and metrics to determine credit ratings; the interaction with the management of a rated obligor or issuer of rated securities; the establishment of the structure and voting process of committees that review or approve credit ratings; the notification of rated obligors or issuers of rated securities about credit rating decisions and for appeals of final or pending credit rating decisions; the monitoring, reviewing, and updating of credit ratings; and the withdrawal, or suspension of the maintenance, of a credit rating.

The list identifies areas where a credit rating agency may establish procedures and methodologies for determining credit ratings. The applicability of certain areas to a particular credit rating agency will depend on whether it uses subjective qualitative analysis, purely quantitative models, or a combination of both.¹⁴³ Consequently, a credit rating agency might not establish a procedure or methodology in a given area if doing so would not be relevant to how the credit rating agency determines credit ratings.

¹⁴² See particularly, Section 3(a)(61)(B) of the Exchange Act (15 U.S.C. 78c(a)(61)(B)).

¹⁴³ See Section 3(a)(61) of the Exchange Act defining the term “credit rating agency” (15 U.S.C. 78c(a)(61)).

In addition, credit rating agencies that issue “unsolicited” credit ratings may establish procedures and methodologies in the areas described above that are unique for such ratings. Credit rating agencies that use a subscription fee based business model may only issue unsolicited ratings because that business model does not rely on fees charged issuers, obligors, and underwriters to determine specific credit ratings (issuers, obligors, and underwriters, however, may subscribe to receive the credit ratings of such credit rating agencies). The procedures and methodologies these credit rating agencies employ, in some respects, may be unique to this business model.

Credit rating agencies that are paid by issuers, obligors, and underwriters to determine specific credit ratings sometimes also issue unsolicited credit ratings. This practice has led to concerns that unsolicited ratings may be used to coerce issuers and obligors into ultimately paying the credit rating agency to determine and maintain the credit rating. Consequently, credit rating agencies that rely on fees from issuers, obligors, and underwriters to determine specific credit ratings, but also issue unsolicited ratings, often establish procedures and methodologies for determining unsolicited credit ratings that are designed to address this concern and the fact that the issuer or obligor may not have participated in the determination of the credit rating (as is most often the case with a solicited credit rating).

The Commission believes that the information about any procedures and methodologies established in the areas described above, including any with respect to unsolicited credit ratings, will be useful to users of credit ratings. The information will provide them with an understanding of the nature of the credit rating agency (i.e., a user

of quantitative models, qualitative analysis, or a combination of both) and how the credit rating agency produces credit ratings. This will provide a basis for comparing NRSROs.

Several commenters stated that the Exhibit should require that an applicant and NRSRO describe its procedures and methodologies rather than submit and disclose each actual procedure and methodology.¹⁴⁴ These commenters pointed out that large credit rating agencies that issue multiple types of credit ratings generally have volumes of detailed procedures that credit analysts must follow in the course of determining a credit rating.¹⁴⁵ They noted that disclosing all this information would be burdensome and could be difficult for users of credit ratings to parse.¹⁴⁶ They also noted that some of the procedures and methodologies may involve the use of proprietary models.¹⁴⁷

The Commission agrees with these commenters that disclosing all the procedures could be burdensome and could result in an overload of information that would be less helpful to users of credit ratings. Therefore, the Commission has modified the instructions to require that the Exhibit contain a description of the procedures and methodologies (not the submission and disclosure of each actual procedure and methodology). The instructions provide that the description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes the applicant or NRSRO employs to determine credit ratings.

¹⁴⁴ See White Letter; DBRS Letter; A.M. Best Letter; Fitch Letter; Moody's Letter.

¹⁴⁵ See, e.g., DBRS Letter; A.M. Best Letter; Fitch Letter; Moody's Letter.

¹⁴⁶ Id.

¹⁴⁷ Id.

As discussed below, rather than have a credit rating agency submit its procedures and methodologies in Exhibit 2, the Commission is adopting a requirement in Rule 17g-2 that an NRSRO must document them internally. Moving this requirement from Exhibit 2 to the recordkeeping rule is designed to reduce the burden on NRSROs, while making these procedures and methodologies available to Commission examination staff. These records are important to the Commission's oversight. For example, Rule 17g-6 prohibits, among other things, an NRSRO from issuing or modifying or threatening to issue or modify a credit rating contrary to the NRSRO's established procedures and methodologies. The Commission's ability to enforce this prohibition will depend on the Commission staff being able to access an NRSRO's documented procedures and methodologies.¹⁴⁸

Two commenters also suggested changes to the Commission's description of an "unsolicited credit rating" in the proposed instructions to Form NRSRO as being a credit rating that is not requested by the issuer or underwriter of the rated securities or the rated obligor.¹⁴⁹ The commenters noted that issuers and obligors may consent to the issuance and participate in the determination of a credit rating even if they did not specifically request that the credit rating be issued. As discussed below, the Commission has eliminated the prohibition in Rule 17g-6 relating to unsolicited credit ratings, in part, because of difficulties with defining the term. Therefore, the Commission has removed the definition from the instructions to Exhibit 2. The Commission wants to gain a better

¹⁴⁸ See letter dated March 12, 2007 from James A. Kaitz, President & CEO, Association for Financial Professionals ("AFP Letter") stating the importance of monitoring whether an NRSRO adheres to its stated procedures and methodologies for determining credit ratings.

¹⁴⁹ See A.M. Best Letter; Moody's Letter.

understanding through its examination function of how credit rating agencies define “unsolicited credit ratings” and the practices they employ with respect to these ratings.

For these reasons, the Commission is adopting Exhibit 2 and the instructions for the Exhibit with the modifications described above.

13. Exhibit 3 (Procedures to prevent the misuse of material non-public information)

Section 15E(g)(1) of the Exchange Act¹⁵⁰ requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act.¹⁵¹ Section 15E(g)(2) of the Exchange Act provides that the Commission shall adopt rules requiring an NRSRO to establish specific policies and procedures to prevent the misuse of material, nonpublic information.¹⁵² As discussed below, Rule 17g-4 requires an NRSRO’s policies and procedures established pursuant to Section 15E(g)(1) of the Exchange Act¹⁵³ to include certain specific types of procedures.

Section 15E(a)(1)(B)(iii) of the Exchange Act¹⁵⁴ requires that an application for registration as an NRSRO contain information regarding policies or procedures adopted and implemented by the credit rating agency to prevent the misuse of material, nonpublic information in violation of Exchange Act¹⁵⁵ provisions and rules. An applicant and

¹⁵⁰ 15 U.S.C. 78o-7(g)(1).

¹⁵¹ 15 U.S.C. 78a et seq.

¹⁵² 15 U.S.C. 78o-7(g)(2).

¹⁵³ 15 U.S.C. 78o-7(g)(1).

¹⁵⁴ 15 U.S.C. 78o-7(a)(1)(B)(iii).

¹⁵⁵ 15 U.S.C. 78a et seq.

NRSRO will provide this information in Exhibit 3 to Form NRSRO. Specifically, Exhibit 3 requires a copy of the policies and procedures to prevent the misuse of material, nonpublic information established pursuant to Section 15E(g) of the Exchange Act¹⁵⁶ and Rule 17g-4.

The Commission received two comments on this Exhibit, as proposed.¹⁵⁷ One commenter stated that the policies and procedures should not have to be made publicly available because they may contain proprietary information and disclosing them could hinder their effectiveness.¹⁵⁸ The Commission agrees that disclosing certain components of these policies and procedures could make it easier for persons to circumvent them. Therefore, the Commission has modified the instructions to provide that the applicant or NRSRO is not required to submit in the Exhibit any specific information in the policies and procedures that is proprietary or would diminish the effectiveness of the policies and procedures if such information is disclosed. The other commenter stated that the procedures should be disclosed on the NRSRO's Web site without further elaboration.¹⁵⁹ The Commission notes that Section 15E(a)(3) of the Exchange Act¹⁶⁰ and Rule 17g-1 thereunder require an NRSRO to make its Form NRSRO and Exhibits 1 through 9 publicly available by posting them on its Web site, or through another comparable, readily accessible means.

¹⁵⁶ 15 U.S.C. 78o-7(g).

¹⁵⁷ See letter dated March 12, 2007 from Ayal Rosenthal ("Rosenthal Letter"); R&I Letter.

¹⁵⁸ See R&I Letter.

¹⁵⁹ See Rosenthal Letter.

¹⁶⁰ 15 U.S.C. 78o-7(a)(3).

For these reasons, the Commission is adopting Exhibit 3 and the instructions for the Exhibit with the modifications described above.

14. Exhibit 4 (Organizational information)

Section 15E(a)(1)(B)(iv) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding the organizational structure of the applicant.¹⁶¹ An applicant and NRSRO will provide this information in Exhibit 4 to Form NRSRO. The Exchange Act does not otherwise define or identify the specific type of organizational information that must be provided under Section 15E(a)(1)(B)(iv) of the Exchange Act.¹⁶² Companies typically create, as applicable, an organizational chart showing ultimate and sub-holding companies, subsidiaries, and material affiliates; an organizational chart showing divisions, departments, and business units within the entity; and an organizational chart showing the management structure and senior management reporting lines within the entity. Users of credit ratings will benefit from this information and, consequently, the Commission proposed that it be provided in this Exhibit. One commenter disagreed that users of credit ratings would find the information helpful in assessing or understanding the NRSRO.¹⁶³ For the reasons discussed below, the Commission continues to believe these three charts will be valuable to users of credit ratings and the Commission.

The first required organizational chart will show the credit rating agency's ultimate and sub-holding companies, subsidiaries, and material affiliates, if applicable.

¹⁶¹ 15 U.S.C. 78o-7(a)(1)(B)(iv).

¹⁶² Id. See also, 15 U.S.C. 78a et seq.

¹⁶³ See MM Letter.

This chart will reveal where potential conflicts of interest relating to the business activities of related companies might arise. Also, the fact that a credit rating agency has a holding company that potentially could provide financial support will be relevant to the Commission's evaluation of whether an applicant or NRSRO has adequate financial resources as required under the Exchange Act.¹⁶⁴ One commenter requested that the Commission define the term "material affiliate."¹⁶⁵ At present, the Commission believes it is more appropriate to rely on the judgment of the credit rating agency to define its material affiliates, given that the size and complexity of NRSROs could vary widely.

The second organizational chart will show the credit rating agency's divisions, departments, and business units, if applicable. This information will assist users of credit ratings and the Commission in understanding where potential conflicts of interest relating to ancillary business activities might arise.

The third organizational chart will show the credit rating agency's management structure and senior management reporting lines and include in the chart its designated compliance officer under Section 15E(j) of the Exchange Act.¹⁶⁶ The Commission will benefit from this chart as it will assist in evaluating whether an applicant and NRSRO has adequate managerial resources as required under the Exchange Act.¹⁶⁷ Users of

¹⁶⁴ See Sections 15E(a)(2)(C) and 15E(d) of the Exchange Act (15 U.S.C. 78o-7(a)(2)(C) and (d)).

¹⁶⁵ See R&I Letter.

¹⁶⁶ 15 U.S.C. 78o-7(j).

¹⁶⁷ See Sections 15E(a)(2)(C) and 15E(d) of the Exchange Act (15 U.S.C. 78o-7(a)(2)(C) and (d)).

credit ratings will be able to use this information to compare the managerial resources of different NRSROs.

Including the compliance officer in the chart will assist the Commission and users of credit ratings in understanding the degree of the compliance officer's independence from the business managers.¹⁶⁸ The compliance officer's reporting lines are relevant in assessing the integrity of the credit rating process of a particular NRSRO, since the officer is responsible for administering the credit rating agency's policies and procedures required by Sections 15E(g) and (h) of the Exchange Act¹⁶⁹ and for ensuring the NRSRO's compliance with the securities laws and rules and regulations thereunder.¹⁷⁰ In carrying out these responsibilities, a compliance officer will be required to review activities overseen by senior business managers. The ability of the compliance officer to objectively review an area can be impacted by whether the officer reported to the senior manager responsible for the area. Thus, the relative independence of the compliance officer will be relevant in assessing the NRSRO's ability to ensure compliance with its policies and procedures.

For these reasons, the Commission is adopting Exhibit 4 and the instructions for the Exhibit substantially as proposed.

15. Exhibit 5 (Code of Ethics)

Section 15E(a)(1)(B)(v) of the Exchange Act requires that an application for registration as an NRSRO disclose whether the applicant has a code of ethics in effect or

¹⁶⁸ See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(x)).

¹⁶⁹ 15 U.S.C. 78o-7(g) and (h).

¹⁷⁰ Section 15E(j) of the Exchange Act (15 U.S.C. 78o-7(j)).

an explanation of why the applicant has not established a code of ethics.¹⁷¹ Exhibit 5 of Form NRSRO elicits this information by requiring an applicant and NRSRO to attach a copy of any established code of ethics or an explanation of why it does not have a code of ethics. The Commission believes the requirement to include a copy of any established code of ethics in the Exhibit is necessary or appropriate in the public interest or for the protection of investors. A statement that an NRSRO has a code of ethics but no further disclosure would not be particularly useful to users of credit ratings. They would not be able to review the code of ethics and use it as a means of comparing different NRSROs.

The Exchange Act does not otherwise define or identify the “code of ethics” that should be provided under Section 15E(a)(1)(B)(v).¹⁷² The Commission believes each credit rating agency must have the flexibility to establish a code of ethics appropriate for its business model and organizational structure and, consequently, the Exhibit does not prescribe any specific elements that must be in the code of ethics, if any, furnished in this Exhibit.

The Commission received several comments on this Exhibit.¹⁷³ Most addressed whether the Exhibit also should require the credit rating agency to disclose whether it complies with international principles and codes of conduct related to credit rating agencies.¹⁷⁴ One commenter suggested that the Exhibit not refer to a code of “ethics”

¹⁷¹ 15 U.S.C. 78o-7(a)(1)(B)(v).

¹⁷² Id.

¹⁷³ See letter dated March 12, 2007 from John Grout, Policy and Technical Director, The Association of Corporate Treasurers (“AST Letter”); Gross Letter; DBRS Letter; S&P Letter; Moody’s Letter; Langohr Letter; JCR 2nd Letter.

¹⁷⁴ A number of these commenters endorsed a requirement that the credit rating agency disclose whether it has adopted a code of conduct consistent with the principles

but rather to a code of “conduct.”¹⁷⁵ Another commenter requested that the Exhibit not require the credit rating agency to “certify” that it is complying with international principles and codes of conduct because some principles permit an entity to comply or explain.

The Commission reiterates that Exhibit 5 does not prescribe any requirements that must be in an NRSRO’s code of ethics and that Section 15E(a)(1)(B)(v) of the Exchange Act does not require an NRSRO to have a code of ethics.¹⁷⁶ An applicant or NRSRO can submit a statement of why it does not have a code of ethics.¹⁷⁷ The Commission believes that the Exhibit should not require the inclusion of any particular type of code of conduct. It could be the case that the code of ethics provided by an applicant or NRSRO is part of a broader code of conduct. For the foregoing reasons, the Commission is adopting Exhibit 5 substantially as proposed.

16. Exhibit 6 (Conflicts of interest)

Section 15E(a)(1)(B)(vi) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding any conflict of interest relating to the issuance of credit ratings by the applicant and NRSRO.¹⁷⁸ The Exchange Act does not otherwise define or identify the types of conflicts of interest that should be

contained in the report: Statement of Principles Regarding the Activities of Credit Rating Agencies, Technical Committee, International Organization of Securities Commissions (“IOSCO”) (September 25, 2003). See also Code of Conduct Fundamentals for Credit Rating Agencies, Technical Committee of IOSCO (December 2004).

¹⁷⁵ See Moody’s Letter.

¹⁷⁶ 15 U.S.C. 78o-7(a)(1)(B)(v).

¹⁷⁷ Id.

¹⁷⁸ 15 U.S.C. 78o-7(a)(1)(B)(vi).

disclosed under Section 15E(a)(1)(B)(vi) of the Exchange Act.¹⁷⁹ Exhibit 6, as proposed, would have required an applicant and NRSRO to describe in general terms each type of conflict that arises, or may arise, from its business model and credit rating activities. Thus, if an NRSRO receives payment from issuers to rate their securities, the NRSRO would have been required to disclose that fact. It would not have had to make a disclosure each time it received payment from an issuer. The purpose of the proposed disclosure was to alert users of credit ratings to the NRSRO's business model (subscriber fee-based, issuer fee-based, or a combination of both), and to potential conflicts that arise from the business model.

The Commission continues to believe that disclosing the types of conflicts that arise from an NRSRO's business model will assist the Commission in evaluating whether an applicant has sufficient financial and managerial resources to comply with the procedures for managing conflicts of interest required under Section 15E(h) of the Exchange Act,¹⁸⁰ given the types of conflicts of interest identified by the applicant.¹⁸¹ The information also will be useful to users of credit ratings in assessing an NRSRO by, for example, comparing the types of conflicts disclosed by the entity in Exhibit 6 with the procedures for managing conflicts of interest disclosed by the entity in Exhibit 7.

Exhibit 6 of Form NRSRO, as adopted, requires an applicant and NRSRO to provide a list describing in general terms the types of conflicts of interest that arise from its business activities. The instructions to the Exhibit have been modified to include a

¹⁷⁹ Id., see also 15 U.S.C. 78a et seq.

¹⁸⁰ 15 U.S.C. 78o-7(h).

¹⁸¹ See Section 15E(a)(2)(C) Exchange Act (15 U.S.C. 78o-7(a)(2)(C)).

list of 10 different generic conflicts of interest that may apply to a credit rating agency based on its business model and activities. These conflicts were included in the proposed instructions as examples of conflicts. These are the types of conflicts that generally arise from the business of issuing credit ratings depending on the business model of the credit rating agency. The instructions further provide that the credit rating agency can use the descriptions provided in the instructions to identify an applicable conflict of interest and is not required to provide any further information. Thus, the credit rating agency can review each item on the list and determine whether it describes an applicable conflict. This modification is intended to make it simpler for the credit rating agency to create the Exhibit since it may rely on the language in the instructions to identify a conflict. A credit rating agency can choose to provide its own description of the conflict or further explanation to one of the descriptions in the instructions.

Several commenters raised concerns with the Commission's identification as a potential conflict the fact that a subscriber may use the entity's credit ratings for regulatory purposes.¹⁸² They argued that it would be impractical to determine how subscribers might be using their credit ratings.¹⁸³ The Commission did not intend to require NRSROs to actively monitor how their subscribers were using their credit ratings. Rather, the intent is to require NRSROs to disclose that subscribers, while they do not pay to have a credit rating issued, may have an interest in a specific credit rating. Therefore, the fact that they compensate the NRSRO could give rise to a conflict of interest. The instructions now describe the conflict as the fact that subscribers may use

¹⁸² See, e.g., DBRS Letter; S&P Letter.

¹⁸³ Id.

the credit ratings for regulatory purposes. This means that any credit rating agency that charges subscribers to access its credit ratings will be required to identify this conflict. The credit rating agency is not required to determine whether, or how, the subscribers are using the credit ratings to comply with statutes and regulations. The purpose of the disclosure is to alert users of credit ratings to the fact that the NRSRO's business model includes charging subscribers to access its credit ratings and that a subscriber may have an interest in a particular credit rating. For similar reasons, the Commission eliminated a provision in the instructions requiring the identification of associated persons that use credit ratings for regulatory purposes as this would have required an applicant and NRSRO to monitor how another legal entity was using its credit ratings.

A commenter noted that subscribers who manage investment portfolios also may have an interest in a particular credit rating.¹⁸⁴ For example, such a subscriber may be limited to investing in debt securities that have investment grade credit ratings and, consequently, would be required to sell, perhaps at a loss, a debt security that is downgraded below investment grade. The Commission believes that, similar to regulatory users, this type of subscriber could raise a potential conflict of interest. Therefore, this type of conflict is specifically identified in the instructions to the Exhibit.

The instructions to the Exhibit, as proposed, also required an NRSRO to identify a person associated with the NRSRO that underwrites securities or money market instruments that are subject to a credit rating of the NRSRO. This type of conflict is identified in Section 15E(h)(2)(D) of the Exchange Act.¹⁸⁵ The concerns raised by

¹⁸⁴ See DBRS Letter.

¹⁸⁵ 15 U.S.C. 78o-7(h)(2)(D).

commenters with respect to monitoring how subscribers use their credit ratings also apply in this context. For example, the provision, as proposed, could be interpreted to require an NRSRO to monitor whether any person associated with the NRSRO is an “underwriter” as that term is defined in Section 2(a)(11) of the Securities Act of 1933.¹⁸⁶ The Commission believes this could impose a very difficult compliance standard in that it would involve continuous monitoring of the securities trading activities of associated persons and legal judgments as to whether they were acting as “underwriters” at any given moment.

At the same time, the Commission believes that where there is a potential affiliation between an NRSRO and a securities underwriter that it is necessary or appropriate in the public interest or for the protection of investors to require it to be disclosed in this Exhibit. Specifically, an affiliation between an NRSRO and a broker or dealer that is in the business of underwriting securities would raise concerns that the NRSRO might be influenced by the affiliation to issue favorable credit ratings for these securities. The Commission further believes that disclosing this type of affiliation does not present the concerns discussed above since most persons associated with an NRSRO likely are not broker-dealers in the business of underwriting securities. Therefore, the NRSRO should be able to identify those associated persons. Further, the requirement to identify these persons is based on being affiliated with such an underwriter that may underwrite securities rated by the NRSRO. Thus, the NRSRO will not need to actively monitor whether it currently has rated such securities and update the Exhibit each time this changes. Consequently, the requirement to identify persons associated with the

¹⁸⁶ 15 U.S.C. 77b(a)(11).

NRSRO that underwrite securities rated by the NRSRO has been narrowed to a requirement to identify any person associated with the NRSRO that is a broker or dealer in the business of underwriting securities or money market instruments.

Finally, the Commission notes that the Exhibit contains a catchall provision requiring the disclosure of any other material conflict of interest. Consequently, the additional conflict added to the instructions is expected to reduce the potential conflicts that must be disclosed under the catchall. With respect to the catchall, the instructions note that a “material” type of conflict will include one that the NRSRO has established specific policies and procedures to address.

For these reasons, the Commission is adopting Exhibit 6 and the instructions for the Exhibit with the modifications described above.

17. Exhibit 7 (Procedures to manage conflicts)

An applicant or NRSRO will be required to furnish in Exhibit 7 a copy of the written policies and procedures it establishes, maintains, and enforces to address and manage conflicts of interest pursuant to Section 15E(h) of the Exchange Act.¹⁸⁷ Requiring inclusion of these policies and procedures in the Form is necessary or appropriate in the public interest or for the protection of investors.¹⁸⁸ First, their disclosure will assist the Commission in monitoring whether an NRSRO is complying with Section 15E(h) of the Exchange Act.¹⁸⁹ Second, their disclosure will assist the Commission in evaluating whether an applicant or NRSRO has adequate financial and

¹⁸⁷ 15 U.S.C. 78o-7(h).

¹⁸⁸ See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(x)).

¹⁸⁹ 15 U.S.C. 78o-7(h).

managerial resources to materially comply with Section 15E(h) of the Exchange Act.¹⁹⁰ Third, their disclosure will allow users of credit ratings to compare an NRSRO's policies and procedures for managing conflicts of interest with the types of conflicts disclosed in Exhibit 7.

One commenter stated that these policies and procedures should not have to be made publicly available because they may contain proprietary information and disclosing them could hinder their effectiveness.¹⁹¹ As with the Exhibit 3 policies and procedures, the Commission has modified the instructions for this Exhibit to provide that the applicant or NRSRO is not required to submit in the Exhibit any specific information in the policies and procedures that is proprietary or would diminish the effectiveness of the policies and procedures if such information were disclosed.

For these reasons, the Commission is adopting Exhibit 7 and the instructions for the Exhibit with the modification described above.

18. Exhibit 8 (Credit Analyst Information)

Exhibit 8, as proposed, would have required an applicant and NRSRO to provide certain background information (e.g., employment history and education) with respect to each credit analyst and credit analyst supervisor. Consistent with its reasons for proposing this request, the Commission believes that the ability of a credit rating agency to assess the creditworthiness of an issuer and obligor depends on the competence of the personnel responsible for determining the entity's credit ratings. Further, the Commission believes that information about the responsibilities, experience, and

¹⁹⁰ Id.

¹⁹¹ See R&I Letter.

employment history of the credit analysts and supervisors is necessary or appropriate in the public interest or for the protection of investors. The information will assist users of credit ratings in assessing the competence of an NRSRO's credit analysts and, thereby, provide a means for users to compare NRSROs. This information also will assist the Commission in evaluating whether the applicant has adequate managerial resources to consistently produce credit ratings with integrity and to materially comply with its procedures and methodologies.¹⁹²

The Commission received numerous comments on Exhibit 8 stating that the requirement to provide information on each credit analyst and credit analyst supervisor was unduly burdensome and unnecessary.¹⁹³ Several commenters suggested, as an alternative, that the Exhibit require general information about the education, qualifications, and number of the credit analysts and their supervisors.¹⁹⁴ After considering the comments and the potential burden associated with the proposed requirement, the Commission has modified the Exhibit to only require aggregate information about these employees. Consequently, the Exhibit, as adopted, requires the following information:

- The total number of credit analysts.
- The total number of credit analyst supervisors.

¹⁹² See Sections 15E(a)(2)(C) and (d) of the Exchange Act (15 U.S.C. 78o-7(a)(2)(C) and (d)).

¹⁹³ See letter dated May 3, 2007 from Barron H. Putnam, Ph.D, Owner and Advisor, LACE Financial Corporation ("LACE Letter"); JCR Letter; R&I Letter; DBRS Letter; A.M. Best Letter; Fitch Letter; S&P Letter; AEI Letter; Moody's Letter.

¹⁹⁴ See, e.g., DBRS Letter; A.M. Best Letter; Fitch Letter; S&P Letter; Moody's Letter.

- A general description of the minimum required qualifications of the credit analysts, including education level and work experience (if applicable, distinguish between junior, mid, and senior level credit analysts).
- A general description of the minimum required qualifications of the credit analyst supervisors, including education level and work experience.

The information about the total number of credit analysts and their supervisors will provide the Commission and users of credit ratings with an understanding of the human resources the credit rating agency devotes to determining credit ratings. This will assist the Commission in assessing the managerial resources of an applicant and NRSRO. The information about the qualifications of the credit analysts and their supervisors will be useful to users of credit ratings in assessing the competency of an NRSRO. The Commission believes this modification strikes an appropriate balance between reducing burden and requiring necessary information. Nonetheless, the Commission intends to monitor whether this aggregate approach to the credit analyst information is sufficient to apprise users of credit ratings of the qualifications of a given NRSRO's credit analysts.

For these reasons, the Commission is adopting Exhibit 8 and the instructions for the Exhibit with the modifications described above.

19. Exhibit 9 (Designated Compliance Officer)

As adopted, Exhibit 9 requires an applicant and NRSRO to provide certain background information on the entity's designated compliance officer. Section 15E(j) of the Exchange Act requires every NRSRO to designate an individual responsible for administering the policies and procedures of the credit rating agency to prevent the

misuse of nonpublic information, to manage conflicts of interest, and to ensure compliance with the securities laws and the rules and regulations under those laws.¹⁹⁵

The ability of the compliance officer to carry out these statutorily mandated responsibilities will depend, in part, on the officer's experience and qualifications.

The Commission continues to believe that requiring information about the experience and employment history of the designated compliance officer is necessary or appropriate in the public interest or for the protection of investors. It will assist the Commission in evaluating whether the applicant has adequate managerial resources to consistently produce credit ratings with integrity and to materially comply with its procedures and methodologies.¹⁹⁶ It also will be useful to users of credit ratings because it would provide information regarding the resources an NRSRO devotes to ensuring, among other things, that credit ratings are determined in accordance with the procedures and methodologies the NRSRO makes public in Exhibit 2.

The Exhibit, as proposed, also required information about the compliance personnel responsible for assisting the compliance officer. Several commenters objected to this aspect of the Exhibit as being unduly burdensome, unnecessary, and intrusive.¹⁹⁷ After considering the comments and the potential burden associated with the proposed requirement, the Commission has modified the Exhibit to eliminate the requirement to provide information about the persons that assist the compliance officer. As with the

¹⁹⁵ 15 U.S.C. 78o-7(j).

¹⁹⁶ See Sections 15E(a)(2)(C) and (d) of the Exchange Act (15 U.S.C. 78o-7(a)(2)(C) and (d)).

¹⁹⁷ See, e.g., R&I Letter; DBRS Letter; A.M. Best Letter; Fitch Letter; S&P Letter; Moody's Letter.

modifications to Exhibit 8, the Commission believes this modification to Exhibit 9 strikes an appropriate balance between reducing burden and requiring necessary information. Nonetheless, the Commission intends to monitor whether information about the designated compliance officer alone is sufficient to apprise users of credit ratings of how this statutorily required compliance function is being addressed by a given NRSRO.

For these reasons, the Commission is adopting Exhibit 9 and the instructions for the Exhibit with the modifications described above.

20. Exhibit 10 (List of large users of credit rating services)

Section 15E(a)(1)(B)(viii) of the Exchange Act requires that an application for registration as an NRSRO include, on a confidential basis,¹⁹⁸ a list of the 20 largest issuers and subscribers that use the credit rating services provided by the credit rating agency by amount of net revenue received by the credit rating agency in the fiscal year immediately preceding the date of submission of the application.¹⁹⁹ This information will be elicited in Exhibit 10 to Form NRSRO. An NRSRO will not be required to make this information publicly available pursuant to Section 15E(a)(3) of the Exchange Act²⁰⁰ and Rule 17g-1(i) thereunder or update the Exhibit after registration.²⁰¹ An NRSRO will

¹⁹⁸ An applicant can request that the Commission keep this information confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

¹⁹⁹ 15 U.S.C. 78o-7(a)(1)(B)(viii).

²⁰⁰ 15 U.S.C. 78o-7(a)(3).

²⁰¹ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

be required to update this information in an unaudited financial report that must be furnished to the Commission pursuant to Rule 17g-3.

Exhibit 10 also requires that an applicant disclose in the list large obligors (i.e., persons who are rated as an entity as opposed to having their securities rated) and underwriters if they are determined to have provided at least as much net revenue as the 20th largest issuer or subscriber. Consequently, a credit rating agency will be required to identify the 20 largest issuers and subscribers as required by Section 15E(a)(1)(B)(viii) of the Exchange Act²⁰² and include in the list any obligor and underwriter that meets the above criteria.

The Commission believes that including large obligors and underwriters in the list of the 20 largest issuers and subscribers is necessary or appropriate in the public interest or for the protection of investors. The information will help identify persons that could potentially have undue influence on an NRSRO given the amount of revenue the person provides the NRSRO. Obligor and securities underwriters may have as much of an interest in potentially influencing a credit rating as issuers and subscribers. One commenter suggested that the list of 20 large clients be determined from the pool of issuers, subscribers, obligors, and underwriters, rather than from only issuers and subscribers, with obligors or underwriters being added only to the extent they meet the above criteria.²⁰³ In this case, the list would never exceed 20 persons. The Commission notes, however, that the statute clearly refers to the 20 largest “issuers and subscribers”

²⁰² Id.

²⁰³ See R&I Letter.

and not to obligors or underwriters.²⁰⁴ Therefore, this provision of the Exhibit is being adopted as proposed.

Section 15E(a)(1)(B)(viii) of the Exchange Act limits the persons required to be included in the list to users of the “credit rating services” of the applicant and NRSRO.²⁰⁵ The Exchange Act²⁰⁶ does not define the term “credit rating services.” The Commission proposed to interpret this term to mean any of the following: rating an obligor (regardless of whether the obligor or any other person paid for the credit rating); rating an issuer’s securities or money market instruments (regardless of whether the issuer, underwriter, or any other person paid for the credit rating); and providing credit ratings to a subscriber. The intent of this proposed interpretation is to include – along with persons that pay for credit ratings and subscriptions – persons that are rated, or whose securities or money market instruments are rated, but that did not pay for the credit rating. Even though these persons may not have paid for the credit rating, they potentially could have undue influence on the credit rating agency if they provide substantial net revenue for other services or products.

One commenter suggested expanding the definition to include providing credit ratings data and analysis to subscribers.²⁰⁷ The Commission agrees that the meaning of “subscribers” should include persons who pay for credit ratings data and the analysis behind credit ratings because it may be difficult to separate these subscribers from other

²⁰⁴ See 15 U.S.C. 78o-7(a)(1)(B)(viii).

²⁰⁵ Id.

²⁰⁶ 15 U.S.C. 78a et seq.

²⁰⁷ See DBRS Letter.

subscribers. Additionally, the Commission notes that credit rating agencies that make their credit ratings publicly available for free may offer subscriptions to receive feeds of the credit ratings or to receive more reports detailing the analysis behind the credit ratings. Consequently, the Commission is interpreting the term “credit rating services” to mean any of the following: rating an obligor (regardless of whether the obligor or any other person paid for the credit rating); rating an issuer’s securities or money market instruments (regardless of whether the issuer, underwriter, or any other person paid for the credit rating); and providing credit ratings, credit ratings data, or credit ratings analysis to a subscriber.

Section 15E(a)(1)(B)(viii) of the Exchange Act provides that the determination of the 20 largest issuers and subscribers is to be based on “net revenue” received from the issuer or subscriber.²⁰⁸ The Exchange Act²⁰⁹ does not define the term “net revenue.” The Commission proposed to interpret the term “net revenue” for the purposes of Section 15E(a)(1)(B)(viii) of the Exchange Act²¹⁰ to mean all fees, sales proceeds, commissions, and other revenue received by the applicant and its affiliates for any type of service or product, regardless of whether related to credit ratings, and net of any fees, sales proceeds, rebates, commissions, and other monies paid to the customer by the credit rating agency and its affiliates.

The Commission received several comments suggesting that this interpretation be narrowed in certain ways to make it more practical to employ in determining the large

²⁰⁸ 15 U.S.C. 78o-7(a)(1)(B)(viii).

²⁰⁹ 15 U.S.C. 78a *et seq.*

²¹⁰ 15 U.S.C. 78o-7(a)(1)(B)(viii).

users of a credit rating agency's services.²¹¹ Commenters stated that tracking revenues received by affiliates of the credit rating agency would be difficult.²¹² Several commenters also stated that payables used to determine the "net revenue" should not include, for example, monies paid to vendors for ordinary course goods and services such as utility bills.²¹³ A commenter also sought clarification on how to realize revenues (e.g., cash receipts, accrued receivables) for purposes of this Exhibit.

The Commission agrees with these commenters that the proposed definition of "net revenues" created some practical difficulties in determining the list required in Exhibit 10. Therefore, the Commission is refining the interpretation to make the calculation of "net revenues" easier to compute but also more focused. Specifically, the Commission interprets "net revenues" to mean revenue earned by the applicant or NRSRO for any type of service or product, regardless of whether related to credit rating services, and net of any rebates and allowances paid or owed to the person by the applicant or NRSRO. This definition excludes revenues received by affiliates that are not part of the credit rating organization. Also the intent in describing the netting payables as "rebates or allowances" is to limit them to items that directly reduce a payable on the revenue side and to exclude unrelated payables (e.g., payables for utility bills). Finally, by using the term "revenue earned" the Commission intends that the applicant and NRSRO apply its standard accounting convention for recognizing revenue.

²¹¹ See Gross Letter; Fitch Letter; S&P Letter; Moody's Letter.

²¹² See, e.g., Fitch Letter; S&P Letter; Moody's Letter.

²¹³ See, e.g., Gross Letter; Moody's Letter.

The Commission is incorporating these interpretations into the instructions for Exhibit 10 and, as discussed below, Rule 17g-3.

The Commission notes that one commenter stated that the Exhibit requires public disclosure and that such disclosure is unnecessary because credit rating agencies establish barriers between credit analysts and the business units.²¹⁴ In response, the Commission notes that, as discussed above, an NRSRO is not required to make this information publicly available under Rule 17g-1(i). The information is intended to be used by the Commission to identify persons that could potentially exert undue influence on an NRSRO. The Commission further notes that Congress specifically prescribed that an applicant and NRSRO provide the information with respect to the 20 largest issuers and subscribers in terms of net revenues.²¹⁵

For these reasons, the Commission is adopting Exhibit 10 and the instructions for the Exhibit with the modifications described above.

21. Exhibit 11 (Audited Financial Statements)

As adopted, Exhibit 11 requires an applicant to furnish audited financial statements for the past three fiscal or calendar years immediately preceding the date of the application. An NRSRO will not be required to make this information publicly available pursuant to Section 15E(a)(3) of the Exchange Act²¹⁶ and Rule 17g-1(i)

²¹⁴ See FSR Letter.

²¹⁵ 15 U.S.C. 78o-7(a)(1)(B)(viii).

²¹⁶ 15 U.S.C. 78o-7(a)(3).

thereunder or update the Exhibit after registration.²¹⁷ An NRSRO will be required to provide audited financial statements to the Commission annually under Rule 17g-3.

The Commission continues to believe this financial information is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in making the finding required by Section 15E(a)(2)(C) of the Exchange Act.²¹⁸ This section directs the Commission to grant a credit rating agency's application for registration as an NRSRO unless, among other things, the Commission finds that the applicant does not have adequate financial and managerial resources to consistently issue ratings with integrity and to materially comply with its procedures and methodologies disclosed pursuant to Section 15E(1)(B) of the Exchange Act and established pursuant to the Sections 15E(g), (h), (i) and (j) of the Exchange Act.²¹⁹ The financial statements will provide the Commission with information as to the applicant's net worth and income, which will assist the Commission in determining whether the applicant has sufficient financial resources. Financial statements for three years will assist the Commission in reviewing whether the applicant has been in the business of issuing credit ratings for the three years immediately preceding the date of its application for registration.²²⁰ The information also will alert the Commission to a significant downward trend in the

²¹⁷ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

²¹⁸ See 15 U.S.C. 78o-7(a)(2)(C).

²¹⁹ See 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

²²⁰ An applicant must have been in the business of issuing credit ratings for the three years preceding the application to be eligible for registration with the Commission as an NRSRO. See Section 3(a)(62)(A) of the Exchange Act (15 U.S.C. 78c(a)(62)(A)).

applicant's financial condition, which could be relevant to whether it has adequate financial resources.

The requirement that the financial statements be audited will provide the Commission with independent verification of the information in the statements. However, the Commission anticipates that some applicants may not have been audited in the past. Consequently, the instructions to the Exhibit provide that in this case the applicant may provide an audited financial statement for the fiscal year immediately preceding the date of the application. The prior years can be covered by unaudited financial statements. The instructions also provide that the applicant must attach a statement by a duly authorized person that the unaudited financial statements present fairly, in all material respects, the financial condition, results of operations, and the cash flows of the applicant. This will provide a level of assurance that the information in the financial statements has been reviewed and verified by the applicant.

Finally, the Commission anticipates that some applicants will be subsidiaries of holding companies. In this case, the applicant may provide audited consolidated financial statements of the parent company. Consolidated financial statements will provide information on the financial strength of the credit rating agency's parent. The parent is in a position to support the credit rating agency and, consequently, its financial condition may be indicative of the financial resources of the credit rating agency. Further, the information on revenues elicited in Exhibit 12 will augment the financial statements by providing information specific to the credit rating agency.

Several commenters sought clarification on whether the financial statements provided in Exhibit 11 must be prepared in accordance with Regulation S-X.²²¹ The Commission's intent with respect to Exhibit 11 is that applicants, to the extent possible, will be able to provide financial statements that have already been prepared for other reasons.

Two commenters also requested that the proposed rule be modified to permit an NRSRO to furnish a tax return prepared by an accountant in lieu of audited financial statements.²²² The Commission believes a tax return will not provide sufficient detail about an applicant's financial condition. For example, it would not provide the information that can be derived from a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity. Moreover, as indicated above, the Commission believes it is important to have an auditor provide independent verification that all this information is presented fairly, in all material respects.

For these reasons, the Commission is adopting Exhibit 11 and the instructions for the Exhibit with the modifications described above.

22. Exhibit 12 (Revenues)

As adopted, Exhibit 12 requires an applicant to provide information as to the amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services. The instructions provide that this information be for the most recently completed fiscal or calendar year and is not required to be audited. An NRSRO will not be required to make this information publicly

²²¹ See DBRS Letter; Fitch Letter; Moody's Letter.

²²² See Letter dated March 12, 2007 from Sean Egan, President, Egan-Jones Ratings Company ("EJR Letter"); LACE Letter.

available pursuant to Section 15E(a)(3) of the Exchange Act²²³ and Rule 17g-1(i) thereunder or update the Exhibit after registration.²²⁴ An NRSRO will be required to update this information in an unaudited financial report furnished to the Commission under Rule 17g-3.

Two commenters stated that the Exhibit should be eliminated because it was unnecessary given the submission of financial statements in Exhibit 11.²²⁵ The Commission continues to believe that this information is necessary or appropriate in the public interest or for the protection of investors. It will assist the Commission in making the finding with respect to adequate financial resources required by Section 15E(a)(2)(C) of the Exchange Act²²⁶ by providing detail as to the revenues generated by different types of credit rating services. Financial statements alone may not separate out or itemize revenues earned from credit rating services as opposed to other services. For example, an applicant that has earned less revenue from credit rating services than its total credit analyst compensation may not be able to continue to support this business line at levels consistent with the statutory mandate.

One commenter stated that the determination of the revenue amounts should be made using a “net revenue” definition that permits flexibility in terms of how revenue is recognized.²²⁷ As with Exhibit 10 and Rule 17g-3, the Commission intends that the

²²³ 15 U.S.C. 78o-7(a)(3).

²²⁴ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

²²⁵ See S&P Letter; AEI Letter.

²²⁶ See 15 U.S.C. 78o-7(a)(2)(C).

²²⁷ See Moody’s Letter.

credit rating agency apply its standard accounting convention for recognizing revenue as this will make revenue calculations consistent across the various financial reports required in Form NRSRO and Rule 17g-3.

Another commenter, with respect to Rule 17g-3, requested the elimination of a requirement to separately report revenues from determining private credit ratings (i.e., credit ratings that are not made readily accessible to the public).²²⁸ The commenter stated that it would be difficult to separate private ratings revenue from public ratings revenue. In an effort to reduce burden, the Commission has eliminated the requirement to separately itemize revenue from private ratings. The private ratings revenue must be included in the revenue item for determining or maintaining credit ratings.

Two commenters disagreed on the information that should be included in the revenue item relating to subscribers.²²⁹ One commenter stated that the item should include revenue from subscribers to an applicant's credit analysis in addition to credit ratings subscribers.²³⁰ The other commenter stated that the item should only apply to credit ratings subscribers.²³¹ The Commission intends the Exhibit to include both types of subscribers. The Commission believes separating out revenues from these two types of subscribers could be difficult in that some credit rating agencies may offer subscriptions that include access to credit ratings and credit analysis. Furthermore, some credit rating agencies make their credit ratings available for free but charge subscribers

²²⁸ See Fitch Letter.

²²⁹ See Gross Letter; R&I Letter.

²³⁰ See Gross Letter.

²³¹ See R&I Letter.

for credit ratings data and credit analysis. The Commission believes there is no reason to distinguish between a subscriber to credit ratings and a subscriber to credit ratings data and analysis in this context.

For these reasons, the Commission is adopting Exhibit 12 and the instructions for the Exhibit with the modifications described above.

23. Exhibit 13 (Analyst Compensation)

As adopted, Exhibit 13 will require an applicant to disclose to the Commission the amount of total aggregate annual compensation paid to its credit analysts and the median compensation. The instructions provide that the information must be for the most recently completed fiscal or calendar year and will not have to be audited. An NRSRO will not be required to make this information publicly available pursuant to Section 15E(a)(3) of the Exchange Act²³² and Rule 17g-1(i) thereunder or update the Exhibit after registration.²³³ An NRSRO will be required to update this information in a financial report furnished to the Commission under Rule 17g-3.

One commenter stated that the information may not be necessary given the different sizes and business models of credit rating agencies.²³⁴ The Commission continues to believe this compensation information is necessary or appropriate in the public interest or for the protection of investors. It will assist the Commission in making the finding with respect to adequate financial resources required by Section 15E(a)(2)(C)

²³² 15 U.S.C. 78o-7(a)(3).

²³³ An applicant can request that this information be kept confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

²³⁴ See AEI Letter.

of the Exchange Act.²³⁵ Similar to the revenue information, this information will augment the financial statements that are required under Exhibit 11 because it provides detail on the expenses necessary to retain the credit rating agency's credit analysts. The Commission will compare this information with the revenues earned by the applicant for credit ratings services to evaluate an applicant's financial condition.

For these reasons, the Commission is adopting Exhibit 13 and the instructions for the Exhibit with the modifications described above.

C. Rule 17g-2 – Recordkeeping

The Rating Agency Act amended Section 17(a)(1) of the Exchange Act to add NRSROs to the list of entities required to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.²³⁶ The inclusion of NRSROs on the list also provides the Commission with authority under Section 17(b)(1) of the Exchange Act to examine all the records of an NRSRO.²³⁷

The Commission is implementing this rulemaking authority through Rule 17g-2. This rule requires an NRSRO to make and retain certain records relating to its business and to retain certain other business records made in the normal course of business operations. The rule also prescribes the time periods and manner in which all these records will be required to be retained.

²³⁵ See 15 U.S.C. 78o-7(a)(2)(C).

²³⁶ See Section 5 of the Rating Agency Act and 15 U.S.C 78q(a)(1).

²³⁷ See 15 U.S.C 78q(b)(1).

Several commenters stated that Rule 17g-2 as proposed was unduly burdensome or onerous.²³⁸ The Commission believes the rule is necessary or appropriate in the public interest or for the protection of investors and narrowly tailored to achieve its purpose.²³⁹ The Commission designed the rule based on its experience with recordkeeping rules for other regulated entities.²⁴⁰ These other books and records rules have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws.²⁴¹ Rule 17g-2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with the provisions of Section 15E of the Exchange Act²⁴² and the rules thereunder. For example, examiners will use the records to review whether an NRSRO is following its disclosed procedures and methodologies for determining credit ratings, its disclosed policies and procedures for preventing the

²³⁸ See, e.g., FSR Letter; AEI Letter.

²³⁹ Section 15E(c)(2) of the Exchange Act (15 U.S.C. 78o-7(c)(2)) requires that the Commission's rules under the Rating Agency Act be narrowly tailored.

²⁴⁰ See, e.g., 17 CFR 240.17a-3 and 17a-4 (broker-dealers); 17 CFR 275.204-2 (investment advisers); 17 CFR 240.17Ad-6 and 17Ad-7 (transfer agents).

²⁴¹ See Electronic Storage of Broker-Dealer Records, Exchange Act Release No. 47806 (May 7, 2003), 68 FR 25281 (May 12, 2003); see also Commission order in Matter of Deutsche Bank Securities, Inc. et al, Exchange Act Release No. 46937 (December 3, 2002) ("The record keeping rules are 'a keystone of the surveillance of broker-dealers'") (citations omitted); Commission order in Matter of J.P. Morgan Securities Inc., Exchange Act Release No. 51200 (February 14, 2005); Electronic Recordkeeping by Investment Companies and Investment Advisers, Investment Company Act Release No. 24991 (May 24, 2001) ("The recordkeeping requirements are a key part of the Commission's regulatory program for funds and advisers, as they allow [the Commission] to monitor fund and adviser operations, and to evaluate their compliance with federal securities laws.").

²⁴² 15 U.S.C. 78o-7.

misuse of material nonpublic information, and managing conflicts of interest, and whether it is complying with Rules 17g-4, 17g-5, and 17g-6 discussed below.

Nonetheless, the Commission is adopting Rule 17g-2 with modifications to address issues commenters raised, to reduce burden, and to enhance recordkeeping requirements with respect to the issuance of credit ratings on certain asset-backed and mortgage-backed securities transactions. As a preliminary matter, the Commission notes that several commenters raised concerns with how examiners would use the books and records required under Rule 17g-2.²⁴³ One commenter requested that the Commission clarify that examiners would not use their inspection of records to second-guess credit rating opinions.²⁴⁴ The Commission does not intend that Rule 17g-2 be used as a means to substitute the Commission's judgment for that of an NRSRO with respect to the NRSRO's credit rating opinion.

Further, Section 15E(c)(2) of the Exchange Act provides that the Commission may not "regulate the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings."²⁴⁵ The purpose of the recordkeeping requirements in Rule 17g-2 is to allow examiners to review whether an NRSRO is following its stated procedures and methodologies and otherwise complying with Section 15E of the Exchange Act²⁴⁶ and the rules thereunder. It is important that users of credit ratings be given the opportunity to understand how a specific NRSRO determines

²⁴³ See DBRS Letter; Langohr Letter.

²⁴⁴ See DBRS Letter.

²⁴⁵ 15 U.S.C. 78o-7(c)(2).

²⁴⁶ 15 U.S.C. 78o-7.

its credit ratings. Consequently, Sections 15E(a)(1)(B)(ii) and 15E(a)(3) of the Exchange Act require an NRSRO to make this information publicly available.²⁴⁷ The Commission's role is to examine whether an NRSRO has accurately disclosed this information so that users of credit ratings can assess its credit rating procedures and methodologies. The Commission's role also is to examine whether an NRSRO adheres to its credit rating procedures and methodologies.

A second commenter raised the concern that using records to examine whether an NRSRO has accurately disclosed information about how it determines credit ratings would result in the Commission's tacit endorsement of the credit ratings.²⁴⁸ The Commission reiterates that the purpose of examining these records is to review whether an NRSRO has accurately disclosed information about, and adheres to, the procedures and methodologies it uses to determine credit ratings. As noted above, the Commission cannot "regulate the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings."²⁴⁹ Users of credit ratings should not view the fact that the Commission has examined whether an NRSRO has accurately disclosed information about, and adheres to, its credit rating procedures and methodologies as an endorsement of the credit ratings or the procedures and methodologies used to determine the credit ratings. Users of credit ratings must evaluate a given NRSRO's procedures and methodologies for themselves and reach their own conclusions as to the quality of the procedures and methodologies. The Commission's role is limited to reviewing

²⁴⁷ 15 U.S.C. 78o-7(a)(1)(B)(ii) and 15 U.S.C. 78o-7(a)(3).

²⁴⁸ See Langohr Letter.

²⁴⁹ 15 U.S.C. 78o-7(c)(2).

whether the information disclosed by an NRSRO is consistent with how the NRSRO conducts its credit rating activities. The Commission also notes that Section 15E(f) of the Exchange Act bars an NRSRO from representing that it has been “designated, sponsored, recommended, or approved, or that [its] abilities or qualifications....have in any respect been passed upon, by the United States, or any agency, officer, or employee thereof.”²⁵⁰

Finally, another commenter stated that the recordkeeping rule should be principles based and permit an NRSRO to implement a recordkeeping system appropriate for its organizational structure and business model.²⁵¹ The Commission does not intend that Rule 17g-2 require a specific form of record or recordkeeping system. An NRSRO will have the flexibility to implement a recordkeeping system that captures the records required in Rule 17g-2 in a manner that conforms to the NRSRO’s internal processes. At the same time, as noted above, Rule 17g-2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with the provisions of Section 15E of the Exchange Act²⁵² and the rules thereunder. The Commission believes that a principles based recordkeeping rule would be difficult to administer. It could lead to inconsistent recordkeeping by NRSROs and also create uncertainty for NRSROs and Commission examiners as to the records that must be retained. The Commission believes the better approach is to prescribe certain records that must be

²⁵⁰ 15 U.S.C. 78o-7(f).

²⁵¹ See Moody’s Letter.

²⁵² 15 U.S.C. 78o-7.

made and retained at a minimum to provide for consistent recordkeeping requirements across all NRSROs.

1. Paragraph (a) of Rule 17g-2

As adopted, paragraph (a) of Rule 17g-2 requires an NRSRO to make and retain certain books and records. The records required under paragraph (a) must be complete and current and not contain inaccurate information.²⁵³ With respect to the specific records required under paragraph (a), the Commission has made several modifications in light of comments that will ease the recordkeeping burden. The Commission believes the records required in this paragraph are necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. As described below, they will assist the Commission in monitoring whether an NRSRO is complying with Section 15E of the Exchange Act and the rules thereunder.²⁵⁴

a. Paragraph (a)(1) of Rule 17g-2

As adopted, paragraph (a)(1) of Rule 17g-2 requires an NRSRO to make records of original entry into an NRSRO's accounting system, and records reflecting entries to and balances in all general ledger accounts of the NRSRO for each fiscal year. Rule 17g-2, as proposed, contained a similar provision. The Commission believes these fundamental business records are necessary for the preparation of the financial reports required to be prepared under Rule 17g-3. In addition, they will assist Commission examiners in reviewing the financial resources of an NRSRO and its revenue sources.

²⁵³ See, e.g., In the Matter of SG Cowens Securities Corporation, Exchange Act Release No. 48335 (August 14, 2003) ("Implicit in the Commission's recordkeeping rules is the requirement that information in a required book or record be accurate.").

²⁵⁴ See 15 U.S.C 78q(a)(1).

The latter information will be important in identifying customers that provide an NRSRO with significant revenues and, consequently, could be in a position to exercise undue influence over a credit rating decision.

One commenter stated that, while it already maintains these types of records, the requirement to make them should be eliminated because the information in the Rule 17g-3 financial reports will be sufficient.²⁵⁵ The Commission believes it is important that an NRSRO make and retain these records. They will provide Commission examiners with the source information that feeds into the Rule 17g-3 financial reports. Further, those financial reports are a snap shot of the NRSRO's financial condition as of its fiscal year end. These records will provide examiners with current financial information as of the time of their exam. For these reasons, the Commission is adopting paragraph (a)(1) of Rule 17g-2 substantially as proposed.

b. Paragraph (a)(2) of Rule 17g-2

As adopted, paragraph (a)(2) of Rule 17g-2 requires an NRSRO to make the following records with respect to each of the NRSRO's current credit ratings, as applicable: the identity of any credit analyst(s) that participated in the determination of the credit rating; the identity of the person(s) who approved the credit rating before it was issued; whether the credit rating was solicited or unsolicited; and the date the credit rating action was taken. This information will assist the Commission in monitoring whether the NRSRO is following its procedures and methodologies for determining credit ratings and whether the NRSRO is complying with procedures designed to prevent the misuse of material nonpublic information. For example, if questions arise about a

²⁵⁵ See Fitch Letter.

particular credit rating, the record will provide the Commission staff with the names of the credit analysts that participated in determining the credit rating and the persons that approved the credit rating. This will identify for the Commission staff the persons with the best information as to how the credit rating was determined.

Rule 17g-2, as proposed, also would have required a record identifying the procedures and methodologies used to determine the credit rating and the method by which the credit rating was made publicly available. The Commission has eliminated these requirements to reduce recordkeeping burden and because Commission examiners can ascertain the information through a less burdensome requirement.²⁵⁶ Under paragraph (a)(6) of Rule 17g-2, an NRSRO is required to separately document the procedures and methodologies it uses to determine credit ratings. The Commission examination staff will be able to refer to these records to understand how specific types of credit ratings are determined by the NRSRO. Therefore, examiners will not need an individual record identifying the methodology used to determine each credit rating. For similar reasons, the Commission has eliminated the proposed requirement to make a record of the method by which each credit rating was made readily accessible. An NRSRO must disclose in Form NRSRO how it makes its credit ratings readily accessible. Commission examiners can review this disclosure to understand how a specific credit rating was made readily accessible.

²⁵⁶ Several commenters requested that the Commission eliminate the requirement to make a record identifying the procedures and methodologies used to determine the credit rating. See DBRS Letter; Fitch Letter; Moody's Letter; Langohr Letter. These commenters argued, among other things, that the requirement interfered with the process of determining credit ratings, was not consistent with normal practice, and was burdensome. *Id.*

The Commission notes, however, that if an NRSRO materially diverges from its stated methodology for determining a specific type of credit rating or for making credit ratings readily accessible, it may violate the requirements to disclose in Form NRSRO information about credit ratings methodologies and how credit ratings are made readily accessible and, in the former case, the requirement in paragraph (a)(6) to document the procedures and methodologies for determining credit ratings. Consequently, an NRSRO must include in its documented procedures any alternative methodologies for determining a specific type of credit rating and when such alternatives may be used by a credit analyst.

Finally, consistent with changes to Form NRSRO discussed above, the final rule changes the requirement proposed in Rule 17g-2(a)(2) to identify the credit analysts “who determined” the credit rating to credit analysts “who participated in determining” the credit rating. In all other respects, the Commission is adopting paragraph (a)(2) of Rule 17g-2 substantially as proposed.

c. Paragraph (a)(3) of Rule 17g-2

As adopted, paragraph (a)(3) of Rule 17g-2 requires an NRSRO to make an account record for each person (for example, an obligor, issuer, underwriter, or other user) that has paid for the issuance or maintenance of a credit rating indicating the identity and address of the person and the credit ratings determined or maintained for the person. This information will assist the Commission in monitoring whether the NRSRO is complying with procedures for addressing and managing conflicts of interest as well as complying with the requirements in Rule 17g-5 prohibiting certain conflicts of interest. For example, examiners can use this record to identify persons that have paid

the NRSRO for a significant number of credit ratings (e.g., a regular sponsor of structured products). These persons, given the large volume of business they provide the NRSRO, may be in a position to exert inappropriate influence on the NRSRO to issue favorable credit ratings.

One commenter pointed out that by using the term “solicits” the rule could be construed to require a record of each person that asks the NRSRO to issue a credit rating, regardless of whether the person ultimately pays for the credit rating or the NRSRO ultimately issues the credit rating.²⁵⁷ The Commission agrees that the rule text, as proposed, contained a degree of ambiguity. Further, the Commission believes it could be difficult and unduly burdensome to create a record of each person who approaches the NRSRO about having a credit rating issued. For example, some contacts between the NRSRO and a person may never progress beyond initial inquiries. For these reasons, the Commission modified the rule to clarify that the requirement is limited to persons who pay for credit ratings that are issued publicly.

The Commission also modified paragraph (a)(3) of Rule 17g-2 by eliminating the requirement to provide the customer’s “principal” address. The term “principal address” has a legal meaning in some contexts and, accordingly, could unduly complicate the process of creating the record. The rule now requires the customer’s “address” without regard to whether it is the principal address. In all other respects, the Commission is adopting paragraph (a)(3) of Rule 17g-2 substantially as proposed.

d. Paragraph (a)(4) of Rule 17g-2

²⁵⁷ See Fitch Letter.

As adopted, paragraph (a)(4) of Rule 17g-2 requires an NRSRO to make an account record for each subscriber to the credit ratings and/or credit analysis reports of the NRSRO indicating the identity and address of the subscriber. This information will assist the Commission in monitoring whether the NRSRO was complying with its procedures for addressing and managing conflicts of interest and the handling of material, nonpublic information as well as complying with the requirements in Rule 17g-5 prohibiting certain conflicts of interest. The Commission did not receive any comments on this provision. For the reasons discussed above with respect to paragraph (a)(3) of Rule 17g-2, the Commission has modified the provision to eliminate the reference to a customer's "principal" address. In all other respects, the Commission is adopting paragraph (a)(4) of Rule 17g-2 substantially as proposed.

e. Paragraph (a)(5) of Rule 17g-2

As adopted, paragraph (a)(5) of Rule 17g-2 requires an NRSRO to make a record listing the general types of services and products offered by the NRSRO. This record will provide the Commission with details of the ancillary business activities of the NRSRO and, therefore, will be useful in identifying potential conflicts of interest that arise from such activities. Commission examiners then will be able to review whether the NRSRO has implemented procedures to manage these potential conflicts.

One commenter pointed out that the rule text as proposed could be construed to require a record each time the NRSRO made an offer to provide a service to a customer.²⁵⁸ This was not the intent of the proposed requirement. Rather, it was to require a record listing the general types of services the NRSRO offers. The record is

²⁵⁸ See Fitch Letter.

designed to provide Commission examiners with a way to quickly understand the NRSRO's business model based on the types of services and products it provides to persons. The record does not require an entry for each offer to a person or transaction with a person. The final rule has been modified to clarify that the provision only requires a list of the types of services offered by the NRSRO. In all other respects, the Commission is adopting paragraph (a)(5) of Rule 17g-2 substantially as proposed.

f. Paragraph (a)(6) of Rule 17g-2

As adopted, paragraph (a)(6) of Rule 17g-2 requires an NRSRO to make a record documenting the established procedures and methodologies used by the NRSRO to determine credit ratings. This provision is being added to Rule 17g-2 in response to comments regarding Exhibit 2 to Form NRSRO, which, as proposed, required an NRSRO to attach the procedures and methodologies to the Form and make them publicly available after registration. As discussed above, Exhibit 2 has been modified so that it now requires a description of the procedures and methodologies as opposed to each procedure and methodology. The intent is to require sufficient information in Exhibit 2 to allow users of credit ratings to develop an understanding of how the NRSRO determines credit ratings without imposing the burden of making a voluminous submission to the Commission and public disclosure. It also is designed to avoid the public disclosure of proprietary information.

Accordingly, rather than require these procedures and methodologies to be attached to Form NRSRO and disclosed publicly, the Commission is requiring that they be documented internally. This will permit Commission examiners to review the procedures and methodologies in order to review whether the NRSRO has disclosed

sufficient information about them in Form NRSRO to permit users of credit ratings to understand how the NRSRO determines credit ratings. It also will permit Commission examiners to review whether the NRSRO is adhering to its procedures and methodologies and complying with other rules.²⁵⁹ For example, Rule 17g-6 prohibits, among other things, an NRSRO from issuing or modifying, or threatening to issue or modify, a credit rating contrary to the NRSRO's established procedures and methodologies. The Commission's ability to enforce this prohibition will depend in part on the NRSRO having fully documented its procedures and methodologies. As discussed below, these records also will be an important means for the Commission to gain a better understanding of the procedures and methodologies used by credit rating agencies to treat the credit ratings of other credit rating agencies when determining the overall credit rating for securities or money market instruments issued by asset pools or as part of any asset-backed or mortgage-backed securities transactions ("structured products").

As noted above, to the extent a credit rating agency permits credit analysts to diverge from the procedures or methodologies it has established, the NRSRO must document the circumstances under which such a divergence will be permitted and the alternative procedure or methodology that must be used. In effect, documenting the divergence in this manner will make it part of the NRSRO's established procedures and methodologies and, therefore, the NRSRO will be adhering to the requirements of paragraph (a)(6) of Rule 17g-2. Failing to document when the divergence will be

²⁵⁹ See AFP Letter.

permitted or required will expose the NRSRO to potential violations of Rules 17g-1, 17g-2, and 17g-6.

For the foregoing reasons and the reasons discussed with respect to Exhibit 2 of Form NRSRO, the Commission is eliminating the requirement that an NRSRO attach to Form NRSRO and make publicly available its procedures and methodologies for determining credit ratings. Instead, the Commission is adopting paragraph (a)(6) of Rule 17g-2 to require that the procedures and methodologies be documented internally.

g. Paragraph (a)(7) of Rule 17g-2

As adopted, paragraph (a)(7) of Rule 17g-2 requires an NRSRO to make a record that lists each security and its corresponding credit rating issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction where the NRSRO in determining the credit rating for the security treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the NRSRO by one or more of four ways specified in the rule to determine a credit rating for the security. This provision was not proposed but is being added because of modifications to paragraph (a)(4) of Rule 17g-6, which prohibits anti-competitive practices relating to determining credit ratings for structured products. As discussed below with respect to paragraph (a)(4) of Rule 17g-6, the Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in monitoring practices in the structured product area that many commenters believe are anti-competitive.

2. Paragraph (b) of Rule 17g-2

As adopted, paragraph (b) of Rule 17g-2 requires an NRSRO to retain certain records (excluding drafts of documents) that relate to its business as a credit rating agency.²⁶⁰ The records required to be retained in paragraph (b) of Rule 17g-2 are those an NRSRO makes or receives as a matter of business practice but are not records an NRSRO is required to make. The Commission believes the records required to be retained under paragraph (b) are necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act because, as described below, they will assist the Commission in monitoring whether an NRSRO is complying with Section 15E of the Exchange Act²⁶¹ and the rules thereunder.

Since these records are not required to be made, an NRSRO will not have to update them. Rather, the NRSRO is required to retain the original record in an unaltered form or a true copy of the original record for the prescribed retention period. The Commission notes, however, that, under Section 15E(b)(1) of the Exchange Act,²⁶² an NRSRO must update, as provided in that section, certain information in the Forms and Exhibits that are required to be retained under paragraph (b)(9) of Rule 17g-2 (discussed below).

a. Paragraph (b)(1) of Rule 17g-2

²⁶⁰ As discussed below, several commenters sought clarification as to whether the record retention requirements in paragraph (b) of Rule 17g-2, as proposed, would apply to drafts of documents. The Commission did not intend these requirements to apply to drafts and has added language in the introductory text of paragraph (b) of Rule 17g-2 excluding drafts of documents.

²⁶¹ 15 U.S.C. 78o-7.

²⁶² See 15 U.S.C. 78o-7(b)(1).

As adopted, paragraph (b)(1) of Rule 17g-2 requires an NRSRO to retain all significant records underlying the information included in the NRSRO's annual financial reports required pursuant to Rule 17g-3. This includes bank statements, bills payable and receivable, trial balances, and records relating to the determination of the largest customers. These records will assist Commission examiners in understanding and reviewing the basis of information provided in the financial reports the NRSRO will be required to annually furnish to the Commission. For example, examiners can use the records relating to the list of the largest customers to review whether the NRSRO has identified such customers in accordance with Rule 17g-3.

The Commission received one comment on this provision.²⁶³ The commenter stated that, while it retains these records, the requirement should be eliminated because the financial reports required in Rule 17g-3 provide sufficient information in these areas. Similar to the records required in paragraph (a)(1) of Rule 17g-2, the Commission believes it is important that an NRSRO retain these records. They will provide Commission examiners with the source information that feeds into the Rule 17g-3 financial reports. Further, as noted above, those financial reports are a snap shot of the NRSRO's financial condition as of its fiscal year end. These records will provide examiners with current information as of the time of their exam. For these reasons, the Commission is adopting paragraph (b)(1) of Rule 17g-2 substantially as proposed.

b. Paragraph (b)(2) of Rule 17g-2

As adopted paragraph (b)(2) of Rule 17g-2 requires an NRSRO to retain internal records, including nonpublic information and work papers, used to form the basis of a

²⁶³ See Fitch Letter.

credit rating. These records will include, for example, notes of conversations with the management of an issuer or obligor that was the subject of the credit rating and the inputs and raw results of a quantitative model used to determine the credit rating. The retention of this information, and other internal records used to determine a credit rating, will assist the Commission in reviewing whether an NRSRO is adhering to its established procedures and methodologies for determining credit ratings and for preventing the misuse of material nonpublic information. It also will assist the Commission in gaining a better understanding of the practices used by credit rating agencies to incorporate the credit ratings of other credit rating agencies into the overall credit rating of a structured product.

The Commission received several comments on the rule text in this paragraph as proposed.²⁶⁴ The comments generally were similar in that they sought clarification that the provision does not require the retention of every record that somehow relates to the credit rating.²⁶⁵ In response, the Commission notes that it did not intend the rule to be interpreted that broadly. The provision only applies to internal records and documents that are used to form the basis of the credit rating. The provision explicitly excludes publicly available information and the introductory text to paragraph (b) of Rule 17g-2 excludes drafts of documents from its provisions. The rule does not require an NRSRO to retain internal documents that a credit analyst reviews but that do not factor into the determination of the credit rating. For the foregoing reasons, the Commission is adopting paragraph (b)(2) of Rule 17g-2 substantially as proposed.

²⁶⁴ See S&P Letter; DBRS Letter; Fitch Letter; Moody's Letter.

²⁶⁵ Id.

c. Paragraph (b)(3) of Rule 17g-2

As adopted, paragraph (b)(3) of Rule 17g-2 requires an NRSRO to retain credit analysis reports, credit assessment reports, and private credit rating reports and internal records, including nonpublic information and work papers, used to form the basis for the opinions expressed in these reports. These reports – which credit rating agencies commonly create and sell as an ancillary service to the issuance of credit ratings – generally provide a detailed analysis of the information and assumptions underlying a credit rating. In developing these reports, the credit analyst may receive material nonpublic information about an issuer or obligor. For example, an issuer may request a private credit rating report to understand how a contemplated transaction would impact the current publicly available credit rating of its debt securities. Consequently, the retention of these reports and internal records used to form the basis of the reports will assist the Commission in monitoring whether the NRSRO is complying with its policies and procedures for preventing the misuse of material nonpublic information.

The Commission received several comments on the rule text of this paragraph as proposed.²⁶⁶ Similar to the comments regarding paragraph (b)(2) of Rule 17g-2, the comments sought clarification that the provision does not require the retention of every potentially relevant record such as records that do not contain information that the credit analysis used to form the basis of conclusions in the report.²⁶⁷ In response to these comments, the Commission notes that it does not intend the rule to be interpreted to apply to internal documents that a credit analyst reviews but that do not factor into the

²⁶⁶ See Letter dated March 8, 2007 from John B. Rutherford, Jr. (“Rutherford Letter”); DBRS Letter; Fitch Letter; Moody’s Letter; S&P Letter.

²⁶⁷ Id.

conclusions in the final report. Further, the provision explicitly excludes publicly available information and the introductory text to paragraph (b) of Rule 17g-2 excludes drafts of documents from its provisions. Consequently, the Commission is adopting paragraph (b)(3) of Rule 17g-2 substantially as proposed.

d. Paragraph (b)(4) of Rule 17g-2

As adopted, paragraph (b)(4) of Rule 17g-2 requires an NRSRO to retain compliance reports and compliance exception reports. The retention of these reports will identify activities of the NRSRO that its designated compliance officer had determined raised, or did not raise, compliance and control issues. Commission examiners will then be able to review how the NRSRO addressed the compliance issues. This can lead to more focused examinations, which also will decrease the burden on the NRSRO. The reports also will provide information as to whether the NRSRO is complying with its established methodologies, procedures, and policies.

The Commission received two comments on this provision.²⁶⁸ One commenter stated that it should be narrowed to exclude compliance reports that do not find any deficiencies.²⁶⁹ The commenter stated that Commission examiners might use reports that do not contain deficiencies to second-guess the designated compliance officer.²⁷⁰ As noted above, compliance reports that do not contain deficiencies will be useful to examiners in terms of focusing exams. This commenter also stated that the provision should not apply to whistleblower reports. The Commission understands the concern

²⁶⁸ See DBRS Letter; Moody's Letter.

²⁶⁹ See DBRS Letter.

²⁷⁰ Id.

that including whistleblower reports with the provision's scope could have a chilling effect on an employee's willingness to report violations, particularly in smaller organizations. For the purposes of this rule, the Commission does not view a whistleblower report as a final compliance report or a compliance exception report. It is an allegation made by someone within the organization about inappropriate or unlawful conduct. However, any final report of the NRSRO's compliance officer resulting from the allegations or disclosures contained in the report of a whistleblower will be a compliance report subject to this provision. The compliance officer's final compliance report on the matter can be drafted in a manner to protect the whistleblower by not identifying the person.

The other commenter stated that the Commission should clarify that the rule does not require the retention of draft reports.²⁷¹ In response, the Commission notes, as discussed above, that it did not intend the rule to be interpreted to require the retention of draft reports and other interim work product. The Commission has clarified this by adding introductory text to paragraph (b) of Rule 17g-2 that excludes drafts of documents from its provisions. For the foregoing reasons, the Commission is adopting paragraph (b)(4) of Rule 17g-2 substantially as proposed.

e. Paragraph (b)(5) of Rule 17g-2

As adopted, paragraph (b)(5) of Rule 17g-2 requires an NRSRO to retain internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by its internal auditors as necessary to perform the audit of an activity that relates to its business as a credit rating agency. The retention of

²⁷¹ See Moody's Letter.

these records will identify activities of the NRSRO that its internal auditors had determined raised, or did not raise, compliance or control issues. They also will assist the Commission in reviewing whether the NRSRO is complying with its established methods, procedures, and policies.

The Commission received two comments on this provision.²⁷² The first commenter requested that the provision be deleted because it would chill NRSROs from establishing robust internal audit departments.²⁷³ The Commission continues to believe these are important records that will assist the Commission examination staff in understanding a given NRSRO's internal operations and activities. As noted above, one of the Commission's oversight roles is to review whether an NRSRO is accurately disclosing information about, and adhering to, its procedures and methodologies for determining credit ratings. Reports of an NRSRO's internal auditors can provide highly useful information to assist the Commission in performing this regulatory function. The Commission notes that the provision requires an NRSRO to maintain internal audit records for three years. This retention period is designed to provide Commission examiners with the opportunity to review them. Finally, the Commission staff's experience with reviewing supervised entities such as broker-dealers and broker-dealer holding companies has not indicated that having access to internal audit reports chills the robust functioning of their internal audit departments.

²⁷² See DBRS Letter; Moody's Letter.

²⁷³ See DBRS Letter.

The second commenter requested that the Commission clarify that the provision only requires the retention of final internal audit reports and not interim work product.²⁷⁴ In response, the Commission notes that it does not intend the provisions to apply to drafts of internal audit records and, as noted above, has added introductory text to paragraph (b) of Rule 17g-2 that excludes drafts of documents from its provisions. The commenter also requested that the provision permit an NRSRO to tailor its internal audit records to its business plan.²⁷⁵ In response, the Commission notes that the provision only requires an NRSRO to retain internal audit records. It does not specify the types of audit records that must be made. An NRSRO is free to establish an internal audit process that is tailored to its business model. Finally, this commenter requested that the Commission clarify that the provision does not require an NRSRO that is a public company to retain financial reporting internal auditing reports beyond those required under the Exchange Act.²⁷⁶ The Commission notes that Rule 17g-2 requires an NRSRO to retain internal audit reports that relate to its business as a credit rating agency. The NRSRO must determine whether an internal audit report created under a statutory or regulatory requirement is one that relates to its credit rating business and, therefore, must be retained under this provision.

For the foregoing reasons, the Commission is adopting paragraph (b)(5) of Rule 17g-2 substantially as proposed.

f. Paragraph (b)(6) of Rule 17g-2

²⁷⁴ See Moody's Letter.

²⁷⁵ Id.

²⁷⁶ Id.

As adopted, paragraph (b)(6) of Rule 17g-2 requires an NRSRO to retain copies of marketing materials that are published or otherwise made available to persons that are not associated with the NRSRO. Section 15E(f) of the Exchange Act prohibits an NRSRO from representing that it has been designated, recommended, or approved, or that its abilities or qualifications have been passed upon by any federal agency or officer.²⁷⁷ The retention of marketing materials will assist the Commission in reviewing whether the NRSRO is complying with this statutory provision.

The Commission received two comments on the provision.²⁷⁸ One commenter sought clarification that it does not apply to internal documents of the marketing department.²⁷⁹ The second commenter requested that the Commission provide guidance on the meaning of “marketing materials.”²⁸⁰ The Commission intended that the provision only apply to materials that are actually used to market the NRSRO’s credit rating services. The Commission has modified the rule text to clarify that the requirement only applies to marketing materials that are published or otherwise made available to persons who are not associated with the NRSRO. The Commission does not intend that the provision be interpreted to apply to records that are used by the marketing department for internal purposes. This modification is designed to provide greater clarity on the marketing materials that must be retained. In response to the second commenter, the Commission notes that marketing materials, generally, will include any

²⁷⁷ 15 U.S.C. 78o-7(f).

²⁷⁸ See R&I Letter; DBRS Letter.

²⁷⁹ See R&I Letter.

²⁸⁰ See DBRS Letter.

written documents that an NRSRO publishes or provides to persons that explain or describe its credit rating services and are designed to induce persons to purchase the services.

In all other respects, the Commission is adopting paragraph (b)(6) of Rule 17g-2 substantially as proposed.

g. Paragraph (b)(7) of Rule 17g-2

As adopted, paragraph (b)(7) of Rule 17g-2 requires an NRSRO to retain external and internal communications, including electronic communications, received and sent by the nationally recognized statistical rating organization and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating. The Commission received several comments on the proposed rule text of the paragraph.²⁸¹

The commenters all stated generally that the requirement was overbroad and should be narrowed.²⁸² One suggested that it only require external communications.²⁸³ Two suggested it only require communications used by a credit analyst to form the basis of a credit rating.²⁸⁴ Another commenter suggested the provision should have a materiality threshold.²⁸⁵

In response to these comments, the Commission notes that the retention of written communications has played an important role in assisting the Commission in

²⁸¹ See ASF Letter; Rutherford Letter; DBRS Letter; Fitch Letter; S&P Letter.

²⁸² Id.

²⁸³ See DBRS Letter.

²⁸⁴ See Rutherford Letter; S&P Letter.

²⁸⁵ See Fitch Letter.

identifying legal violations and compliance issues with respect to other regulated entities.²⁸⁶ The Commission believes that internal communications will play an important role in assisting the Commission in identifying legal violations and compliance issues in its oversight of NRSROs. For example, paragraph (a)(4) of Rule 17g-6 prohibits certain practices if they are undertaken with anti-competitive intent. The ability of the Commission to prove intent will be difficult absent communications that demonstrate why an NRSRO engaged in a particular act. Further, the Commission believes that narrowing the provision to communications used by a credit analyst to form the basis of a credit rating would carve out highly relevant communications, including communications that could be relevant to compliance with Rule 17g-4 (nonpublic information), Rule 17g-5 (conflicts of interest), and, as noted above, Rule 17g-6 (prohibited practices). Finally, the Commission believes that a materiality threshold would be very difficult to comply with and enforce. The degree of materiality of a communication viewed in isolation may not be apparent. In some cases, a seemingly innocuous communication may in fact be highly material when placed in the context of related events and other communications.

For the foregoing reasons, the Commission is adopting paragraph (b)(7) of Rule 17g-2 substantially as proposed.

h. Paragraph (b)(8) of Rule 17g-2

²⁸⁶ See, e.g., Commission complaint in Commission v. Citigroup Global Markets Inc., 03 CV 2945 (WHP) (S.D.N.Y.) (April 28, 2003); Commission complaint in Commission v. Merrill, Lynch, Pierce, Fenner & Smith, 03 CV 2941 (WHP) (S.D.N.Y.) (April 28, 2003); Commission Order in Matter of Columbia Management Advisers, Inc. and Columbia Funds Distributor, Inc., Securities Act Release No. 8534 (February 9, 2005).

As adopted, paragraph (b)(8) of Rule 17g-2 requires an NRSRO to retain internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another NRSRO for the purpose of determining a credit rating of a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction.²⁸⁷

This provision was not proposed but is being added because of modifications to paragraph (a)(4) of Rule 17g-6, which prohibits anti-competitive practices relating to determining credit ratings for structured products. As discussed below with respect to paragraph (a)(4) of Rule 17g-6, the Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in monitoring practices in the structured product area that many commenters believe are anti-competitive.

i. Paragraph (b)(9) of Rule 17g-2

As adopted, paragraph (b)(9) of Rule 17g-2 requires an NRSRO to retain for each security identified in the record required under paragraph (a)(7) of Rule 17g-2, any document that contains a description of how any assets within such pool or as a part of such transaction not rated by the NRSRO but rated by another NRSRO were treated for the purpose of determining the credit rating of the security. This provision was not proposed but is being added because of modifications to paragraph (a)(4) of Rule 17g-6,

²⁸⁷ As proposed, paragraph (b)(8) required an NRSRO to retain a record required to be made under paragraph (b) of proposed Rule 17g-6. The record required under paragraph (b) of proposed Rule 17g-6 would have documented when an NRSRO refused to issue or withdrew a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage backed securities transaction. This proposed provision in Rule 17g-6 has been eliminated and, therefore, the requirement to retain this record in Rule 17g-2 also has been eliminated.

which prohibits anti-competitive practices relating to determining credit ratings for structured products. As discussed below with respect to paragraph (a)(4) of Rule 17g-6, the Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in monitoring practices in the structured product area that many commenters believe are anti-competitive.

j. Paragraph (b)(10) of Rule 17g-2

As adopted, paragraph (b)(10) of Rule 17g-2 requires an NRSRO to retain Form NRSROs (including Exhibits and accompanying information and documents) submitted to the Commission. This provision will make the Forms and Exhibits subject to the retention and production requirements in Rule 17g-2. For example, NRSROs will be required to retain them in a manner that makes them easily accessible to the NRSRO's principal office. This will assist Commission examiners, particularly examiners in regional offices, in accessing the records on site during an examination.

The Commission did not receive any comments on the proposed rule text in this paragraph (proposed as paragraph (b)(9)) and is adopting it substantially as proposed.

3. Paragraph (c) of Rule 17g-2

As adopted, paragraph (c) of Rule 17g-2 requires an NRSRO to retain the records identified in paragraphs (a) and (b) for three years after the date the record is made or received. The Commission believes the three-year retention period is necessary or appropriate in the public interest or for the protection of investors because it is designed to ensure that the records are preserved for at least one internal audit or Commission exam cycle.

The proposed rule, however, articulated different retention periods for the records identified in paragraphs (a)(2) and (a)(3); namely, for three years after the NRSRO's business relationship with the person ended. The Commission received a number of comments on this proposed retention period all of which stated that it was either too long or unclear.²⁸⁸ The Commission believes there has been some confusion regarding the retention requirement for these records. The proposed rule was designed so that an NRSRO would retain the last version of an account record for three years after the account was closed. The Commission believes the simpler and clarified text in the adopted version of the rule is designed to ensure this record is retained for this period.

In other respects, paragraph (c) of Rule 17g-2 is being adopted substantially as proposed.

4. Paragraph (d) of Rule 17g-2

As adopted, paragraph (d) of Rule 17g-2 requires an NRSRO to maintain an original, or a true and complete copy of the original, of each record required to be retained pursuant to paragraphs (a) and (b) of Rule 17g-2 in a manner that, for the applicable retention period specified in paragraph (c) of Rule 17g-2, makes the original record or copy easily accessible to the principal office of the NRSRO and to any other office that conducted activities causing the record to be made or received. The Commission believes this rule is necessary or appropriate in the public interest or for the protection of investors because it is designed to facilitate Commission examination of the NRSRO and to avoid delays in obtaining the records during an on-site examination. The rule does not specify the format in which the records must be retained.

²⁸⁸ See Gross Letter; Rutherford Letter; R&I Letter; DBRS Letter; Fitch Letter; S&P Letter; Moody's Letter; LACE Letter.

Consequently, NRSROs may retain them in, for example, paper form, on microfilm or microfiche, or electronically.

The Commission did not receive any comments on this provision and is adopting it substantially as proposed.

5. Paragraph (e) of Rule 17g-2

As adopted, paragraph (e) of Rule 17g-2 provides that an NRSRO can use the services of a third-party record custodian to make and retain the records identified in paragraphs (a) and (b), provided the NRSRO furnishes the Commission with a written undertaking of the custodian. The rule prescribes the form of the undertaking; namely, that the third-party must represent that the records are the exclusive property of the NRSRO, will be produced promptly to the NRSRO or the Commission or its representatives at the request of the NRSRO, and will be available for inspection by the Commission or its representatives. The rule also provides that an NRSRO remains responsible for complying with the Commission's books and records rules, notwithstanding the fact that a third-party is making and/or storing them. The Commission believes this rule is necessary or appropriate in the public interest or for the protection of investors because it is designed to ensure that storing the records with a third-party does not make them less accessible than records stored at an NRSRO's offices.

The Commission received three comments on this provision.²⁸⁹ One commenter stated that the form of the undertaking could conflict with certain foreign business practices and, therefore, suggested that the NRSRO be required to provide the

²⁸⁹ See R&I Letter; Fitch Letter; LACE Letter.

undertaking.²⁹⁰ The Commission notes, however, that the undertaking is designed to ensure that a third-party custodian is under a direct obligation to produce the records to the Commission and its representatives. An NRSRO already is obligated under Section 17(b)(1) of the Exchange Act and Rule 17g-2 to produce these records.²⁹¹ This obligation is in no way diminished because a third-party custodian is holding the records. The undertaking establishes a direct obligation on the third-party to produce the records to the Commission and its representatives. This direct obligation will be particularly important in situations where the NRSRO is unable or unwilling to request that the third-party produce the records.

The second commenter requested that the form of the undertaking be modified in a manner that would obligate the third-party to only comply with “reasonable” requests for records and only to the extent that producing the records was permitted by local law.²⁹² While the Commission is not codifying this suggestion into the rule, the Commission and its representatives make every effort to work with regulated entities on the scope and timing of record requests to lessen the burden and establish a production schedule that is practicable, given the circumstances.

The final commenter stated that an NRSRO should not be required to use a third-party to store its records.²⁹³ The Commission notes that the rule does not require an

²⁹⁰ See R&I Letter.

²⁹¹ 15 U.S.C. 78q(b)(1).

²⁹² See Fitch Letter.

²⁹³ See LACE Letter.

NRSRO to use a third-party custodian to store its records. Rather, it provides the option for an NRSRO to use a third-party record custodian.

For these reasons, the Commission is adopting paragraph (e) of Rule 17g-2 substantially as proposed.

6. Paragraph (f) of Rule 17g-2

As adopted, paragraph (f) of Rule 17g-2 requires an NRSRO to promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested English translations, of those records of the NRSRO required to be retained under Rule 17g-2, or any other records of the NRSRO subject to examination under Section 17(b) of the Exchange Act²⁹⁴ that are requested by the Commission or its representatives. As discussed in the next section, the proposed rule has been modified to incorporate a provision that the produced records be translated if necessary. The Commission believes this rule is necessary or appropriate in the public interest or for the protection of investors because it is designed to facilitate Commission examinations of NRSROs.

The Commission received one comment on the provision.²⁹⁵ Specifically, the commenter stated that the provision should not require an NRSRO to produce compliance and audit reports because doing so could adversely impact deliberations related to these functions and chill whistleblowers. The Commission explained above how the retention of compliance and audit reports under paragraphs (b)(4) and (b)(5) of Rule 17g-2, respectively, will assist Commission examiners in reviewing NRSROs.

²⁹⁴ See 15 U.S.C 78q(b).

²⁹⁵ See Moody's Letter.

However, the retention of these records without the corresponding requirement to produce them would prevent the Commission and its examiners from using the records for these purposes. Therefore, the Commission believes they must be produced upon request to the Commission and its representatives.

For these reasons, the Commission is adopting the provisions in paragraph (f) of Rule 17g-2 substantially as proposed.

7. Non-resident NRSROs

Rule 17g-2, as proposed, contained provisions in two paragraphs (paragraphs (f) and (h)) designed to address the fact that credit rating agencies not located in the U.S. may become NRSROs. After consideration of the comments and for the reasons discussed below, the Commission is eliminating these provisions from Rule 17g-2, as adopted, except for the provision concerning translating records.

Paragraph (f) of proposed Rule 17g-2 would have required that a non-resident NRSRO must undertake to send books and records to the Commission and its representatives upon request. The undertaking would have been required to be attached to an initial application for registration as an NRSRO. The Commission explained in the proposing release that the undertaking was designed to provide a mechanism for the Commission examination staff to inspect records maintained overseas without having to travel to the location. In addition, because some non-resident NRSROs may maintain original records in a language other than English, the proposed undertaking would have required a translation if the Commission requested it.

The Commission received four comments on the proposed rule text in this paragraph.²⁹⁶ Generally, the commenters objected to various representations in the form of the non-resident undertaking²⁹⁷ or to the requirement to provide the undertaking altogether.²⁹⁸ After considering the comments, the Commission believes the requirement for non-resident NRSROs to provide a special undertaking is unnecessary. As NRSROs, they are subject to the production requirements of Section 17(b) of the Exchange Act²⁹⁹ and Rule 17g-2(f). Therefore, the Commission and its representatives will not require the non-resident undertaking to compel a foreign NRSRO to produce the records. Moreover, Rule 17g-2(f), as adopted, requires the records to be “furnished” to the Commission. Thus, an NRSRO located outside the U.S. is required to send the records to the Commission upon request.

However, the Commission continues to believe that the representation in the proposed undertaking to provide translated records is necessary or appropriate in the public interest or for the protection of investors. Providing un-translated records to the Commission could significantly delay and hinder its oversight function. Consequently, this provision has been moved into the provisions of paragraph (f) of Rule 17g-2. In all other respects, the provisions of paragraph (f) of proposed Rule 17g-2 have been eliminated from the final rule.

²⁹⁶ See AEI Letter; R&I Letter; DBRS Letter; Fitch Letter.

²⁹⁷ See, e.g., DBRS Letter.

²⁹⁸ See AEI Letter.

²⁹⁹ See 15 U.S.C 78q(b).

The provisions of paragraph (h) of proposed Rule 17g-2 would have defined the term non-resident rating organization for the purpose of specifying the type of NRSRO that would have been required to provide the non-resident undertaking. The definition is no longer necessary and has been eliminated from the adopted rule.

For these reasons, the Commission is eliminating the provisions in Rule 17g-2 relating to non-resident NRSROs except for the provision concerning the translation of records.

D. Rule 17g-3 – Annual Financial Reports

Section 15E(k) of the Exchange Act requires an NRSRO to furnish to the Commission, on a confidential basis³⁰⁰ and at intervals determined by the Commission, such financial statements and information concerning its financial condition as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.³⁰¹ The statute also provides that the Commission may, by rule, require that the financial statements be certified by an independent public accountant.³⁰² Rule 17g-3 requires an NRSRO to furnish the Commission on an annual basis certain financial reports. The furnishing of these reports will serve two important functions in the NRSRO regulatory program.

First, Section 15E(d) of the Exchange Act provides that the Commission shall, by order, censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO if, among

³⁰⁰ An applicant can request that the Commission keep this information confidential. See 17 CFR 200.80 and 17 CFR 200.83.

³⁰¹ 15 U.S.C. 78o-7(k).

³⁰² Id.

other things, the NRSRO fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.³⁰³ The financial reports will assist the Commission in monitoring the NRSRO's financial resources and the resources it commits to management to evaluate whether the Commission must take action under Section 15E(d) of the Exchange Act.³⁰⁴

Second, Section 15E(b)(1) of the Exchange Act requires an NRSRO to promptly amend its application for registration, as prescribed in that section, if any information or document provided in the application becomes materially inaccurate.³⁰⁵ Form NRSRO requires the following financial information: a list of large customers in terms of net revenues; audited financial statements; information about revenues; and information about credit analyst compensation. This information is required to be as of, or for, the NRSRO's previous fiscal year. Accordingly, the information only will become materially inaccurate and, therefore, be required to be updated on an annual basis. In addition, the information will be submitted with Form NRSRO on a confidential basis to the extent permitted by law³⁰⁶ and will not have to be made publicly available pursuant to Section 15E(a)(3) of the Exchange Act³⁰⁷ and Rule 17g-1(i) thereunder. Therefore, because the information only will be disclosed to the Commission, it is more appropriate to require that it be updated through the Commission's authority under Section 15E(k) of

³⁰³ 15 U.S.C. 78o-7(d).

³⁰⁴ Id.

³⁰⁵ 15 U.S.C. 78o-7(b)(1).

³⁰⁶ An applicant can request that the Commission keep this information confidential. See 17 CFR 200.80 and 17 CFR 200.83.

³⁰⁷ 15 U.S.C. 78o-7(a)(3).

the Exchange Act and Rule 17g-3 thereunder than through annual furnishings of Form NRSRO.³⁰⁸

After consideration of the comments, Rule 17g-3 has been modified in several ways. In particular, the rule has been restructured to prescribe that the audit requirement only applies to the financial statements. The proposed schedules to the financial statements are now separate financial reports that are not required to be audited. For the reasons discussed above and below, the Commission believes Rule 17g-3, as modified, is necessary or appropriate in the public interest or for the protection of investors.³⁰⁹

1. Paragraph (a) to Rule 17g-3

As adopted, paragraph (a) of Rule 17g-3 requires an NRSRO to annually furnish the Commission four, or in some cases five, financial reports. The reports must be furnished not more than 90 days after the end of the NRSRO's fiscal year and the information in the reports must be as of the most recently ended fiscal year. The reports will consist substantially of the same information that would have been in the financial statements and schedules required under Rule 17g-3, as proposed. The Commission received numerous comments requesting that the proposed schedules to the audited financial statements not be subject to the audit requirement.³¹⁰ The comments stated generally that obtaining an audit of the information in the proposed schedules would be

³⁰⁸ The Commission notes that some NRSROs may have fiscal year ends that are not on December 31. Therefore, if the Commission required that this financial information be updated through furnishing Form NRSROs, these entities would not be able to furnish the update with their annual certifications, which – pursuant to Section 15E(b)(2) of the Exchange Act (15 U.S.C. 78o-7(b)(2)) – must be furnished on a calendar year basis.

³⁰⁹ See 15 U.S.C. 78o-7(k).

³¹⁰ See DBRS Letter; A.M. Best Letter; Fitch Letter; AEI Letter; Moody's Letter.

difficult and unduly expensive. After consideration of these comments, the Commission has modified Rule 17g-3 to eliminate the requirement that the information that would have been provided in the schedules be audited. This will lessen the burden of preparing the information for submission to the Commission. Moreover, Rule 17g-3 no longer requires that this information be submitted in schedules to the NRSRO's financial statements. Instead, the information must be furnished in separate financial reports. This is intended to clarify that the independent auditor that certifies the NRSRO's financial statements is not required to include the other unaudited financial reports in the opinion covering the financial statements.

As noted above, Rule 17g-3 requires that the financial reports be furnished within 90 days after the end of the NRSRO's fiscal year. One commenter requested that the period be lengthened to 120 days for non-resident NRSROs.³¹¹ The Commission notes that paragraph (c) of Rule 17g-3 provides a mechanism for an NRSRO to seek an extension of the time to furnish the financial reports. An NRSRO that cannot provide its financial reports within 90 days will be able to request an extension under this provision. Therefore, the Commission does not believe it is necessary to create a different standard for non-resident NRSROs, particularly since Rule 17g-3 has been modified to make the preparation of the financial reports less burdensome.

a. Paragraph (a)(1): Audited Financial Statements

The first report, required under paragraph (a)(1) of Rule 17g-3, must contain audited financial statements of the NRSRO. Rule 17g-3, as proposed, also required the submission of audited financial statements and, as noted above, certain schedules to the

³¹¹ See R&I Letter.

financial statements. The schedules are now separate financial reports that are not required to be audited. Two commenters stated that an NRSRO that is a separately identifiable department or division of a public company should be permitted to furnish audited financial statements of its parent.³¹² As noted above with respect to Exhibit 11, the Commission believes that, in this case, the financial statements of the parent provide information from which it can assess the financial resources of the NRSRO. The Commission believes, however, that certain financial information about the NRSRO must be furnished as well. For these reasons, the rule has been modified to permit an NRSRO to furnish audited consolidated financial statements of its parent; however, the NRSRO also will have to furnish unaudited consolidating financial statements under paragraph (a)(2) of Rule 17g-3 discussed below.

The audited financial statements must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity. They must be prepared in accordance with generally accepted accounting principles in the jurisdiction where the NRSRO or its parent is incorporated, organized, or has its principal office. Finally, the audited financial statements must be certified by an accountant who is qualified and independent in accordance with 17 CFR 240.210.2-01(a), (b), and (c)(1), (2), (3), (4), (5) and (8). In addition, the accountant must give an opinion on the financial statements in accordance with 17 CFR 210.2-02(a), (b), (c) and (d). The first financial report is how an NRSRO will update the information initially provided in Exhibit 11 of Form NRSRO.

³¹² See S&P Letter; Moody's Letter.

The requirement to have the financial statements audited will provide the Commission with an independent verification that the information in them is presented fairly, in all material respects. The Commission received numerous comments on these audit requirements. Several commenters stated that non-resident NRSROs should be permitted to provide financial statements prepared in accordance with generally accepted accounting principles of the jurisdiction where the NRSRO is incorporated or has its principal place of business.³¹³ The commenters stated that preparing them according U.S. generally accepted accounting principles could be very expensive.³¹⁴ Similarly, several commenters stated that complying with certain provisions of Regulation S-X (17 CFR 210.1-01 - 12-29) would be unduly burdensome for non-resident NRSROs and non-reporting companies.³¹⁵

The Commission notes that the financial statements will be prepared to assist the Commission in carrying out its oversight responsibilities with respect to monitoring the financial resources of NRSROs and not as a disclosure item for public consumption. The Commission staff will have the opportunity to discuss the financial statements with a non-resident NRSRO to gain an understanding of any material divergences from U.S. generally accepted accounting principles. Accordingly, the Commission believes that it is appropriate to permit the financial statements to be prepared in accordance with generally accepted accounting principles in the jurisdiction where the NRSRO or its parent is incorporated, organized, or has its principal office. This will lessen the burden

³¹³ See Letter dated March 12, 2007 from Makoto Utsumi, President & CEO, Japan Credit Rating Agency, Ltd. ("JCR Letter"); R&I Letter; DBRS Letter.

³¹⁴ Id.

³¹⁵ See JCR Letter; R&I Letter; DBRS Letter; Fitch Letter.

for non-resident NRSROs and still provide the Commission with the financial information necessary to carry out its oversight responsibilities.

For these reasons, the Commission also agrees that applying many provisions of Regulation S-X would be unnecessary and, therefore, has eliminated most of this requirement from the rule. The Commission does believe that certain provisions of Regulation S-X relating to the qualifications and independence of the auditor and the auditor's attestation and the scope of the auditor's opinion are appropriate for all NRSROs, including non-residents and non-public companies. Consequently, Rule 17g-2, as adopted, eliminates the proposed requirement to comply with all the provisions of Regulation S-X. Instead, the rule requires the auditor to be qualified and independent in accordance with 17 CFR 240.210.2-01(a), (b), and (c)(1), (2), (3), (4), (5) and (8).³¹⁶

These provisions are designed to ensure that auditors are independent of their audit clients.³¹⁷ In addition, the accountant must give an opinion on the financial statements in accordance with 17 CFR 210.2-02(a), (b), (c) and (d). The retained provisions of Regulation S-X are appropriate for any audit as they relate to general standards of competence, independence, and audit work and are not specifically designed for public companies. Accordingly, the audited financial statements in Rule 17g-3 must be prepared in accordance with them.

³¹⁶ The Commission notes NRSROs that furnish consolidated audited financial statements of parents that are public companies should furnish those statements as they are prepared in accordance with all applicable reporting requirements for public companies, which may include adhering to all provisions of Regulation S-X.

³¹⁷ See Final Rule: Strengthening the Commission's Rules Regarding Auditor Independence, Securities Act Release No. 8183 (January 28, 2003), 68 FR 6005 (February 5, 2003).

As noted with respect to Exhibit 11, two commenters also requested that the proposed rule be modified to permit an NRSRO to furnish a tax return prepared by an accountant in lieu of audited financial statements.³¹⁸ One of the commenters suggested that this lesser requirement only apply to smaller entities (less than \$5 to \$10 million in asset size) and could be augmented with a requirement to include with the tax return a balance sheet and income statement signed by an accountant.³¹⁹

As discussed with respect to Exhibit 11, the Commission does not believe a tax return will provide sufficient information. Further, the Commission notes that the financial responsibility rules for broker-dealers require audited financial statements for small broker-dealers with a minimum capital requirement of \$5,000.³²⁰ The accountants performing an audit of a small NRSRO will tailor the audit and audit report to the size and complexity of the entity's business. This will keep costs for smaller NRSROs lower. This is especially true in light of the changes discussed above with respect to eliminating requirements with respect to Regulation S-X and the proposed requirement that the information proposed for the schedules be audited. Moreover, in response to the second commenter, it is unclear to the Commission in what capacity an accountant would sign financial statements short of performing an audit of them. For the purposes of Rule 17g-3, the Commission believes that the only appropriate review of the financial statements is an audit by an independent accountant. The audit, as noted above, is designed to

³¹⁸ See EJR Letter; LACE Letter.

³¹⁹ See LACE Letter.

³²⁰ See 17 CFR 240.17a-5.

provide a reasonable level of assurance that the financial statements are free of material misstatement.

The Commission believes that the annual audit will be integral to its ability to effectively monitor the financial resources of an NRSRO as required under Section 15E(d) of the Exchange Act, since it provides an independent verification of an NRSRO's financial condition. For these reasons, Rule 17g-3, as adopted, requires audited financial statements on an annual basis.³²¹

Finally, one commenter suggested that the requirement that the audited financial statements be "certified" by the accountant is inconsistent with accounting practice because financial statements are either "audited" or "certified."³²² The Commission notes that the authority to require that an auditor "certify" the audited financial statements is set forth in Section 15E(k) of the Exchange Act.³²³ Moreover, this provision is consistent with other Commission financial reporting requirements.³²⁴ Consequently, the final rule retains the provision.

b. Paragraph (a)(2): Consolidating Financial Statements

As adopted, paragraph (a)(2) of Rule 17g-3 requires an NRSRO furnishing audited consolidated financial statements of its parent to furnish a second report containing unaudited consolidating financial statements of its parent that include the NRSRO. This will provide the Commission with information about the financial

³²¹ 15 U.S.C. 78o-7(d).

³²² See DBRS Letter.

³²³ 15 U.S.C. 78o-7(k).

³²⁴ See, e.g., Section 13(a) of the Exchange Act (15 U.S.C. 78m(a)) and the rules thereunder; Section 17 of the Exchange Act (15 U.S.C. 78q).

condition of the NRSRO as distinct from the financial condition of its parent. One commenter requested that this information not be subject to the audit requirement if the audited consolidated statements include operating segment reporting in accordance with Regulation S-X.³²⁵ As noted above, this financial report is not required to be audited.

c. Paragraph (a)(3): Revenue Information

The third report, required under paragraph (a)(3) of Rule 17g-3, must contain the following unaudited information about the NRSRO's revenues: (1) revenue from determining and maintaining credit ratings; (2) revenue from subscribers; (3) revenue from granting licenses or rights to publish credit ratings; and (4) revenue from all other services and products offered by the NRSRO. This financial report will be how an NRSRO updates the information initially provided in Exhibit 12 to Form NRSRO. This information would have been required in the first schedule to the financial statements required under Rule 17g-3, as proposed.

This information will augment the audited financial statements by providing detail as to the revenues generated specifically from credit rating services. The revenue information will assist the Commission in monitoring whether an NRSRO maintains adequate financial resources to consistently produce credit ratings with integrity.³²⁶ As discussed with respect to Exhibit 12, one commenter requested the elimination of a requirement in the proposed rule to separately report revenues from determining private credit ratings (i.e., credit ratings that are not made readily accessible to the public).³²⁷

³²⁵ See Moody's Letter.

³²⁶ 15 U.S.C. 78o-7(d).

³²⁷ See Fitch Letter.

The commenter stated that it would be difficult to separate private ratings revenue from public ratings revenue. The Commission agrees and the requirement to separately itemize private ratings revenue has been eliminated. This revenue must be included in the revenue item for determining or maintaining credit ratings.

The Commission is adopting this provision with the modifications discussed above.

d. Paragraph (a)(4): Credit Analyst Compensation

The fourth report, required under paragraph (a)(4) of Rule 17g-3, must contain the total aggregate and median annual compensation of the NRSRO's credit analysts. The information in this report is not required to be audited. This financial report will be how an NRSRO updates the information initially provided in Exhibit 13 to Form NRSRO. This information would have been required in the second schedule to the financial statements required under Rule 17g-3, as proposed.

The information on analyst compensation will augment the audited financial statements by providing detail as to expenses necessary to retain the credit rating agency's credit analysts. This information collectively will assist the Commission in monitoring whether an NRSRO maintains adequate financial resources to consistently produce credit ratings with integrity.³²⁸ As discussed with respect to Exhibit 13, one commenter requested that the Commission clarify how an NRSRO should treat deferred compensation.³²⁹ The Commission believes an NRSRO should have the flexibility to include or exclude deferred compensation in making the calculation. If deferred

³²⁸ 15 U.S.C. 78o-7(d).

³²⁹ See Fitch Letter.

compensation is excluded, the rule requires the NRSRO to make a note of that fact in the financial report. The Commission also believes that an NRSRO must be consistent in its approach of either including or excluding deferred compensation.

The Commission is adopting this provision with the modifications discussed above.

e. Paragraph (a)(5): List of Large Customers

The fifth report, required under paragraph (a)(5) of Rule 17g-3, must contain a list of the NRSRO's 20 largest issuer and subscriber customers in terms of net revenue earned from the customers and, include in the list, any obligor or underwriter customers that are as large as or larger than the 20th largest issuer or subscriber customer. The information in this report is not required to be audited. This financial report will be the mechanism that an NRSRO uses to update the information initially provided in Exhibit 10 to Form NRSRO. This information would have been required in the third schedule to the financial statements required under Rule 17g-3, as proposed.

The largest customers will be determined applying the same definitions of "net revenues" and "credit rating services" used for Exhibit 10, including the changes to those definitions discussed above with respect to Exhibit 10. In addition, just as with Exhibit 10, obligor and underwriter customers must be added to the list to the extent they are as large as, or larger than, the 20th largest issuer or subscriber customer.

The list will assist the Commission in identifying conflicts arising from any influence a person may have on the NRSRO given the amount of revenue the person provides the credit rating agency.

2. Paragraph (b) of Rule 17g-3

Paragraph (b) of Rule 17g-3 requires that the NRSRO attach to each financial report provided under paragraph (a) a statement by a duly authorized person of the NRSRO that the information in the report presents fairly, in all material respects and as applicable, the financial condition, results of operations, income, cash flows, revenues, and analyst compensation of the NRSRO. This information will provide a level of assurance that the information in the financial reports has been reviewed by the NRSRO. Further, the requirement parallels Commission Rule 17a-5(e)(2), which requires a duly authorized officer of a broker-dealer (or, in the case of a general partnership, the general partner) to attach an oath or affirmation stating the financial statements and schedules required under that rule are true and correct.³³⁰ This requirement was proposed in paragraph (c) of Rule 17g-3.

One commenter suggested that the Commission eliminate this requirement because it was unnecessary given the NRSRO's legal exposure for furnishing an inaccurate report.³³¹ The commenter stated that the requirement could dissuade a credit rating agency from registering with the Commission. The Commission believes it is important that a person within the NRSRO be responsible for reviewing the information in the financial reports and stating that they are a fair representation of its financial condition, results of operations, income, cash flows, revenues, and analyst compensation. This provision is designed to enhance the accuracy of these reports inasmuch as the individual within the NRSRO will perform some level of due diligence before executing

³³⁰ 17 CFR 240.17a-5(e)(2).

³³¹ See A.M. Best Letter.

the statements. Moreover, since only the information in the first financial report will be audited, the Commission believes a person within the NRSRO must be responsible for the information in all the reports. For these reasons, the Commission is retaining the requirement in the final rule.

3. Paragraph (c) of Rule 17g-3

Paragraph (c) of Rule 17g-3 provides that the Commission may grant an extension of time or exemption from any requirements in the rule either unconditionally or on specified terms and conditions on the written request of an NRSRO, if the Commission finds that such extension or exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. This provision was proposed in paragraph (d) of Rule 17g-3. The Commission did not receive any comments on this provision and is adopting it substantially as proposed.

E. Rule 17g-4 – Procedures to Prevent the Misuse of Material, Nonpublic Information

Rule 17g-4 will require an NRSRO to establish procedures to address three areas where material, nonpublic information could be inappropriately disclosed or used. Section 15E(g)(1) of the Exchange Act³³² requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information in violation of the Exchange Act.³³³ Section 15E(g)(2) of the Exchange Act provides that the Commission shall adopt rules requiring an

³³² 15 U.S.C. 78o-7(g)(1).

³³³ 15 U.S.C. 78a et seq.

NRSRO to establish specific policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.³³⁴

1. Paragraph (a)(1) of Rule 17g-4

Paragraph (a)(1) of Rule 17g-4 requires procedures reasonably designed to prevent the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained for the purpose of developing a credit rating. Some credit rating agencies, as part of their analysis, contact senior management of the obligors and issuers subject to their credit ratings. In the course of these contacts, an issuer or obligor may provide the credit rating agency with nonpublic information including contemplated business transactions or estimated financial projections.³³⁵

Credit rating agencies have commented that this confidential information greatly assists them in issuing credible and reliable ratings.³³⁶ In fact, the Commission's Regulation FD, which governs the disclosure of material, nonpublic information by issuers, contains an exception that permits issuers to intentionally disclose such information to a credit rating agency without making a simultaneous public disclosure of the information.³³⁷ The selective disclosure to the credit rating agency, however, must be solely for the purpose of developing a publicly available credit rating.³³⁸

³³⁴ 15 U.S.C. 78o-7(g)(2).

³³⁵ See Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 8570 (April 19, 2005), 70 FR 21306 (April 25, 2005).

³³⁶ Id.

³³⁷ See 17 CFR 243.100.

³³⁸ 17 CFR 243.100(b)(2)(iii).

One concern that has been raised in the past is that subscribers to a credit rating agency's more detailed credit reports also may be granted direct access to the credit analysts.³³⁹ If the credit analyst is in possession of material, nonpublic information, there is a risk the information may be inappropriately disclosed to the subscriber during the course of communications with the credit analyst.³⁴⁰

The rule does not prescribe specific procedures that must be established. Therefore, NRSROs will have flexibility to develop procedures tailored to their organizational structures and business models. An NRSRO may have procedures requiring credit analysts to receive training in the laws governing the misuse of material, nonpublic information; defining the persons within the NRSRO with whom the credit analyst can share the information; prohibiting the credit analyst from disclosing the information to any other persons; and requiring the credit analyst to take steps to safeguard documents containing the information. An NRSRO that does not use management contacts as part of its methodology for determining credit ratings may prohibit credit analysts from contacting rated issuers or obligors.

The Commission received one comment on this provision.³⁴¹ The commenter stated that an NRSRO should be permitted to disclose material, nonpublic information in aggregate form (e.g., through usage in models) in a manner that does not identify

³³⁹ See Commission 2003 CRA Report and Commission 2003 Concept Release, Securities Act Release No. 8236 (June 4, 2003), 68 FR 35258 (June 12, 2003), noting the concern raised by some that subscribers may have preferential access to credit analysts and, as a result, may inappropriately learn material nonpublic information in the possession of a credit analyst.

³⁴⁰ Id.

³⁴¹ See S&P Letter.

individual issuers.³⁴² The Commission notes, however, that the rule, by itself, does not expressly prohibit any types of disclosures. As discussed above, Section 15E(g)(1) of the Exchange Act³⁴³ requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act and the rules thereunder.³⁴⁴ Rule 17g-4 requires an NRSRO to address the inappropriate disclosure of material, nonpublic information when establishing these procedures required by statute.

For these reasons, the Commission is adopting paragraph (a)(1) of Rule 17g-4 substantially as proposed.

2. Paragraph (a)(2) of Rule 17g-4

Paragraph (a)(2) of Rule 17g-4 requires procedures reasonably designed to prevent a person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material, nonpublic information obtained for the purpose of developing a credit rating. This provision requires an NRSRO to address the risk that individuals in possession of material, nonpublic information about an issuer or obligor may trade securities or money market instruments on the information.³⁴⁵

³⁴² Id.

³⁴³ 15 U.S.C. 78o-7(g)(1).

³⁴⁴ 15 U.S.C. 78a et seq.

³⁴⁵ See, e.g., Commission complaint in Commission v. Rick A. Marano, William Marano and Carl Loizzi, 04 CV 5828 (Judge Kimba Wood) (S.D.N.Y.); see also Commission Litigation Release No. 18799 (July 27, 2004).

As with paragraph (a), the provision does not prescribe specific procedures that must be established. An NRSRO may have policies prohibiting persons within the NRSRO from purchasing or selling a security or money market instrument that is subject to a pending credit rating action; requiring persons within the NRSRO to obtain pre-approval before purchasing or selling a security or money market instrument; or requiring persons within the NRSRO to be notified of securities or money market instruments that are on a “do not trade” list.

The Commission made three modifications to the provision, as proposed, to address comments. The Commission believes the commenters identified areas where the provision could cause some practical difficulties in designing procedures. The changes are designed to remove these impediments.

First, the Commission deleted a reference in the provision to members of the household of an NRSRO employee. This change was made in response to a comment that it would be difficult to design procedures addressing the trading activities of household members since a household may include persons that the employee has no influence over, such as roommates.³⁴⁶ The commenter further noted that procedures designed to prevent an employee “from otherwise benefiting” from the use of material non-public information would cover an employee’s immediate family members.³⁴⁷

Second, the Commission replaced a reference in the provision to an employee “possess[ing]” or having “access” to material, non-public information. The provision, as adopted, refers to an employee being “aware” of material, nonpublic information. This

³⁴⁶ See S&P Letter.

³⁴⁷ Id.

change was made in response to a comment that having “access” to material, nonpublic information could be interpreted very broadly, which would make designing procedures to address the issue difficult.³⁴⁸ The commenter also noted that Commission Rule 10b5-1, which concerns trading on the basis of material, nonpublic information in insider trading cases, refers to being “aware” of material, nonpublic information.³⁴⁹

The third modification narrowed the scope of the provision to “persons within” the NRSRO. As proposed, the provision would have required procedures designed to prevent persons “associated” with the NRSRO from trading on material, nonpublic information. A commenter stated that this made the provision overly broad since the definition of persons “associated” with an NRSRO in Section 3(a)(63) of the Exchange Act includes employees of affiliates engaged in activities wholly unrelated to credit rating services.³⁵⁰ Similar to Item 8 of Form NRSRO (statutory disclosures) and, as discussed next, Rule 17g-5, the Commission is narrowing the scope of this provision to persons “within” the NRSRO. Paragraph (b) of Rule 17g-4 defines a person “within” the NRSRO to mean the NRSRO, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the NRSRO or its credit rating affiliates (or any person occupying a similar status or performing similar functions).

³⁴⁸ See Moody’s Letter.

³⁴⁹ See 17 CFR 240.10b5-1.

³⁵⁰ See Moody’s Letter.

Finally, a commenter stated that the provision should not apply to indirect trading in securities such as through transactions in mutual funds.³⁵¹ The Commission notes that the rule by itself does not expressly prohibit any types of transactions. As discussed above, Section 15E(g)(1) of the Exchange Act³⁵² requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act and the rules thereunder.³⁵³ Rule 17g-4 requires an NRSRO to address the inappropriate use of material, nonpublic information when establishing these procedures required by statute.

For these reasons, paragraph (a)(2) of Rule 17g-4 is being adopted with the modifications described above.

3. Paragraph (a)(3) of Rule 17g-4

Paragraph (a)(3) of Rule 17g-4 requires procedures reasonably designed to prevent the inappropriate dissemination within and outside the NRSRO of a credit rating action before issuing the credit rating on the Internet or through another readily accessible means. This provision recognizes that a credit rating action of an NRSRO may be material, nonpublic information. Consequently, an NRSRO must have policies designed to ensure that its pending credit rating actions are not selectively disclosed before the credit rating is issued on the Internet or through another readily accessible means.

³⁵¹ See Moody's Letter.

³⁵² 15 U.S.C. 78o-7(g)(1).

³⁵³ 15 U.S.C. 78a et seq.

As with paragraphs (a)(1) and (a)(2), paragraph (a)(3) does not prescribe specific procedures. However, as applicable to the business model of the NRSRO, these policies may include procedures designed to ensure that a credit rating action is issued in a way that makes it readily accessible to the market place, such as posting the credit rating or an announcement of the credit rating action on the NRSRO's Web site or through a news or information service used by market participants or by making it available to all subscribers simultaneously. The policies also may include procedures prohibiting credit analysts from selectively disclosing the pending action to persons outside the NRSRO and to persons inside the NRSRO who do not need to know of the pending action.

At the same time, some credit rating agencies, as part of their methodologies for determining credit ratings, will discuss a proposed credit rating action with the management of the issuer or obligor being rated to solicit their views or provide an opportunity to appeal the decision. NRSROs engaging in this practice must have procedures reasonably designed to ensure that the discussions with the issuer or obligor do not lead to the selective disclosure of the information to persons other than those persons within the issuer or obligor who are authorized to receive the information.

For these reasons, the Commission is adopting paragraph (a)(3) of Rule 17g-4 substantially as proposed.

4. Paragraph (b) of Rule 17g-4

As discussed above with respect to paragraph (a)(2) of Rule 17g-4, paragraph (b) of Rule 17g-4 contains the definition of a person "within" the NRSRO. The definition narrows the scope of the paragraph (a)(2) to persons involved in credit rating activities.

F. Proposed Rule 17g-5 – Management of Conflicts of Interest

Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage conflicts of interest.³⁵⁴ Section 15E(h)(2) of the Exchange Act requires the Commission to adopt rules to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings.³⁵⁵ The statute also identifies certain types of conflicts relating to the issuance of credit ratings that the Commission may include in its rules.³⁵⁶ It also contains a catchall provision for any other potential conflict of interest the Commission deems is necessary or appropriate in the public interest or for the protection of investors to include in its rules.³⁵⁷ Rule 17g-5 implements these statutory provisions by prohibiting the conflicts identified in the statute and certain additional conflicts either outright or if the NRSRO has not disclosed them and established policies and procedures to manage them.

1. Paragraph (a) of Rule 17g-5

Paragraph (a) of Rule 17g-5 prohibits a person within an NRSRO from having a conflict of interest relating to the issuance of a credit rating that is identified in paragraph (b) of the rule unless the NRSRO has disclosed the type of conflict of interest in compliance with Rule 17g-1 (i.e., in Exhibit 6 to Form NRSRO) and has implemented policies and procedures to address and manage the type of conflict of interest in

³⁵⁴ 15 U.S.C. 78o-7(h)(1).

³⁵⁵ 15 U.S.C. 78o-7(h)(2).

³⁵⁶ See 15 U.S.C. 78o-7(h)(2)(A) – (D).

³⁵⁷ See 15 U.S.C. 78o-7(h)(2)(E).

accordance with Section 15E(h)(1) of the Exchange Act.³⁵⁸ Paragraph (d) of Rule 17g-5 defines a person within an NRSRO. The Commission believes that these prohibitions are appropriate in the public interest and for the protection of investors because they are designed to ensure that users of credit ratings are made aware of the potential conflicts of interest that arise from an NRSRO's business activities and that an NRSRO establishes policies and procedures for managing the specific conflicts it identifies.

This provision, as proposed, would have made it "unlawful" for an NRSRO to have a conflict in these circumstances. As adopted, paragraph (a) "prohibits" an NRSRO from having the conflict. The Commission adopted this change to make the rule text more consistent with the Section 15E(h)(2) of the Exchange Act, which provides the Commission with authority to "prohibit, or require the management and disclosure of" conflicts of interest.³⁵⁹

For these reasons, the Commission is adopting paragraph (a) of Rule 17g-5 substantially as proposed with the modification described above.

2. Paragraph (b) of Rule 17g-5

The types of conflicts identified in paragraph (b) of Rule 17g-5 are the same conflicts listed in the instructions to Exhibit 6 of Form NRSRO.³⁶⁰ These are the types of conflicts that commonly arise from the business of providing credit rating services. Prohibiting these types of conflicts outright may adversely impact the ability of an NRSRO to operate as a credit rating agency. Nonetheless, the conflicts must be

³⁵⁸ 15 U.S.C. 78o-7(h)(1).

³⁵⁹ 15 U.S.C. 78o-7(h)(2); see also R&I Letter.

³⁶⁰ See DBRS Letter proposing that the conflicts identified in Exhibit 6 and Rule 17g-5 better track one another.

managed through policies and procedures and disclosed so that users of the credit ratings can assess whether the conflict impacts the NRSRO's judgment.

Paragraph (b), as adopted, has been restructured from the proposed version of the rule. For example, certain conflicts are now identified in separate paragraphs as opposed to a single paragraph.³⁶¹ The Commission's intent is to provide greater clarity to the descriptions of the types of conflicts and, as noted above, to have them track the conflicts described in Exhibit 6 to Form NRSRO. As discussed below, the conflicts identified in paragraph (b) of Rule 17g-5 are substantially the same conflicts identified in the paragraph as proposed; though they have been refined to address comments. The one exception is the conflict identified in paragraph (b)(5) of Rule 17g-5, which – as discussed below – the Commission added in response to a comment identifying it as a potential conflict.

a. Paragraph (b)(1) Rule 17g-5

The conflict identified in paragraph (b)(1) of Rule 17g-5 involves being paid by an issuer or underwriter to determine credit ratings with respect to securities or money market instruments they issue or underwrite. The Commission believes the inclusion of this conflict in the rule is necessary or appropriate in the public interest or for the protection of investors. The concern is that an NRSRO may be influenced to issue a more favorable credit rating than warranted in order to obtain or retain the business of the issuer or underwriter. The Commission did not receive any comments on prohibiting this type of conflict unless it is disclosed and managed as required pursuant to Section

³⁶¹ For example, the conflicts identified in paragraphs (b)(1), (2) and (3) were all identified in paragraph (b)(1) of the proposed rule.

15E of the Exchange Act³⁶² and Rule 17g-1 and is adopting the requirement substantially as proposed.

b. Paragraph (b)(2) of Rule 17g-5

The conflict identified in paragraph (b)(2) of Rule 17g-5 involves being paid by an obligor to determine a credit rating of the obligor as an entity. This conflict is identified in Section 15E(h)(2)(A) of the Exchange Act.³⁶³ This business practice raises the same concerns as being paid by an issuer or underwriter to determine a credit rating on a security or money market instrument. The Commission did not receive any comments on prohibiting this type of conflict unless it is disclosed and managed as required pursuant to Section 15E of the Exchange Act³⁶⁴ and Rule 17g-1 and is adopting the requirement substantially as proposed.

c. Paragraph (b)(3) of Rule 17g-5

The conflict identified in paragraph (b)(3) of Rule 17g-5 involves being paid by issuers, underwriters, or obligors for ancillary services when they also have paid for a credit rating. This conflict as it relates to obligors is identified in Section 15E(h)(2)(B) of the Exchange Act.³⁶⁵ The Commission believes the inclusion of this conflict in the rule as it relates to issuers and underwriters is necessary or appropriate in the public interest or for the protection of investors. The concern with respect to all of these types of entities is that the NRSRO may issue a more favorable than warranted credit rating in

³⁶² 15 U.S.C. 78o-7.

³⁶³ 15 U.S.C. 78o-7(h)(2)(A).

³⁶⁴ 15 U.S.C. 78o-7.

³⁶⁵ 15 U.S.C. 78o-7(h)(2)(B).

order to obtain business from them for the ancillary services.³⁶⁶ The Commission did not receive any comments on the requirement that this type of conflict be prohibited unless it is disclosed and managed as required pursuant to Section 15E of the Exchange Act³⁶⁷ and Rule 17g-1 and is adopting the requirement substantially as proposed.

d. Paragraph (b)(4) of Rule 17g-5

The conflict identified in paragraph (b)(4) of Rule 17g-5 involves being paid by subscribers for access to credit ratings and for other credit ratings services where such subscribers may use the credit ratings to comply with, and obtain benefits or relief under, statutes and regulations using the term “nationally recognized statistical rating organization.” The Commission believes the inclusion of this conflict in the rule is necessary or appropriate in the public interest or for the protection of investors. The concern is that a subscriber potentially could be subject to one or more of these statutes and regulations and, consequently, benefit depending on how the NRSRO rates the subscriber, or securities held or issued by the subscriber. A broker-dealer subscriber holding debt securities is able to apply lower haircuts when computing its net capital under Exchange Act Rule 15c3-1 if the securities are rated investment grade by two NRSROs.³⁶⁸ Broker-dealers frequently subscribe to receive credit analysis or other services from credit rating agencies.

³⁶⁶ See Commission 2003 CRA Report noting concerns of some that conflicts in this area could become much greater if these ancillary services were to become a substantial portion of an NRSRO’s business. See also Commission 2003 CRA Concept Release, Securities Act Release No. 8236 (June 4, 2003), 68 FR 35258 (June 12, 2003), noting concerns of some that greater concerns about conflicts of interest that arise when a credit rating agency offers consulting or other advisory services to issuers it rates.

³⁶⁷ 15 U.S.C. 78o-7.

³⁶⁸ See 17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H).

As noted with respect to Exhibit 6 to Form NRSRO, several commenters raised a concern with the identification of this conflict because, as proposed, it could have been construed to require an NRSRO to affirmatively ascertain whether, and how, its subscribers were using its credit ratings.³⁶⁹ For this reason, the Commission has modified the description in Exhibit 6 and Rule 17g-5 to make it generally applicable to any subscriber, since any subscriber potentially could be a user of credit ratings for regulatory purposes. Consequently, an NRSRO that has subscribers will be required to make the disclosure in Exhibit 6 and have a policy and procedure to address the conflict.

The Commission notes, however, that Rule 17g-5 does not prescribe any specific policies and procedures to address conflicts of interest. The Commission does not expect that an NRSRO will be required to affirmatively ascertain whether, and how, its subscribers were using its credit ratings to manage this conflict. General policies and procedures designed to keep persons within the NRSRO who participate in the determination of credit ratings free of the undue influence of all persons who pay the NRSRO for credit rating services (e.g., issuers, underwriters, obligors, and subscribers) will be a way of addressing this conflict.

For these reasons, the Commission is adopting the requirement with the modifications discussed above.

e. Paragraph (b)(5) of Rule 17g-5

The conflict identified in paragraph (b)(5) of Rule 17g-5 involves being paid by subscribers that also may own investments or have entered into transactions that could be

³⁶⁹ See DBRS Letter; S&P Letter; Moody's Letter.

favorably or adversely impacted by a credit rating issued by the nationally recognized statistical rating organization. As discussed with respect to Exhibit 6, this conflict was added in response to a commenter who pointed out that subscribers who manage investment portfolios also may have interests in a particular credit rating.³⁷⁰ The Commission believes the inclusion of this conflict in the rule is necessary or appropriate in the public interest or for the protection of investors. The Commission believes the commenter identified a conflict that should be disclosed and managed because certain large investors that may derive benefits from the issuance of a particular credit rating could provide a credit rating agency with substantial revenues for credit rating services. As with potential regulatory users, the Commission does not expect that an NRSRO will be required to affirmatively ascertain how the investment portfolios of its subscribers would be impacted by a pending credit rating. General policies and procedures designed to keep persons within the NRSRO who participate in the determination of credit ratings free of the undue influence of clients will be a way of addressing this conflict.

For these reasons, the Commission is adding this conflict to the conflicts identified in paragraph (b) of Rule 17g-5.

f. Paragraph (b)(6) of Rule 17g-5

The conflict identified in paragraph (b)(6) of Rule 17g-5 involves allowing persons within the NRSRO to own directly securities or money market instruments of, or having any other direct ownership interests in, issuers or obligors subject to a credit rating determined by the NRSRO.³⁷¹ This conflict as it relates to obligors is identified in

³⁷⁰ See DBRS Letter.

³⁷¹ See Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 8570 (April 19, 2005), 70 FR 21306 (April 25, 2005), which

Section 15E(h)(2)(C) of the Exchange Act.³⁷² The Commission believes the inclusion of this conflict in the rule as it relates to issuers is necessary or appropriate in the public interest or for the protection of investors. The concern is that allowing persons within the NRSRO, even if they are not directly involved in determining the credit rating, to own securities of an issuer or obligor subject to a credit rating could lead to situations where they seek to influence a credit analyst to issue a credit rating favorable to their trading position.³⁷³ For example, a manager or supervisor may be in a position to exert undue influence on a credit analyst.

The Commission, however, does not believe this conflict should be prohibited for employees that have no involvement in determining or approving the credit rating. They should be able to own securities or money market instruments of an issuer or obligor subject to a credit rating issued by the NRSRO, provided the practice is disclosed and managed.³⁷⁴ A prohibition against owning any rated securities may be a particular hardship for the employees of an NRSRO that issues credit ratings with respect to most public companies.

The Commission has modified the description of the conflict so it now involves “allowing” persons within the NRSRO to have these ownership interests. This is

noted that conflicts may arise when a person associated with a credit rating agency also is associated with, or has an interest in, an issuer that is being rated.

³⁷² 15 U.S.C. 78o-7(h)(2)(C).

³⁷³ As discussed below, the NRSRO and a person within the NRSRO who participated in the determination of a credit rating is prohibited from having this conflict under paragraph (c) of Rule 17g-5.

³⁷⁴ Cf. 17 CFR 275.204A-1(e)(1) (defining “access person” for purposes of requiring investment advisers to establish procedures requiring access persons to report their personal securities holdings).

intended to clarify that the conflict does not arise only when these persons actually have such an ownership interest. This distinction is intended to simplify the rule.

Specifically, as proposed, the rule could have been construed as requiring an NRSRO to affirmatively determine if, and when, an employee purchased a rated security. The rule, as adopted, only requires the NRSRO to disclose that it allows persons within the NRSRO to have these direct ownership interests in rated securities.

Finally, two commenters noted that indirect ownership of rated securities – such as through mutual funds and blind trusts – should not be within the scope of the provision.³⁷⁵ The Commission believes that indirect ownership of rated securities by employees does not present the same concerns as direct ownership, since an indirect ownership interest implies the investor does not have control over the decision to purchase or sell a specific security. Therefore, the provision specifically references “direct” ownership. The Commission also believes that an NRSRO must have flexibility to define through its policies and procedures when an ownership interest would not be “direct” for the purposes of this provision.

For these reasons, the Commission is adopting the requirement with the modifications described above.

g. Paragraph (b)(7) of Rule 17g-5

The conflict identified in paragraph (b)(7) of Rule 17g-5 involves allowing persons within the NRSRO to have a business relationship that is more than an ordinary course business relationship with an issuer or obligor subject to a credit rating determined by the NRSRO. This conflict as it relates to obligors is identified in Section

³⁷⁵ See, e.g., S&P Letter; JCR 2nd Letter.

15E(h)(2)(C) of the Exchange Act.³⁷⁶ The Commission believes the inclusion of this conflict in the rule as it relates to issuers is necessary or appropriate in the public interest or for the protection of investors. The concern is that persons within the NRSRO having these types of business relationships may be influenced to determine a favorable credit rating for the entity based on the business relationship or exert improper influence on credit analysts to determine a favorable credit rating. The Commission believes an NRSRO should be required to disclose that it allows these types of relationships and be required to have policies and procedures to manage them. Otherwise, the conflicts should be prohibited.

The Commission notes that in the case of a credit analyst it may be difficult to remain impartial with respect to an issuer or obligor where the credit analyst has a non-ordinary course business relationship with the entity. For example, in the case where the issuer or obligor extends a loan to the credit analyst that has an interest rate far below market rates. However, the Commission believes that NRSROs should have flexibility in designing policies and procedures to address these types of conflicts, in part, because of the difficulty of defining when a business relationship creates too much potential for a loss of impartiality on behalf of the credit analyst or person within the NRSRO. Consequently, the Commission is not prohibiting these conflicts outright.

The Commission is modifying the provision to clarify that it does not apply to ordinary course business relationships such as arms length mortgage loans and bank and credit card accounts. Commenters stated that these types of business relationships do not

³⁷⁶ 15 U.S.C. 78o-7(h)(2)(C).

raise conflict of interest concerns.³⁷⁷ The Commission agrees that, for example, a credit analyst likely would not be influenced to issue a favorable credit rating simply because the analyst has a bank account at the rated entity. Examples of a non-ordinary course business relationship would be an employee entering into a joint business venture with a rated obligor or, as noted above, obtaining a loan from an obligor with an interest rate far below market rates.

For these reasons, the Commission is adopting the requirement with the modifications discussed above.

h. Paragraph (b)(8) of Rule 17g-5

The conflict identified in paragraph (b)(8) of Rule 17g-5 involves having a person associated with the NRSRO that is a broker or dealer engaged in the business of underwriting securities or money market instruments. This type of conflict is identified in Section 15E(h)(2)(D) of the Exchange Act.³⁷⁸ The Commission believes the inclusion of this conflict in the rule is necessary or appropriate in the public interest or for the protection of investors. As the Commission discussed with respect to Exhibit 6 of Form NRSRO, an affiliation with a broker or dealer that is in the business of underwriting securities would raise concerns that the NRSRO might be influenced by the affiliation to issue favorable credit ratings for these securities.

This requirement was in paragraph (b)(5) of Rule 17g-5, as proposed. However, the conflict identified was broader in that it referred to “having any...affiliation with...an underwriter of securities or money market instruments rated by the [NRSRO].”

³⁷⁷ See, e.g., Moody’s Letter.

³⁷⁸ 15 U.S.C. 78o-7(h)(2)(D).

As discussed with respect to Exhibit 6, the Commission has narrowed the description of the conflict to address concerns that the requirement, as proposed, could have created a difficult compliance standard by requiring an NRSRO to monitor whether any person associated with the NRSRO is an “underwriter” as that term is defined in Section 2(a)(11) of the Securities Act of 1933.³⁷⁹

For these reasons, the Commission is adopting the requirement with the modifications discussed above.

i. Paragraph (b)(9) of Rule 17g-5

The conflict referred to in paragraph (b)(9) of Rule 17g-5 is any other type of conflict that the NRSRO identifies on Form NRSRO in compliance with Section 15E(a)(1)(B)(vi) of the Exchange Act³⁸⁰ and Rule 17g-1. The Commission believes the inclusion of this provision is necessary or appropriate in the public interest or for the protection of investors. This catchall provision will capture conflicts not specifically listed in the instructions for Exhibit 6 and Rule 17g-5 that the NRSRO has identified on Exhibit 6 to Form NRSRO as arising from its business activities.³⁸¹ The Commission did not receive any comments on the proposal that this type of conflict be prohibited unless it is disclosed and managed as required pursuant to Section 15E of the Exchange Act³⁸² and Rule 17g-1 and is adopting the requirement substantially as proposed.

³⁷⁹ 15 U.S.C. 77b(a)(11).

³⁸⁰ 15 U.S.C. 78o-7(a)(1)(B)(vi).

³⁸¹ See 15 U.S.C. 78o-7(h)(2)(E).

³⁸² 15 U.S.C. 78o-7.

3. Paragraph (c) of Rule 17g-5

Section 15E(h)(2) of the Exchange Act requires the Commission to adopt rules to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings.³⁸³ Paragraph (c) of proposed Rule 17g-5 specifically prohibits outright four types of conflicts of interest. The Commission believes prohibiting these conflicts is necessary or appropriate in the public interest or for the protection of investors. These are conflicts that are not a necessary consequence of how credit rating agencies operate. They would be difficult to manage given the risk that they could cause undue influence. Therefore, the Commission is prohibiting them; rather than requiring they be disclosed and managed. Nonetheless, the Commission intends to monitor how the prohibitions operate in practice and, if it appears a prohibition is interfering inappropriately, the Commission will re-evaluate whether it should be subject to disclosure and management (rather than prohibited).³⁸⁴

a. Paragraph (c)(1) of Rule 17g-5

As adopted, paragraph (c)(1) prohibits an NRSRO from having a conflict relating to the issuance of a credit rating where the person soliciting the credit rating was the source of 10% or more of the total net revenue of the NRSRO during the most recently ended fiscal year.³⁸⁵ Such a person will be in a position to exercise substantial influence

³⁸³ 15 U.S.C. 78o-7(h)(2).

³⁸⁴ See, e.g., S&P Letter stating that all the conflicts identified in paragraph (c) of Rule 17g-5 should not be prohibited as they can be managed.

³⁸⁵ The determination of “net revenue” is same as the determination of net revenue for purposes of Form NRSRO and Rule 17g-3.

on the NRSRO.³⁸⁶ Consequently, it will be difficult for the NRSRO to remain impartial, given the impact on the NRSRO's income if the person withdrew its business. Given the Commission's understanding that fees from a single entity generally compose a very small percentage of the revenues of entities currently identified as NRSROs, the Commission believes that a 10% threshold is a reasonable threshold for registered NRSROs.³⁸⁷

Several commenters stated that this conflict should not be prohibited but rather subject to procedures to manage it.³⁸⁸ One commenter, while not requesting that the proposal be changed, noted that in an atypical circumstance such as issuing credit ratings for structured products sponsored by a large client an NRSRO may be required to request a waiver of the prohibition.³⁸⁹ Another commenter also mentioned structured product sponsors as clients that potentially could approach the 10% revenue threshold and, therefore, that exemptive relief may be appropriate in such circumstances.³⁹⁰ The Commission continues to believe that 10% of net revenues is a very high threshold. Moreover, the definition of net revenues has been narrowed to exclude revenues earned by affiliates that are not persons within the NRSRO. Therefore, the threshold will be

³⁸⁶ As noted in the Commission 2003 CRA Report, some participants in the Commission 2002 CRA Hearings expressed concern that ancillary services could become much greater in the future and suggestions were made that their percentage contribution to total revenue be capped.

³⁸⁷ As noted in the Commission 2003 CRA Report, fees from any single issuer typically comprise a very small percentage, less than 1%, of an NRSRO's total revenue.

³⁸⁸ See R&I Letter; Fitch Letter; S&P Letter; AEI Letter; Langohr Letter; AST Letter; ASF Letter.

³⁸⁹ See LACE Letter.

³⁹⁰ See R&I Letter.

higher than that proposed for NRSROs with affiliates engaged in activities unrelated to credit ratings. Consequently, the Commission does not believe the conflict should be subject to a requirement that it be managed (rather than prohibited).

Nonetheless, as noted above, the Commission intends to monitor how the prohibition operates in practice, particularly with respect to structured products. The intent behind all the prohibitions in paragraph (c) is not to prohibit a business practice that is a normal part of an NRSRO's activities. Rather, the intent is to prohibit conflicts that are not a necessary consequence of providing credit rating services. If the prohibition in paragraph (c)(1) interferes with how NRSROs as a matter of course deal with structured product sponsors, the Commission will evaluate whether the rule should be modified to accommodate this business practice or whether – as suggested by the commenter – an exemption would be appropriate.

For these reasons, the Commission is adopting the prohibition substantially as proposed.

b. Paragraph (c)(2) of Rule 17g-5

As adopted, paragraph (c)(2) prohibits an NRSRO from having a conflict relating to the issuance of a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the nationally recognized statistical rating organization, a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the rated person. This conflict as it relates to obligors is identified in Section 15E(h)(2)(C) of the Exchange Act.³⁹¹ The Commission believes

³⁹¹ 15 U.S.C. 78o-7(h)(2)(C).

prohibiting these conflicts, including with respect to issuers, is necessary or appropriate in the public interest or for the protection of investors. An NRSRO and persons within the NRSRO that participate in the credit rating should not have a direct financial interest in the issuer or obligor subject to the credit rating. It will be difficult for these persons to remain impartial and issue an objective credit rating in this circumstance.³⁹²

As with the provision in paragraph (b)(6) of Rule 17g-5, the Commission has narrowed the scope of this provision to “direct” ownership interests. These persons will be permitted to have indirect ownership interests, for example, through mutual funds or blind trusts. The prohibition also excludes from its scope ownership of securities issued by a sovereign government or an agency of a sovereign government. The Commission added this exclusion in response to a comment that sovereign government and agency securities may be held as cash equivalents.³⁹³ Further, the Commission believes for many of these securities it would be difficult to influence their market price through the issuance of a credit rating. Therefore, a prohibition on a credit analyst owning securities of sovereign the analyst rates is not necessary. The Commission notes that this ownership interest is subject to the requirements of paragraphs (a) and (b)(6) of Rule 17g-5. Consequently, it will be required to be addressed in the procedures for managing the conflicts that arise from direct ownership of rated securities.

³⁹² The Senate Report notes that rating agencies argue that although the pay-for-rating business model presents inherent conflicts of interest, the conflict is effectively managed inasmuch as credit analysts do not benefit financially from any of their ratings decisions. The Senate Report further notes that credit analysts are not permitted to own any of the securities they follow.

³⁹³ See S&P Letter.

For the reasons, the Commission is adopting the prohibition with the modifications discussed above.

c. Paragraph (c)(3) of Rule 17g-5

Paragraph (c)(3) prohibits an NRSRO from having a conflict relating to the issuance of a credit rating where the rated entity is a person associated with the NRSRO (i.e., a company directly or indirectly controlling, controlled by, or under common control with, the NRSRO).³⁹⁴ This conflict as it relates to obligors is identified in Section 15E(h)(2)(C) of the Exchange Act.³⁹⁵ The Commission believes prohibiting this conflict, including with respect to issuers, is necessary or appropriate in the public interest or for the protection of investors. The Commission believes that it is appropriate to prohibit such conflicts because of the degree of difficulty the Commission foresees in maintaining an appropriate level of impartiality, when issuing a credit rating with respect to an affiliated entity.

Two commenters stated that this conflict can be managed and should not be prohibited.³⁹⁶ The Commission believes that for a credit analyst to determine a credit rating for the company where the analyst works or an affiliate of that company would place the analyst in an untenable position. Moreover, the Commission does not believe there will be a need for such a credit rating as long as other NRSROs are available to determine credit ratings for these companies. The Commission will entertain requests for exemptive relief from this prohibition where appropriate, such as if circumstances

³⁹⁴ See Section 3(a)(63) of the Exchange Act (15 U.S.C. 78c(a)(63)) defining “person associated with an NRSRO.”

³⁹⁵ 15 U.S.C. 78o-7(h)(2)(C).

³⁹⁶ See Moody’s Letter; S&P Letter.

develop to a point where an NRSRO or its affiliate requires a public credit rating and cannot obtain one from another NRSRO. For these reasons, the Commission is adopting this prohibition substantially as proposed.

d. Paragraph (c)(4) of Rule 17g-5

Paragraph (c)(4) prohibits an NRSRO from having a conflict relating to the issuance of a credit rating where the credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, also is an officer or director of the person that is the subject of the credit rating.³⁹⁷ This conflict as it relates to obligors is identified in Section 15E(h)(2)(C) of the Exchange Act.³⁹⁸ The Commission believes prohibiting this conflict, including with respect to issuers, is necessary or appropriate in the public interest or for the protection of investors. The Commission believes that an NRSRO or person associated with the NRSRO having such a position will have difficulty remaining objective in these circumstances.

The Commission did not receive any comments on this specific prohibition and is adopting it substantially as proposed.

F. Rule 17g-6 – Prohibited Unfair, Coercive, or Abusive Practices

Section 15E(i)(1) of the Exchange Act³⁹⁹ provides that the Commission shall adopt rules prohibiting any act or practice by an NRSRO that the Commission determines is unfair, abusive, or coercive, including certain acts and practices set forth in

³⁹⁷ Cf. Rule 2711 of the National Association of Securities Dealers, Inc. (“NASD”) allowing a securities research analyst to be an officer or director of a subject company if proper disclosure is made.

³⁹⁸ 15 U.S.C. 78o-7(h)(2)(C).

³⁹⁹ 15 U.S.C. 78o-7(i)(1).

paragraphs (i)(1)(A)-(C) of Section 15E of the Exchange Act.⁴⁰⁰ In explaining this statutory provision, the Senate Report stated that “the Commission, as a threshold consideration, must determine that the practices subject to prohibition under this section are unfair, coercive or abusive before adopting rules prohibiting such practices.”

In the proposing release, the Commission made a preliminary determination that the acts and practices described in paragraphs (i)(1)(A)-(C) of Section 15E of the Exchange Act⁴⁰¹ would be unfair, coercive, or abusive. Consequently, the Commission proposed that they be prohibited through provisions in paragraphs (a)(1) through (a)(4) of Rule 17g-6, with one conditional exception. The Commission also made a preliminary determination in the proposing release that using an unsolicited credit rating to pressure an issuer or obligor into paying for the rating or another service would be unfair, coercive, or abusive. Consequently, the Commission proposed to use its authority under Section 15E(i)(1) of the Exchange Act⁴⁰² to prohibit such act and practice through the provisions in paragraph (a)(5) of Rule 17g-6.⁴⁰³

1. Paragraph (a)(1) of Rule 17g-6

Section 15E(i)(1)(A) of the Exchange Act provides that the Commission shall prohibit the following practice if the Commission determines it is unfair, coercive, or abusive:

⁴⁰⁰ 15 U.S.C. 78o-7(i)(1)(A), (B) and (C).

⁴⁰¹ Id.

⁴⁰² 15 U.S.C. 78o-7(i)(1).

⁴⁰³ See Commission 2003 CRA Report, which noted that some participants in the Commission 2002 CRA Hearings questioned the appropriateness of unsolicited credit ratings because they could be used to engage in “strong-arm” tactics to induce payment for a credit rating the issuer did not request.

Conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products of the nationally recognized statistical rating organization or any person associated with such nationally recognized statistical rating organization[.]⁴⁰⁴

In the proposing release, the Commission preliminarily determined that this practice would be unfair, coercive, or abusive. Consequently, the Commission proposed to prohibit it in paragraph (a)(1) of Rule 17g-6. Specifically, this paragraph, as proposed, would have prohibited an NRSRO from conditioning or threatening to condition the issuance of a credit rating on the purchase of other products or services, including pre-credit rating assessment products.⁴⁰⁵

Credit ratings play an important role in the financial markets. Market participants use them in making financial decisions on whether to buy or sell debt securities and extend credit to rated entities. Moreover, credit ratings of NRSROs are used in federal and state laws and regulations to establish limits or confer exemptions or privileges. Consequently, an entity may benefit from having an NRSRO credit rating because the credit rating makes its securities more marketable; or the credit rating qualifies the entity for an exemption or privilege or makes holding the entity's debt securities or transacting with the entity more attractive to other regulated entities. An

⁴⁰⁴ 15 U.S.C. 78o-7(i)(1)(A).

⁴⁰⁵ See Commission 2003 CRA Report, which noted that some participants in the Commission's 2002 CRA Hearings worried that issuers could be unduly pressured to purchase advisory services, particularly in cases where they were solicited by the credit rating analyst.

NRSRO could abuse this incentive by using it to coerce an issuer or obligor to purchase services from the NRSRO or its affiliates.

The Commission did not receive any comments objecting to its preliminary determination that this practice would be unfair, coercive, or abusive. The Commission has determined this practice would be unfair, coercive, or abusive and, consequently, is adopting paragraph (a)(1) of Rule 17g-6 substantially as proposed in order to prohibit it.

One commenter did state that there are certain circumstances where it would not be unfair, coercive, or abusive to condition the determination of a credit rating on a security on further analysis of the issuer.⁴⁰⁶ Specifically, the commenter stated that to determine a credit rating for a subordinated debt security, a credit rating agency may be required to analyze the overall capital structure of the issuer and determine credit ratings for the issuer as an entity and for its senior debt.⁴⁰⁷ The commenter requested that the rule text in paragraph (a)(1) of proposed Rule 17g-6 be amended to clarify that this specific practice is not prohibited.⁴⁰⁸

The Commission believes that the rule text as proposed and as adopted would not prohibit this specific practice. The prohibition applies to conditioning a credit rating on the purchase of “other” services of the credit rating agency. In the situation described above, the requirement to analyze the capital structure of the issuer and the creditworthiness of its senior debt is part of the process of determining the credit rating

⁴⁰⁶ See Moody’s Letter.

⁴⁰⁷ Id.

⁴⁰⁸ Id.

on the subordinated debt. Therefore, the Commission views this as all part of one service and not three different services.

For these reasons, the Commission is adopting the prohibition substantially as proposed.

2. Paragraphs (a)(2) and (a)(3) of Rule 17g-6

Section 15E(i)(1)(C) of the Exchange Act provides that the Commission shall prohibit the following practices if the Commission determines they are unfair, coercive, or abusive:

Modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with such organization.⁴⁰⁹

In the proposing release, the Commission preliminarily determined that these practices would be unfair, coercive, or abusive. Consequently, the Commission proposed to prohibit them through paragraphs (a)(2) and (a)(3) of proposed Rule 17g-6. The Commission did not receive any comments objecting to its preliminary determination that these practices are unfair, coercive, or abusive. The Commission has determined they are unfair, coercive, or abusive for the reasons discussed below and, consequently,

⁴⁰⁹ 15 U.S.C. 78o-7(i)(1)(C).

is adopting paragraphs (a)(2) and (a)(3) of Rule 17g-6 substantially as proposed in order to prohibit them.

As adopted, paragraph (a)(2) prohibits an NRSRO from issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the NRSRO's established procedures for determining credit ratings based on whether the rated person purchases or will purchase the credit rating or another product or service.⁴¹⁰ Under this provision, an NRSRO is prohibited from issuing or threatening to issue a credit rating that is lower than would result from using its methodology for determining credit ratings based on whether the issuer or obligor pays for the credit rating or any other service or product of the NRSRO and its affiliates. The NRSRO also will be prohibited from issuing or promising to issue a higher credit rating in these circumstances.⁴¹¹

The practice prohibited in this paragraph is distinguishable from the practice prohibited in Paragraph (a)(1) of Rule 17g-6. Paragraph (a)(1) addresses the situation where an NRSRO conditions the issuance of a credit rating on the purchase of another service or product. Paragraph (a)(2) addresses the situation where an NRSRO conditions the opinion reached in the credit rating on the purchase of the credit rating or another

⁴¹⁰ Paragraph (a)(2) of Rule 17g-6.

⁴¹¹ Presumably, an issuer or obligor would not agree to compensate an NRSRO for a credit rating that was lower than would result from applying the NRSRO's methodologies. Nonetheless, if an NRSRO agreed to issue a lower than warranted credit rating in return for compensation, the NRSRO would violate paragraph (a)(2) as well.

service or product.⁴¹² Thus, unlike paragraph (a)(1), an NRSRO will violate paragraph (a)(2) if it conditions the issuance of the credit rating on the obligor or issuer paying for the credit rating. This is because the NRSRO will not be agreeing to determine a credit rating that reflected the NRSRO's assessment of the creditworthiness of the issuer or obligor as determined by its methodologies. Rather, the NRSRO will be agreeing to skew the credit rating higher based on the issuer or obligor agreeing to pay for it.

Paragraph (a)(3) Rule 17g-6 prohibits an NRSRO from modifying, or offering or threatening to modify, a credit rating in a manner contrary to its procedures for modifying a credit rating based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the NRSRO and its affiliates. The prohibition in paragraph (a)(2) of Rule 17g-6 applies to threats or promises with respect to the issuance of a credit rating. Paragraph (a)(3) extends this prohibition to threats or promises with respect to changing an existing credit rating.⁴¹³

The Commission believes these practices are unfair, coercive, or abusive because an entity's cost of credit and, in some cases, ability to obtain credit, generally depends on its credit rating. Entities with lower credit ratings must pay higher interest rates to borrow funds or issue debt. In some cases, a low credit rating could block an entity's access to credit. Thus, it is in a borrower's economic interest to have a high credit

⁴¹² See Commission 2003 CRA Report, which noted that some participants in the Commission 2002 CRA Hearings believed that, even if the purchase of ancillary services did not impact the credit rating decision, issuers may be pressured into using the services out of fear that their failure to do so may adversely impact their credit rating.

⁴¹³ As noted above, the prohibitions in paragraphs (a)(2) and (a)(3) Rule 17g-6 are being adopted pursuant to authority in Section 15E(i)(1)(C) of the Exchange Act (15 U.S.C. 78o-7(i)(1)(C)).

rating. This creates the potential for an NRSRO to have inappropriate leverage over an issuer or obligor.

An NRSRO could use this leverage to obtain business by threatening to issue or modify a credit rating in a manner that results in a lower credit rating than would have resulted from using its established methodologies. The NRSRO also could issue a lower credit rating or lower an existing rating to punish an issuer or obligor for not purchasing the credit rating or another service or product of the NRSRO and its affiliates.

Conversely, the NRSRO could promise to issue or modify a credit rating in a manner that results in a higher credit rating than would have resulted from using its established methodologies as a reward for purchasing the credit rating or other services or products. Paragraphs (a)(2) and (3) of Rule 17g-6 are designed to provide a check on the potential inappropriate influence an NRSRO may have over issuers and obligors by prohibiting an NRSRO from using this leverage to coerce an issuer or obligor into purchasing a credit rating or other services and products of the NRSRO and its affiliates.

The Commission further notes that these practices could result in credit ratings that mislead the marketplace and undermine the regulatory use of NRSRO credit ratings. An NRSRO that follows through on a threat to issue a low credit rating or promise to issue a high credit rating will be issuing a credit rating that does not accurately reflect the credit rating agency's true assessment of the creditworthiness of the issuer or obligor. The credibility and reliability of an NRSRO and its credit ratings depends on the NRSRO developing and implementing sound methodologies for determining credit ratings and following those methodologies. The fact that an issuer or obligor agrees or refuses to purchase a credit rating or other service or product from the NRSRO and its

affiliates should have no bearing on the NRSRO's credit assessment of the issuer or obligor.⁴¹⁴

For these reasons, the Commission is adopting the prohibition substantially as proposed.

3. Paragraph (a)(4) of Rule 17g-6

Section 15E(i)(1)(B) of the Exchange Act provides that the Commission by rule shall prohibit any act or practice the Commission determines to be unfair, coercive, or abusive relating to:

Lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the nationally recognized statistical rating organization[.]⁴¹⁵

In explaining this statutory provision, the Senate Report stated that “there may be instances when a rating agency may refuse to rate securities or money market instruments for reasons that are not intended to be anti-competitive.” The Senate Report further

⁴¹⁴ The Commission is mindful of the limitation in Section 15E(c)(2) of the Exchange Act that the rules the Commission adopts under the Exchange Act not regulate the substance of credit ratings (15 U.S.C. 78o-7(c)(2)). The Commission does not believe that this prohibition will interfere with the process by which an NRSRO assesses the creditworthiness of a security, money market instrument, or obligor. An issuer's or obligor's agreement or refusal to pay the NRSRO or its affiliate for a service or product is, of itself, not relevant to a credit assessment of the issuer or obligor. Moreover, this is a practice that Congress specifically identified in Section 15E(i)(1)(C) of the Exchange Act as potentially unfair, coercive, or abusive (15 U.S.C. 78o-7(i)(1)(C)).

⁴¹⁵ 15 U.S.C. 78o-7(i)(1)(B).

stated that “the Commission . . . should prohibit only those ratings refusals that occur as part of unfair, coercive or abusive conduct.”

a. Structured Product Credit Rating Practices

Two of the current NRSROs – Fitch and DBRS – believe two other NRSROs – S&P and Moody’s engage in anti-competitive practices in the area of determining credit ratings for structured products and, consequently, these practices should be found by the Commission to be unfair, coercive, or abusive.⁴¹⁶ These practices relate to instances where the credit rating agency has not rated particular securities that have been rated by another credit rating agency and that underlie a structured product. S&P and Moody’s believe their practices are necessary to determine a credible credit rating.⁴¹⁷

The practices take several forms. The credit rating agency may, as a condition of issuing a credit rating for a structured product, require that it effectively issue a public credit rating for a fee for most, if not all, the assets underlying the structured product.⁴¹⁸ The second form involves the credit rating agency insisting that it provide a private credit rating or credit assessment for a fee with respect to the unrated assets.⁴¹⁹ The third form involves the credit rating agency taking into consideration the internal credit analysis of another person (e.g., the underwriter, sponsor, or manager of the structured

⁴¹⁶ See DBRS Letter; Fitch Letter; letter dated April 11, 2007 from Charles D. Brown, General Counsel, Fitch Ratings (“Fitch 2nd Letter”).

⁴¹⁷ See letter dated March 30, 2007 from Raymond W. McDaniel, President, Moody’s Investor Services (“Moody’s 2nd Letter”); letter dated April 24, 2007 from Jeanne M. Dering, Executive Vice President, Global Regulatory Affairs & Compliance (“Moody’s 3rd Letter”); S&P Letter; Moody’s Letter.

⁴¹⁸ Id.

⁴¹⁹ Id.

product) with respect to the unrated assets to determine a credit rating or private credit rating, or perform a credit assessment of the unrated assets.⁴²⁰ The fourth form involves the credit rating agency taking into consideration but not necessarily adopting the credit ratings of another credit rating agency to determine a credit rating or private credit rating, or perform a credit assessment of the unrated assets.⁴²¹ Under this last form, the credit rating agency may employ a standardized methodology to discount (notch down) the credit ratings of the other credit rating agency based on the type of security and category of credit rating.⁴²²

b. Proposed Rule 17g-6(a)(4)

In the proposing release, the Commission preliminarily determined that it would be unfair, coercive, or abusive for an NRSRO to issue or threaten to issue a lower credit rating, lower or threaten to lower an existing credit rating, refuse to issue a credit rating, or to withdraw a credit rating with respect to a structured product unless a portion of the assets underlying the structured product also are rated by the NRSRO. Consequently, the Commission proposed to prohibit these practices in paragraph (a)(4) of proposed Rule 17g-6.

The Commission also proposed an exception to the prohibition that would permit an NRSRO to refuse to issue the credit rating or withdraw the credit rating if the NRSRO has rated less than 85% of the market value of the assets underlying the structured product. This was designed to address the concern that an NRSRO when assessing the

⁴²⁰ Id.

⁴²¹ Id.

⁴²² Id.

creditworthiness of the structured product would be forced to issue a credit rating either when a substantial portion of the underlying assets were not rated or when the underlying assets have been rated by another credit rating agency. If the underlying assets were unrated, the NRSRO may not have sufficient information for issuing a credit rating on the structured product. In the case where the underlying assets were rated by another credit rating agency, the other credit rating agency may have used different methodologies to assess the creditworthiness of the asset and may have determined a credit rating that is different than the credit rating the NRSRO would issue, if it had rated the asset.

c. Comments on Proposed Rule 17g-6(a)(4)

i. Support for a Prohibition

The Commission received far more comments on this provision of the proposed rules than on any other provision. Many commenters expressed strong support for the prohibition; though many of the supporters stated that the 85% exception was too high and should be lowered to at least 66%.⁴²³ These commenters generally believe the

⁴²³ See e.g., DBRS Letter; Fitch letter; Fitch 2nd Letter. See also letter dated February 13, 2007 from Janet M. Tavakoli, President, Tavakoli Structured Finance, Inc.; letter dated February 14, 2007 from Gregory G. Raab, Chief Executive Officer, Axon; letter dated February 16, 2007 from Emile Van den Bol, Managing Director, Deutsche Bank; letter dated February 16, 2007 from Kent D. Born, Senior Managing Director, PPM America; letter dated February 23, 2007 from Patti Unti, Managing Director, Capmark Investments LP; letter dated February 23, 2007 from David Lazarus, Managing Director, Capmark Securities, Inc.; letter dated February 28, 2007 from Ronald E. Schrage, Chief Executive Officer, LNR Property Corporation; letter dated March 5, 2007 from David Hynes, Partner, Northcross Capital LLP; letter dated March 6, 2007 from S. Trezevant Moore, Jr., President & COO, Luminent Mortgage Capital, Inc.; letter dated March 7, 2007 from Bruce E. Stern, Chairman, Government Affairs Committee, Association of Financial Guaranty Insurers; letter dated March 9, 2007 from Petra Spiegel, Eurohypo AG; letter dated March 9, 2007 from Landon D. Parsons, Managing Director, G-Bass ("G-Bass Letter"); letter dated March 9, 2007 from Pat G. Halter, Chief Executive Officer, Principal Real Estate Investors; letter dated March 12, 2007 from Charles Covell, Executive Vice President, Citigroup Alternative Investments; letter dated March

proposed rule would serve to increase competition within the credit ratings market, thus benefiting investors in structured products.⁴²⁴

For example, DBRS stated that notching has a ripple effect on competition wider than just the structured products and affects competition in the corporate bond rating market and that the practices employed by S&P and Moody's could have a profound and harmful effect on efforts to increase competition among NRSROs.⁴²⁵ Fitch stated that adoption of the proposed rule is critical to achieving the Rating Agency Act's objective of greater accountability, transparency, and competition in the credit ratings market.⁴²⁶ Fitch noted that structured products increasingly are designed to hold other structured products.⁴²⁷ Fitch stated that the practices employed by S&P and Moody's have increased their market share in rating structured products,

As the structured finance market has grown exponentially in terms of both dollar value and number of market participants, it has

12, 2007 from Rodney J. Dillman, General Counsel, Babson Capital Management LLC; letter dated March 12, 2007 from Louis C. Lucido, Group Managing Director, Trust Company of the West; letter dated March 12, 2007 from Daniel Ivascyn, Managing Director, PIMCO ("PIMCO Letter"); letter dated March 27, 2007 from Dottie Cunningham, Chief Executive Officer, Commercial Mortgage Securities Association; letter dated April 23, 2007 from Dwight M. Jaffe, Professor, Haas School of Business ("Jaffe Letter"); letter dated April 24, 2007 from Daniel Rubinfeld, Professor, Boalt Law School ("Rubinfeld Letter"); letter dated April 25, 2007 from Dottie Cunningham, Chief Executive Officer, Commercial Mortgage Securities Association; letter dated May 11, 2007 from Kent Wideman, Group Managing Director, Policy and Rating Committee, and Mary Keogh, Managing Director, Policy and Regulatory Affairs, Dominion Bond Rating Service ("DBRS 2nd Letter").

⁴²⁴ Id.

⁴²⁵ See DBRS Letter; DBRS 2nd Letter.

⁴²⁶ See Fitch Letter.

⁴²⁷ Id.

become increasingly circular. Most notably, [structured product] issuers regularly acquire securities of other [structured product] issuers. The circularity of the market, in which large, intertwined investors are each subject to notching guidelines mandated by Moody's and S&P, has allowed Moody's and S&P to extend their partner monopoly in the traditional bond market to the increasingly prominent structured finance market. Therein lies the power of the unfair, coercive, and abusive practice of notching.⁴²⁸

Academic commenters also stated that Moody's and S&P's practices are unfair, coercive, and abusive within the meaning of the Rating Agency Act.⁴²⁹ They stated that the securities market would benefit from increased competition in the credit rating market, and that these practices have served to hinder Fitch's ability to compete.⁴³⁰ One commenter also argued that these practices may lead to misleading credit ratings if another credit rating agency's ratings are categorically reduced without analytic support.⁴³¹

As noted above, many of the commenters that supported the prohibition stated that the 85% threshold should be lowered to 66% or less.⁴³² They based this assertion on Fitch's showing that S&P, Moody's, and Fitch each shared approximately 66% of the

⁴²⁸ Fitch Letter.

⁴²⁹ See Rubinfeld Letter; Jaffe Letter.

⁴³⁰ Id.

⁴³¹ See Jaffe Letter.

⁴³² See, e.g., Fitch Letter; PIMCO Letter; G-Bass Letter.

structured product market before S&P and Moody's began their practices in 2001.⁴³³

They further stated that as a direct result of notching, S&P and Moody's have significantly increased their market share; while Fitch has lost market share.⁴³⁴

The commenters that support prohibiting the practices of S&P and Moody's believe that the remedy is to require an NRSRO to rely on the credit ratings of another NRSRO without employing any mapping methodology that would lower the credit rating.⁴³⁵ For example, Fitch argues that historical default, transition rate, and rating comparability studies indicate that the credit ratings of S&P, Moody's, and Fitch for structured products are comparable.⁴³⁶ Therefore, Fitch asserts that NRSROs should rely on the credit ratings of other NRSROs at face value.⁴³⁷ Fitch suggested that the proposed rule be modified to provide that if an NRSRO has rated 66% of the par value of an asset pool, and all assets in the pool are publicly rated by two or more NRSROs, for those assets the NRSRO has not itself rated, the NRSRO be required to use one of the two or more public ratings assigned to the underlying asset.⁴³⁸

ii. Opposition to a Prohibition

⁴³³ Id.

⁴³⁴ Id.

⁴³⁵ See, e.g., Fitch Letter.

⁴³⁶ Id.

⁴³⁷ See Fitch Letter.

⁴³⁸ See Fitch 2nd Letter.

S&P, Moody's, and several other commenters (including academic commenters) strongly opposed the prohibition in paragraph (a)(4) of proposed Rule 17g-6.⁴³⁹ They cited a number of reasons, most notably that it would require one NRSRO to rely on the credit ratings of another NRSRO.⁴⁴⁰ Several commenters asserted that the proposed rule would have an anticompetitive effect.⁴⁴¹ They argued that requiring an NRSRO to adopt the credit ratings of competitors in its credit ratings analysis would reduce competition because the ability of an NRSRO to reach an independent determination of creditworthiness based on different methodologies or criteria would be impeded.⁴⁴² These commenters state that value is brought to the market by allowing NRSROs to deliver different analytical perspectives on issuers and securities.⁴⁴³ Another commenter wrote that the proposed rule would require an NRSRO to put its own reputation at risk

⁴³⁹ See, e.g., S&P Letter; S&P 2nd Letter; Moody's Letter; Moody's 3rd; R&I Letter; FSR Letter; Rutherford Letter; Langohr Letter; AST Letter; letter dated March 30, 2007 from Raymond W. McDaniel, President, Moody's Investor Services ("Moody's 2nd Letter"); letter dated March 30, 2007 from Charles W. Calomiris, Professor, Columbia University, et. al. ("Calomiris Letter"); letter dated April 3, 2007, from J. Darrell Duffie, Professor, Stanford University, Graduate School of Business; letter dated April 6, 2007 from Jean Helwege, Associate Professor of Finance, Penn State University; letter dated April 13, 2007 from Robert M. Chilstrom, Esq., Skadden, Arps, Slate, Meagher & Flom LLP, on behalf of Moody's Investor Services; letter dated April 18, 2007 from Gunter Loeffler, Professor, University of Ulm, Germany; letter dated April 26, 2007 from Louis H. Ederington, Professor, Price College of Business, University of Oklahoma; letter dated April 28, 2007 from Mitchell A. Petersen, Professor, Kellogg School of Management, Northwestern University; letter dated May 3, 2007 from the Honorable Charles E. Schumer, Senator, Robert Menendez, Senator, John E. Sununu, Senator, and Mike Enzi, Senator, U.S. Senate; letter dated May 12, 2007 from Ren-Raw Chen, Professor, Rutgers University.

⁴⁴⁰ Id.

⁴⁴¹ See Calomiris Letter.

⁴⁴² See Moody's 3rd Letter; Calomiris Letter.

⁴⁴³ See Moody's Letter; Calomiris Letter.

on behalf of the commercial interests of a competitor.⁴⁴⁴ Further, Moody's argued that differences among credit rating opinions on the same security tend to be larger than those observed when comparing only published credit ratings on jointly-rated securities, and that differences between credit rating opinions are more common and are often greater when Moody's rates securities in a category other than Aaa.⁴⁴⁵ A rule that prohibited notching would, in the view of many commenters, prohibit an agency from forming its own opinion about the risks of collateral in a structured product.⁴⁴⁶

Additionally, S&P and Moody's believe the proposed rule would unduly interfere with their methodologies for determining credit ratings, could lead to inaccurate credit ratings and credit ratings that violate securities laws, and unnecessarily raise constitutional issues.⁴⁴⁷ They argue that users of credit ratings believe ratings reflect the agency's bona fide opinion of the creditworthiness of a particular issuer, security, or transaction.⁴⁴⁸ S&P wrote that when an agency is asked to rate structured products it must understand the credit quality of all of the underlying assets.⁴⁴⁹ If an NRSRO was required to use the credit rating of another NRSRO, it would in effect lose the right to understand the credit quality of the underlying assets, and lose control over the credit

⁴⁴⁴ See Langohr Letter.

⁴⁴⁵ See Moody's 2nd Letter.

⁴⁴⁶ See, e.g., Moody's Letter.

⁴⁴⁷ See S&P Letter; Moody's Letter.

⁴⁴⁸ Id.

⁴⁴⁹ See S&P Letter.

rating opinions it publishes.⁴⁵⁰ Such a result, it argues, would be contrary to the legislative intent that credit ratings be independent and free from interference by third parties, including governments, issuers, investors, and competitors.⁴⁵¹ Moody's similarly argues that such a credit rating would not reflect an evaluation of the credit risk of all the assets in the pool, and therefore, negatively impact the credibility and reliability of its credit ratings and increase the risks to investors who rely on its credit ratings.⁴⁵²

S&P and Moody's argue that prohibiting their practices, in effect, would require them to rely on another NRSRO's credit rating even when they believed that credit rating to be unsupportable.⁴⁵³ Further, if they were required to rely on a credit rating from another NRSRO, they argue they would be placed in a position of having to publish credit ratings that they do not believe are accurate or engage in a prohibited practice.⁴⁵⁴ They state that this would create the untenable choice of taking an action that is inconsistent with general securities law principles or violating Rule 17g-6.⁴⁵⁵

S&P and Moody's state that their practices are analytically justified methods of forming an independent credit rating opinion.⁴⁵⁶ S&P asserts that it is appropriate to

⁴⁵⁰ Id.

⁴⁵¹ Id.

⁴⁵² See Moody's 3rd Letter.

⁴⁵³ See Moody's Letter; Moody's 2nd Letter; Moody's 3rd Letter; S&P Letter; S&P 2nd Letter.

⁴⁵⁴ Id.

⁴⁵⁵ Id.

⁴⁵⁶ Id.

reserve the right to discount the credit ratings of other credit rating agencies when incorporating these credit ratings into its own analysis to account for differences in analytical and surveillance practices among credit rating agencies, preserve its ability to perform its own surveillance of the underlying assets, and account for the possibility that the assets could be down-rated by another credit rating agency without notice.⁴⁵⁷

S&P and Moody's also have disputed the assertion that there are no differences between their credit ratings and Fitch's credit ratings.⁴⁵⁸ S&P argues that historical correlations that may have existed are not a justification for adopting a rule that would require recognition of future credit ratings issued by credit rating agencies that may register as NRSROs.⁴⁵⁹ Moreover, S&P and Moody's say that their practice of mapping to other credit ratings was developed to accommodate structured product sponsors who did not want to wait or pay for credit analysis on the assets underlying a structured product that the agency had not previously rated.⁴⁶⁰ They asserted that this practice provides a quicker means to close a structured product issuance because the existing credit rating serves as a starting point in analyzing a portion of the pool of underlying assets.⁴⁶¹ Therefore, in their view, prohibiting their practices would harm users of credit ratings.⁴⁶²

⁴⁵⁷ See S&P Letter; S&P 2nd Letter.

⁴⁵⁸ See S&P 2nd Letter; Moody's 3rd Letter.

⁴⁵⁹ See S&P 2nd Letter.

⁴⁶⁰ See Moody's Letter; Moody's 2nd Letter; Moody's 3rd Letter; S&P Letter; S&P 2nd Letter.

⁴⁶¹ Id.

⁴⁶² Id.

S&P and Moody's also commented on how paragraph (a)(4) of proposed Rule 17g-6 should be revised. For example, Moody's commented that the 85% threshold in the proposed rule was not appropriate.⁴⁶³ It argued that credit ratings for tranches of structured products are sensitive to the accuracy of credit ratings for even small portions of the underlying asset pool. Further, S&P and Moody's argued that the 85% threshold would create an incentive for collateral managers to include the riskiest securities in the 15% unrated portion of the structured product.⁴⁶⁴ Other commenters also argued the proposed rule would undermine the market's ability to offset potential harm from credit rating shopping.⁴⁶⁵

Moody's and S&P recommended that the Commission strike paragraph (a)(4) of Proposed Rule 17g-6 in its entirety. Alternatively, Moody's commented that if paragraph (a)(4) is retained, the rule should be revised to clearly prohibit only conduct that is motivated by an "unfair, coercive or abusive" intent.⁴⁶⁶ Moody's suggested that the rule be amended to provide, among other things, that the prohibitions of paragraph (a)(4) shall not apply if any such action is taken in accordance with the NRSRO's analytical procedures and methodologies and that the rule should not compel credit rating agencies to use or to rely upon the credit rating opinions of other persons as their own.

⁴⁶³ See Moody's Letter; Moody's 2nd Letter; Moody's 3rd Letter; S&P Letter; S&P 2nd Letter.

⁴⁶⁴ Id.

⁴⁶⁵ See Calomiris Letter.

⁴⁶⁶ See Moody's Letter.

S&P commented that one alternative to prohibiting these practices would be a record retention regime whereby NRSROs would be required to retain records related to their decisions to treat another NRSRO's credit ratings, including the NRSRO's reasons for the treatment.⁴⁶⁷ S&P stated that requiring the firm to explain its reasons would guard against unfair, coercive, or abusive practices.⁴⁶⁸

In lieu of striking paragraph (a)(4) or adopting only recordkeeping requirements, S&P commented that paragraph (a)(4) should be revised to provide that in situations where it has not rated 100% of the underlying assets, an NRSRO should have three options: (i) accepting the credit ratings of others at face value; (ii) refusing to rate the transaction at all; or (iii) reviewing all the underlying assets and receiving compensation for the additional work involved.⁴⁶⁹

d. Final Rule 17g-6(a)(4)

At this time, the Commission cannot determine that the acts and practices described above are unfair, coercive, or abusive in and of themselves. The Commission needs more information about these practices to gain a better understanding of how they were developed and are being employed. The Commission is concerned, however, that these practices have adversely affected competition among credit rating agencies and that they may occur for anticompetitive purposes. Consequently, the Commission is

⁴⁶⁷ See S&P Letter; see also DBRS 2nd Letter supporting increased recordkeeping and revising its earlier comment that an NRSRO should be required to rely on the credit ratings of another NRSRO in light of objections that this would interfere with how an NRSRO determines credit ratings.

⁴⁶⁸ See S&P Letter.

⁴⁶⁹ Id.

adopting a final rule that is intended to increase accountability and transparency in the structured product credit ratings market.

First, the Commission has determined that the practices identified in Section 15E(i)(1)(B) of the Exchange Act⁴⁷⁰ are unfair, coercive, or abusive to the extent they are practiced with anticompetitive intent. Consequently, paragraph (a)(4) of Rule 17g-6 prohibits an NRSRO from issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the nationally recognized statistical rating organization where such practice is engaged in by the nationally recognized statistical rating organization for an anticompetitive purpose.

The Commission recognizes that proving anticompetitive intent will be difficult, particularly where an NRSRO has analysis to support the contention that its methodology is not arbitrary and is designed to make the credit rating of a structured product more accurate. Nonetheless, the Commission believes this prohibition will be an important deterrent against anticompetitive practices when combined with the enhanced recordkeeping requirements in Rule 17g-2 discussed below.

e. Enhanced Recordkeeping Requirements

As noted above, two commenters suggested that an alternative to banning the practices of S&P and Moody's would be a record retention regime whereby NRSROs

⁴⁷⁰ 15 U.S.C. 78o-7(i)(1)(B).

would be required to retain records related to their decisions on how to treat, and methodology for treating, another NRSRO's credit ratings into the credit rating of a structured product.⁴⁷¹ S&P stated that requiring an NRSRO to explain its reasons for the treatment would guard against unfair, coercive, or abusive practices.⁴⁷²

The Commission believes that recordkeeping requirements aimed at these practices are necessary or appropriate in the public interest or for the protection of investors. Consequently, the Commission is adopting three recordkeeping requirements in this area. These requirements will assist the Commission in better understanding how these practices are developed and employed. This information may provide a basis for the Commission to determine whether it should find a specific practice to be unfair, coercive, or abusive. The Commission also believes that increased scrutiny on the practices coupled with the potential for liability under Rule 17g-6 will deter an NRSRO from acting with anticompetitive intent.

i. Paragraph (a)(7) of Rule 17g-2

As adopted, paragraph (a)(7) of Rule 17g-2 requires an NRSRO to make a record that lists each security and its corresponding credit rating issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction where the NRSRO in determining the credit rating for the security treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the NRSRO by any or a combination of the practices described above and identified in paragraphs (a)(7)(i) through (iv) of Rule 17g-2.

⁴⁷¹ See S&P Letter; DBRS 2nd Letter.

⁴⁷² See S&P Letter.

As discussed above, there are four practices by which a credit rating agency may treat unrated assets underlying a structured product when determining a credit rating for the structured product.⁴⁷³ Moreover, the credit rating agency may condition the issuance of a credit rating for the structured product on its employing one or more of these practices. First, the credit rating agency may require that it effectively issue a public credit rating for most, if not all, the assets underlying the structured product.⁴⁷⁴ This practice is described in paragraph (a)(7)(i) of Rule 17g-2. Second, the credit rating agency may require that it provide a private credit rating or credit assessment for a fee with respect to the unrated assets.⁴⁷⁵ This practice is described in paragraph (a)(7)(ii) of Rule 17g-2.

Third, the credit rating agency may take into consideration the internal credit analysis of another person (e.g., the underwriter, sponsor, or manager of the structured product) with respect to the unrated assets to determine a credit rating or private credit rating, or perform a credit assessment of the unrated assets.⁴⁷⁶ This practice is employed after the credit rating agency has done a review of how the person performs its credit analysis, including a review of the specific procedures and methodologies employed by the person. This practice is described in paragraph (a)(7)(iii) of Rule 17g-2.

Fourth, the credit rating agency may take into consideration but not necessarily adopt the credit ratings of another credit rating agency for the unrated assets to determine

⁴⁷³ See DBRS Letter; Fitch Letter; Fitch 2nd Letter; Moody's Letter; Moody's 2nd Letter; Moody's 3rd Letter; S&P Letter; S&P 2nd Letter.

⁴⁷⁴ Id.

⁴⁷⁵ Id.

⁴⁷⁶ Id.

a credit rating or private credit rating, or perform a credit assessment of the unrated assets.⁴⁷⁷ Under this last practice, the credit rating agency may employ a standardized methodology to discount (notch down) the credit ratings of the other credit rating agency based on the type of security and category of credit rating.⁴⁷⁸ This practice is described in paragraph (a)(7)(iv) of Rule 17g-2.

The intent of the recordkeeping provision in paragraph (a)(7) of Rule 17g-2 is to alert Commission examiners to those structured product credit ratings issued by an NRSRO that have been determined using one or more of these practices, which commenters have argued are unfair, coercive, or abusive. This will assist the examiners in requesting the records relating to these credit ratings in order to monitor these practices and get a better understanding of how they are employed. The Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in reviewing whether these practices are being engaged in with anticompetitive intent in violation of Rule 17g-6(a)(4).

For these reasons, the Commission is adopting the provision in Rule 17g-2.

ii. Paragraph (b)(8) of Rule 17g-2

As adopted, paragraph (b)(8) of Rule 17g-2 requires an NRSRO to retain internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another NRSRO for the purpose

⁴⁷⁷ Id.

⁴⁷⁸ Id.

of determining a credit rating of a security or money market instrument issued by an asset pool or part of any asset-backed or mortgage-backed securities transaction.

As discussed above, the commenters who opposed the prohibition in Rule 17g-6(a)(4), as proposed, stated that there were legitimate reasons for using, but lowering, another credit rating agency's credit ratings or insisting on performing an independent assessment of the assets rated by another credit rating agency.⁴⁷⁹ As noted above, the Commission has insufficient information at this time to determine that such practices are a pretext for anticompetitive behavior or that such practices are appropriate. The records that an NRSRO must retain under this provision will assist the Commission in understanding whether the NRSROs that engage in these practices have analytical, statistical, or other bases to support their methodologies. The existence (or absence) and nature of such information will assist the Commission in analyzing whether the practices are employed with the intent to improve the quality and accuracy of credit ratings or as pretexts for anticompetitive behavior.

For example, the Commission understands issuers may ask for pre-credit rating assessments for a security from three or more credit rating agencies and, based on the assessments or other considerations, hire one or more, but not all, of the credit rating agencies to issue the credit rating.⁴⁸⁰ A credit rating agency that was not hired to issue a credit rating for the security may use its pre-credit rating assessment as part of an analysis of how it would rate this type of security as compared to the other credit rating agencies. This analysis may be used to develop a procedure or methodology to treat the

⁴⁷⁹ See S&P Letter; Moody's Letter.

⁴⁸⁰ See Moody's 3rd Letter.

credit ratings of the other credit rating agencies for securities underlying a structured product in developing a credit rating for the structured product.⁴⁸¹ The treatment may include a schedule in which the credit ratings of the other credit rating agencies are notched down to the extent they are included in the structured product. Under paragraph (b)(8) of Rule 17g-2, an NRSRO that uses pre-credit rating assessments to develop such a schedule will need to retain any records documenting its pre-credit rating assessments and the process by which the pre-credit rating assessments were used to arrive at the number of notches the securities will be discounted.

The Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in reviewing whether these practices are being engaged in with anticompetitive intent in violation of Rule 17g-6(a)(4).

iii. Paragraph (b)(9) of Rule 17g-2

As adopted, paragraph (b)(9) of Rule 17g-2 requires an NRSRO to retain for each security identified in the record required under paragraph (a)(7) of Rule 17g-2, any document that contains a description of how assets within such pool or as a part of such transaction not rated by the NRSRO but rated by another NRSRO were treated for the purpose of determining the credit rating of the security.

These records will permit Commission examiners to review on a case-by-case basis the method by which an NRSRO incorporates the credit ratings of another NRSRO into the credit rating of a structured product. For example, examiners will be able to compare the methodologies for incorporating highly rated assets with those for lower

⁴⁸¹ See 17 CFR 240.17g-2(b)(8).

rated assets. One commenter that strongly supports prohibiting these practices states that credit rating agencies engaging in these practices notch down assets they have rated in the highest credit rating categories even though studies suggest that its credit ratings perform comparably.⁴⁸²

The Commission believes this provision is necessary or appropriate in the public interest or for the protection of investors because it will assist the Commission in reviewing whether these practices are being engaged in with anticompetitive intent in violation of Rule 17g-6(a)(4).

5. Unsolicited credit ratings

In the proposing release, the Commission preliminarily determined that it would be unfair, coercive, or abusive to issue an unsolicited credit rating and communicate with the issuer or obligor to induce or attempt to induce them to pay for the credit rating or another product or service of the NRSRO or its affiliates. Consequently, paragraph (a)(5) of proposed Rule 17g-6 would have prohibited this practice.

Commenters raised a number of concerns with respect to how this prohibition would operate in practice.⁴⁸³ For the most part, they worried it was overbroad and, consequently, would prohibit legitimate business activities that are not coercive.⁴⁸⁴ As discussed with respect to Exhibit 2, issuers and obligors, for example, may consent to the issuance, and participate in the determination, of a credit rating even if they did not specifically request that the credit rating be issued. The Commission wants to gain a

⁴⁸² See Fitch Letter.

⁴⁸³ See R&I Letter; FSR Letter; DBRS Letter; A.M. Best Letter; Fitch Letter; S&P Letter; Moody's Letter; Langohr Letter; LACE Letter.

⁴⁸⁴ Id.

better understanding through its examination function of how credit rating agencies define “unsolicited credit ratings” and the practices they employ with respect to these ratings. The Commission believes it must gain this understanding before prohibiting any practices in this area.

For these reasons, the prohibition has been eliminated from Rule 17g-6.

V. PAPERWORK REDUCTION ACT

Certain provisions of the rules contain a “collection of information” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).⁴⁸⁵ The Commission published a notice requesting comment on the collection of information requirements in the proposing release and submitted the proposed rules to the Office of Management and Budget (“OMB”) for review in accordance with the PRA. The Commission will publish notice in the Federal Register when it receives clearance from OMB. The Commission did not receive any comments on the burden estimates in the proposing release.

An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid control number.

The titles for the collections of information are:

- (1) Rule 17g-1, Application for registration as a nationally recognized statistical rating organization; Form NRSRO and the Instructions for Form NRSRO;
- (2) Rule 17g-2, Records to be made and retained by national recognized statistical rating organizations;
- (3) Rule 17g-3, Annual financial reports to be furnished by nationally recognized statistical rating organizations; and
- (4) Rule 17g-4, Prevention of Misuse of Material Nonpublic Information.

⁴⁸⁵ 44 U.S.C. 3501 *et seq.*; 5 CFR 1320.11.

A. Collections of Information in the Rules

The rules being adopted implement registration, recordkeeping, financial reporting, and oversight provisions of the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”).⁴⁸⁶ The rules contain recordkeeping and disclosure requirements that are subject to the PRA for registered NRSROs and impose mandatory collection of information obligations.

In summary, the rules require a credit rating agency that wishes to register as an NRSRO to furnish an initial application to the Commission for registration on Form NRSRO;⁴⁸⁷ and a credit rating agency or NRSRO to furnish a written notice to the Commission to withdraw an initial application or application to be registered in an additional class of credit ratings prior to final action by the Commission.⁴⁸⁸ Further, the rules require an NRSRO to (1) furnish an application to the Commission on Form NRSRO for registration in an additional class of credit ratings;⁴⁸⁹ (2) furnish an application supplement on Form NRSRO to update information for an initial application or for an application to register an additional class of credit ratings prior to final Commission action;⁴⁹⁰ (3) furnish an amendment to the Commission on Form NRSRO to update information in the application after registration;⁴⁹¹ (4) furnish an annual

⁴⁸⁶ Pub. L. No. 109-291 (2006).

⁴⁸⁷ Section 15E(a)(1) of the Exchange Act (15 U.S.C. 78o-7(a)(1)) and Rule 17g-1(a).

⁴⁸⁸ Rule 17g-1(d); see also Section 15E(a)(1) of the Exchange Act (15 U.S.C. 78o-7(a)(1)).

⁴⁸⁹ Rule 17g-1(b).

⁴⁹⁰ Rule 17g-1(c).

⁴⁹¹ Section 15E(b)(1) of the Exchange Act (15 U.S.C. 78o-7(b)(1)) and Rule 17g-1(e).

certification to the Commission on Form NRSRO;⁴⁹² (5) furnish a withdrawal of registration to the Commission on Form NRSRO;⁴⁹³ (6) make the current Form NRSRO and Exhibits 1 through 9 publicly available on its Web site, or through another comparable, readily accessible means;⁴⁹⁴ (7) make, retain, and preserve certain records;⁴⁹⁵ (8) furnish an undertaking to the Commission if a third-party custodian makes or retains these records;⁴⁹⁶ (9) furnish the Commission with annual financial reports;⁴⁹⁷ and (10) establish certain procedures to prevent the misuse of material nonpublic information.⁴⁹⁸ Many of these requirements are prescribed in Section 15E of the Exchange Act.⁴⁹⁹

B. Use of the Information

Rules 17g-1 through 17g-6, Form NRSRO, and the Instructions for Form NRSRO establish a framework for Commission oversight of NRSROs. The collections of information in the rules are designed to allow the Commission to determine whether an entity should be registered as an NRSRO. Further, they will assist the Commission in

⁴⁹² Section 15E(b)(2) of the Exchange Act (15 U.S.C. 78o-7(b)(2)) and Rule 17g-1(f).

⁴⁹³ Section 15E(e)(1) of the Exchange Act (15 U.S.C. 78o-7(e)(1)) and Rule 17g-1(g).

⁴⁹⁴ Section 15E(a)(3) of the Exchange Act (15 U.S.C. 78o-7(a)(3)) and Rule 17g-1(i).

⁴⁹⁵ Rule 17g-2 under authority in Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

⁴⁹⁶ Rule 17g-2(e) under authority in Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

⁴⁹⁷ Section 15E(k) of the Exchange Act (15 U.S.C. 78o-7(k)) and Rule 17g-3.

⁴⁹⁸ Section 15E(g) of the Exchange Act (15 U.S.C. 78o-7(g)) and Rule 17g-4.

⁴⁹⁹ See 15 U.S.C. 78o-7.

effectively monitoring, through its examination function, whether an NRSRO is conducting its activities in accordance with Section 15E of the Exchange Act⁵⁰⁰ and the rules thereunder. The rules also are designed to assist users of credit ratings by requiring the disclosure of information that may be used to compare the credit ratings quality of different NRSROs. The disclosures include information about methods for determining credit ratings, organizational structure, policies for safeguarding non-public information, conflicts of interest, policies for managing conflicts of interest, and credit analyst qualifications. As noted in the Senate Report accompanying the Rating Agency Act, this information “will facilitate informed decisions by giving investors the opportunity to compare ratings quality of different firms.”⁵⁰¹

C. Respondents

The number of respondents will depend, in part, on the number of entities that meet the statutory requirements to be eligible for registration. The Rating Agency Act, by adding definitions to Section 3 of the Exchange Act,⁵⁰² identifies the types of entities that may apply for registration with the Commission as an NRSRO.⁵⁰³ First, it defines an “NRSRO” as a “credit rating agency” that, in pertinent part, has been in business as a credit rating agency for at least three consecutive years immediately preceding the date of its application for registration; issues credit ratings certified by 10 QIBs (unless

⁵⁰⁰ 15 U.S.C. 78o-7.

⁵⁰¹ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”).

⁵⁰² 15 U.S.C. 78c.

⁵⁰³ See Section 3 of the Rating Agency Act.

exempted from that requirement) with respect to financial institutions, brokers, dealers, insurance companies, corporate issuers, issuers of asset-backed securities (as that term defined in 17 CFR 229.1101(c)), issuers of government securities, issuers of municipal securities, or issuers of foreign government securities; and is registered with the Commission.⁵⁰⁴

Section 3 of the Exchange Act also defines the term “credit rating agency” as, in pertinent part, any person engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee; employing either a quantitative or qualitative model, or both, to determine credit ratings; and receiving fees from either issuers, investors, or other market participants, or a combination of these persons.⁵⁰⁵ The definition specifically excludes a commercial credit reporting company.⁵⁰⁶ Finally, Section 3 of the Exchange Act defines the term “credit rating” to mean “an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.”⁵⁰⁷

These definitions create threshold eligibility requirements with respect to the entities that are eligible to apply for registration as an NRSRO. Because NRSROs have not previously been supervised as such, and because credit rating agencies include

⁵⁰⁴ Section 3(a)(62) of the Exchange Act (15 U.S.C. 78c(a)(62)). Section 3(a)(64) of the Exchange Act (15 U.S.C. 78c(a)(64)) defines the term “qualified institutional buyer” (“QIB”) as having the “meaning given such term in [17 CFR 230.144A(a)] or any successor thereto.”

⁵⁰⁵ Section 3(a)(61) of the Exchange Act (15 U.S.C. 78c(a)(61)).

⁵⁰⁶ Section 3(a)(61)(A) of the Exchange Act (15 U.S.C. 78c(a)(61)(A)).

⁵⁰⁷ Section 3(a)(60) of the Exchange Act (15 U.S.C. 78c(a)(60)).

publicly and privately held companies located throughout the world, it is difficult to estimate the number of entities that are eligible to register as NRSROs.

In 2000, a working group of the Basel Committee on Banking Supervision⁵⁰⁸ issued a report on credit rating agencies that was based, in part, on surveys of 28 credit rating agencies located around the world, including the five credit rating agencies currently identified as NRSROs through the Commission's no-action letter process.⁵⁰⁹ In its report, the working group estimated that there were approximately 150 credit rating agencies located world-wide.⁵¹⁰ The working group also noted that there was a wide disparity in size among credit rating agencies in terms of number of employees and credit ratings issued.⁵¹¹ In addition, the working group noted that some credit rating agencies focus exclusively on issuers in the countries where they are located.⁵¹²

The Web site www.DefaultRisk.com, which has tracked the number of credit rating agencies, identifies 57 credit rating agencies as of February 2006 and indicates that this count reflects a decrease from a previous count of 74.⁵¹³ The Web site

⁵⁰⁸ The Basel Committee on Banking Supervision is comprised of members from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. More information about the Basel Committee for Banking Supervision can be found at: <http://www.bis.org/>.

⁵⁰⁹ Credit Ratings and Complementary Sources of Credit Quality Information, Working group of the Basel Committee on Banking Supervision, No. 3 – August 2000 (“Basel Report”).

⁵¹⁰ Id.

⁵¹¹ Id.

⁵¹² Id.

⁵¹³ See <http://www.defaultrisk.com> (“DefaultRisk.com”).

attributed the decrease to smaller firms either being consolidated into larger firms or ceasing operations.⁵¹⁴

The estimates in the 2000 Basel Report and by DefaultRisk.Com provide some basis upon which to estimate the number of entities engaging in the business of issuing credit ratings. We cannot determine how many of the entities included in these estimates meet the statutory requirements to apply for, and be registered as, an NRSRO.

In addition, it is difficult to estimate with certitude how many credit rating agencies ultimately would volunteer to be registered as NRSROs.⁵¹⁵ Some credit rating agencies may decide not to seek registration because, for example, they do not believe that being an NRSRO would benefit them based on their business model. The Commission staff's experience with the expiring no-action letter process of identifying NRSROs provides some support for the conclusion that a substantial number of credit rating agencies may not apply for registration. Specifically, if the number of credit rating agencies has fluctuated over the years from between approximately 150 as of 2000 (Basel Report) and 57 as of February 2006 (DefaultRisk.com), then a large majority of these firms have not applied to the Commission to be identified as NRSROs under the no-action letter process. It is possible that certain firms that did not seek NRSRO status previously will seek it under Section 15E of the Exchange Act.⁵¹⁶ In addition, the use of QIB certifications as a prerequisite to registration (as opposed to the no-action letter

⁵¹⁴ Id.

⁵¹⁵ Section 15E(a)(1) of the Exchange Act makes registration voluntary (15 U.S.C. 78o-7(a)(1)).

⁵¹⁶ 15 U.S.C. 78o-7.

process which evaluated national recognition) also may increase the number of credit rating agencies that are eligible for registration as an NRSRO.

For all these reasons, we estimated that the number of credit rating agencies applying for registration would be larger than the sum of the number of credit rating agencies currently identified as NRSROs plus the handful of entities that requested no-action letters. At the same time, the Commission did not believe that all of the 57 credit rating agencies identified by DefaultRisk.Com would apply for, or be granted, registration. Consequently, the Commission estimated that approximately 30 credit rating agencies would be registered as NRSROs under Section 15E of the Exchange Act.⁵¹⁷

The Commission requested comment on this estimate and whether more or fewer credit rating agencies would be registered as NRSROs. The Commission also requested comment on whether the sources of industry information referenced in the proposing release (the Basel Report and the DefaultRisk.Com Web site) provided a reasonable basis for arriving at the estimate of 30 NRSROs. The Commission further requested comment on whether there were other industry sources that could provide credible statistics that could be used to determine the number of credit rating agencies that would be registered as NRSROs.

The Commission did not receive any comments in response to these requests. The Commission continues to estimate, for purposes of this PRA, that approximately 30 credit rating agencies will be registered as NRSROs.

D. Total Annual Recordkeeping and Reporting Burden

⁵¹⁷ 15 U.S.C. 78o-7.

The Commission estimates the total recordkeeping burden resulting from these rules is approximately 15,722 hours⁵¹⁸ on an annual basis and 21,755 hours⁵¹⁹ on a one-time basis.

The total annual and one-time hour burden estimates are averages across all types of expected NRSROs. The size and complexity of NRSROs will range from small entities to entities that are part of complex global organizations employing thousands of credit analysts. Larger NRSROs generally have established written policies and procedures and recordkeeping systems that comply with a substantial portion of the requirements in the rules. For example, many of the requirements in the rules are consistent with the IOSCO Code, which a number of credit rating agencies have adopted. The Commission assumed in its estimate that these firms would be required to augment or modify existing policies and procedures and recordkeeping systems to comply with the rules.

The Commission further estimated that some smaller entities also have implemented the policies, procedures, and recordkeeping systems that substantially would comply with the proposed rules. Moreover, given their smaller size and simpler structure, the Commission assumed that smaller entities would require significantly fewer hours to comply with a substantial portion of the requirements in the proposed rules.

⁵¹⁸ This total is derived from the total annual hours set forth in the order that the totals appear in the text: $1 + 1,500 + 300 + 1 + 300 + 7,620 + 6,000 = 15,722$ hours.

⁵¹⁹ This total is derived from the total one-time hours set forth in the order that the totals appear in the text: $9,000 + 1,200 + 125 + 900 + 9,000 + 50 + 1,500 = 21,775$ hours.

Consequently, the burden hour estimates in the proposing release were designed to represent the average time across all NRSROs (regardless of size) and taking into account that many firms would only be required to augment existing policies, procedures, and recordkeeping systems and processes to comply with the proposed rules. The Commission noted that, given the significant variance in size between the largest credit rating agencies and the smaller firms, the burden estimates, as averages across all NRSROs, were skewed higher by the largest firms. Furthermore, because the Commission proposed to require additional information in Form NRSRO beyond that prescribed in Section 15E(1)(B) of the Exchange Act,⁵²⁰ the burden estimates for Rule 17g-1 included estimates arising from requirements of Section 15E of the Exchange Act.⁵²¹ The intent was to quantify the incremental burden of complying with these statutory requirements as a result of the additional information that would be required under Rule 17g-1. Thus, the estimates did not seek to capture paperwork burden that would be solely attributable to requirements in Section 15E of the Exchange Act.⁵²²

The Commission sought comment on whether these factors were reasonably incorporated into the burden estimates. The Commission did not receive any comments in response to this request. The Commission continues to believe that it is appropriate to incorporate these factors into the final estimates, and has done so.

1. Rule 17g-1, Form NRSRO, and Instructions for Form NRSRO

⁵²⁰ 15 U.S.C. 78o-7(a)(1)(B).

⁵²¹ 15 U.S.C. 78o-7.

⁵²² Id.

Section 15E(a)(1) of the Exchange Act requires a credit rating agency applying for registration with the Commission to furnish an application containing certain specified information and such other information as the Commission prescribes as necessary or appropriate in the public interest or for the protection of investors.⁵²³ Rule 17g-1⁵²⁴ implements this statutory provision by requiring a credit rating agency to furnish a completed initial application on Form NRSRO to the Commission to apply to be registered under Section 15E of the Exchange Act.⁵²⁵ The Commission estimated that the average time necessary to complete the initial Form NRSRO, and compile the various attachments, would be approximately 300 hours per applicant. This estimate was based on staff experience with the current NRSRO no-action letter process.⁵²⁶ The Commission, therefore, estimated that the total one-time burden to the industry as a result of this requirement would be approximately 9,000 hours.⁵²⁷

The Commission did not receive any comments on these specific estimates. The Commission notes that Form NRSRO has been changed to ease the burden of completing the Form. For example, applicants will not be required to provide information about each credit analyst, credit analyst supervisor, and compliance

⁵²³ 15 U.S.C. 78o-7(a)(1).

⁵²⁴ See paragraphs (a), (c), and (h) of Rule 17g-1.

⁵²⁵ 15 U.S.C. 78o-7.

⁵²⁶ As a comparison, the proposing release noted that Form ADV, the registration form for investment advisers, is estimated to take approximately 22.25 hours to complete. See Investment Advisor Act of 1940 Release No. 2266 (July 20, 2004). The Commission estimated that the hour burden under Rule 17g-1 would be greater, given the substantially larger amount of information that will be required in Form NRSRO.

⁵²⁷ 300 hours x 30 entities = 9,000 hours.

employee that assists the designated compliance officer. As discussed above, we developed these estimates based on the rules as proposed. We continue to believe the estimates are appropriate for the rules as now modified. Indeed, because we have in a variety of respects narrowed the requirements of the rules, we believe the estimates are likely to be conservative. We also note that NRSROs with small staffs will be less impacted by these modifications.

The Commission also noted that an NRSRO likely would engage outside counsel to assist it in the process of completing and submitting a Form NRSRO. The Commission estimated that the amount of time an outside attorney will spend on this work would depend on the size and complexity of the NRSRO. Therefore, the Commission estimated that, on average, an outside counsel would spend approximately 40 hours assisting an NRSRO in preparing its application for registration for a one-time aggregate burden to the industry of 1,200 hours.⁵²⁸ The Commission further estimated that this work would be split between a partner and associate, with an associate performing a majority of the work. Therefore, the Commission estimated that the average hourly cost for an outside counsel would be approximately \$400 per hour. For these reasons, the Commission estimated that the average one-time cost to an NRSRO would be \$16,000⁵²⁹ and the one-time cost to the industry would be \$480,000.⁵³⁰ The Commission did not receive any comments on these specific estimates and continues to

⁵²⁸ 40 hours x 30 entities = 1,200 hours.

⁵²⁹ \$400 per hour x 40 hours = \$16,000.

⁵³⁰ \$16,000 x 30 NRSROs = \$480,000.

believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

Rule 17g-1 requires that an NRSRO registered for fewer than the five classes of credit ratings listed in Section 3(a)(62)(B) of the Exchange Act apply to be registered for an additional class by furnishing an amendment on a completed Form NRSRO.⁵³¹ The Commission estimated that it would take an NRSRO substantially less time to update the Form NRSRO for this purpose than to prepare the initial application. For example, much of the information on the Form and many of the Exhibits would still be current and not have to be updated. Based on the burden estimate to complete a Form ADV, the Commission estimated that furnishing an application on Form NRSRO for this purpose would take an average of approximately 25 hours per NRSRO.⁵³²

The Commission further estimated based on staff experience that approximately five of the 30 credit rating agencies expected to register with the Commission would apply to register for additional classes of credit ratings within the first year. The Commission explained that almost all NRSROs would initially apply to register for the first three classes of credit ratings identified in the definition of NRSRO: (1) financial institutions, brokers, or dealers; (2) insurance companies; and (3) corporate issuers.⁵³³ These are the most common types of credit ratings issued, particularly since some credit rating agencies limit their credit ratings to domestic companies. The Commission

⁵³¹ See paragraphs (c), (d), and (h) of Rule 17g-1.

⁵³² As noted above, the Commission's burden estimate for Form ADV is approximately 22.25 hours to complete. See Investment Advisor Act of 1940 Release No. 2266 (July 20, 2004).

⁵³³ Section 3(a)(62)(B) of the Exchange Act (15 U.S.C. 78c(a)(62)(B)).

explained that, after these three classes, the next largest class of credit ratings for which most NRSROs would be registered would be for credit ratings with respect to issuers of government securities, municipal securities, and foreign government securities.⁵³⁴ These types of credit ratings take additional expertise. Finally, the Commission explained that the class of credit ratings for which the least number of NRSROs would be registered would be credit ratings of issuers of asset-backed securities (as that term defined in 17 CFR 229.1101(c)).⁵³⁵ This assumption was based on the fact that determining a credit rating for an asset-backed security takes specialized expertise beyond that for determining credit ratings of corporate issuers and obligors. For example, it requires analysis of complex legal structures.

For these reasons, the Commission anticipated that some NRSROs might register for less than all five classes of credit ratings. Moreover, these NRSROs, in time, may develop their businesses to include issuing credit ratings in a class for which they are not initially registered. Based on staff experience, the Commission estimated that approximately five of the 30 NRSROs would apply to add another class of credit ratings to their registration within the first year. Therefore, given the 25 hour per NRSRO average burden estimate, the total aggregate one-time burden to the industry for filing the amended Form NRSRO to change the scope of registration was estimated be approximately 125 hours.⁵³⁶ The Commission did not receive any comments on these

⁵³⁴ Section 3(a)(62)(B)(v) of the Exchange Act (15 U.S.C. 78c(a)(62)(B)(v)).

⁵³⁵ Section 3(a)(62)(B)(iv) of the Exchange Act (15 U.S.C. 78c(a)(62)(B)(iv)).

⁵³⁶ 25 hours x 5 NRSROs = 125 hours.

specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

Rule 17g-1 requires a credit rating agency to provide the Commission with a written notice if it intends to withdraw its application prior to final Commission action.⁵³⁷ Based on staff experience, the Commission estimated that one credit rating agency per year would withdraw a Form NRSRO prior to final Commission action on the application and, consequently, would furnish a notice of its intent to withdraw the application. Based on current estimates for a broker-dealer to file a notice under Rule 17a-11, the Commission estimated the average burden to an NRSRO to furnish the notice of withdrawal would be one hour.⁵³⁸ Thus, the Commission estimated that the aggregate annual burden to the industry of providing a notice of withdrawal prior to final Commission action would be one hour per year.⁵³⁹ The Commission did not receive any comments on these specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

Section 15E(b)(1) of the Exchange Act requires an NRSRO to promptly amend its application for registration if any information or document provided in the application becomes materially inaccurate.⁵⁴⁰ Rule 17g-1 requires an NRSRO to comply with this statutory requirement by furnishing the amendment on Form NRSRO.⁵⁴¹ Based on staff

⁵³⁷ See paragraph (d) of Rule 17g-1.

⁵³⁸ See Exchange Act Release No. 49830 (June 8, 2004); see also 17 CFR 240.17a-11.

⁵³⁹ 1 hour x 1 entity = 1 hour.

⁵⁴⁰ 15 U.S.C. 78o-7(b)(1).

⁵⁴¹ See paragraph (e) of Rule 17g-1.

experience, the Commission estimated that an NRSRO would file two amendments of its Form NRSRO per year on average. Furthermore, for the reasons discussed above, the Commission estimated that it would take an average of approximately 25 hours to prepare and furnish an amendment on Form NRSRO.⁵⁴² Therefore, the Commission estimated that the total aggregate annual burden to the industry to update Form NRSRO would be approximately 1,500 hours each year.⁵⁴³ The Commission did not receive any comments on these specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

Section 15E(b)(2) of the Exchange Act requires an NRSRO to furnish an annual certification.⁵⁴⁴ Rule 17g-1 requires an NRSRO to furnish the annual certification on Form NRSRO.⁵⁴⁵ The Commission estimated that the annual certification, generally, would take less time than an amendment to Form NRSRO because it would be done on a regular basis (albeit yearly) and, therefore, become more a matter of routine over time. Consequently, the Commission estimated that the burden would be similar to that of broker-dealers filing the quarterly reports required under Rules 17h-1T and 17h-2T, which is approximately 10 hours per year for each respondent.⁵⁴⁶ Therefore, the Commission estimated it would take an NRSRO approximately 10 hours to complete the annual certification for a total aggregate annual hour burden to the industry of 300

⁵⁴² This estimate also is based on the estimates for the collection of information on Rule 17i-2 under the Exchange Act (17 CFR 240.17i-2).

⁵⁴³ 25 hours per amendment x 2 amendments x 30 NRSROs = 1,500 hours.

⁵⁴⁴ 15 U.S.C. 78o-7(b)(2).

⁵⁴⁵ See paragraph (f) of Rule 17g-1.

⁵⁴⁶ See 17 CFR 240.17h-1T and 2T.

hours.⁵⁴⁷ The Commission did not receive any comments on these specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

Rule 17g-1 has been modified to require an NRSRO to furnish the Commission with a withdrawal of registration on Form NRSRO.⁵⁴⁸ As proposed, the Commission required a written notice without prescribing the form of the notice. The Commission expects that the furnishing of these withdrawals will be rare, given that only 30 credit rating agencies are expected to register. Based on staff experience, the Commission estimates that one NRSRO per year will withdraw its registration. Further, the instructions to Form NRSRO provide that only the items on the Form are required to be completed in the case of a withdrawal; an NRSRO would not be required to update or attach any of the information required in the Exhibits. Based on current estimates for a broker-dealer to file a notice under Rule 17a-11, the Commission estimates the average burden to an NRSRO to furnish the notice of withdrawal would be one hour.⁵⁴⁹ Thus, the Commission estimates that the aggregate annual burden to the industry of providing a notice of withdrawal prior to final Commission action would be one hour per year.⁵⁵⁰

Section 15E(a)(3) of the Exchange Act requires an NRSRO to make certain information and documents submitted in its application publicly available on its Web

⁵⁴⁷ 10 hour x 30 NRSROs = 300 hours.

⁵⁴⁸ See paragraph (g) of Rule 17g-1.

⁵⁴⁹ See Exchange Act Release No. 49830 (June 8, 2004); see also 17 CFR 240.17a-11.

⁵⁵⁰ 1 hour x 1 entity = 1 hour.

site, or through another comparable, readily accessible means.⁵⁵¹ Rule 17g-1 requires that this be done within 10 business days of the granting of an NRSRO's registration or the furnishing of an amendment, annual certification, or withdrawal.⁵⁵² The Commission believed that each NRSRO already would have a Web site and would choose to use its Web site to comply with Section 15E(a)(3) of the Exchange Act (15 U.S.C. 78o-7(a)(3)). Therefore, based on staff experience, the Commission estimated that, on average, an NRSRO would spend 30 hours to disclose the information in its initial application on its Web site and, thereafter, 10 hours per year to disclose updated information. Accordingly, the total aggregate one-time burden to the industry to make Form NRSRO publicly available would be 900 hours⁵⁵³ and the total aggregate annual burden would be 300 hours.⁵⁵⁴ The Commission did not receive any comments on these specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

2. Rule 17g-2

Section 17(a)(1) of the Exchange Act (as amended by the Rating Agency Act)⁵⁵⁵ provides the Commission with authority to require an NRSRO to make and maintain such records as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the

⁵⁵¹ 15 U.S.C. 78o-7(a)(3).

⁵⁵² See Rule 17g-1(i).

⁵⁵³ 30 hours x 30 NRSROs = 900 hours.

⁵⁵⁴ 10 hours x 30 NRSROs = 300 hours.

⁵⁵⁵ See Section 5 of the Rating Agency Act.

Exchange Act.⁵⁵⁶ Rule 17g-2 implements this rulemaking authority by requiring an NRSRO to make and keep current certain records relating to its business. In addition, the rule requires an NRSRO to preserve these and other records for certain prescribed time periods. This rule is designed to assist the Commission in monitoring, through its examination function, whether NRSROs are complying with the requirements of Section 15E of the Exchange Act⁵⁵⁷ and the regulations thereunder. The Commission estimated that the average one-time burden of implementing a recordkeeping system to comply with this rule would be approximately 300 hours. This estimate was based on the Commission's experience with, and burden estimates for, certain recordkeeping requirements of consolidated supervised entities ("CSEs") subject to Commission supervision.⁵⁵⁸

The Commission also estimated that an NRSRO might be required to purchase recordkeeping system software to establish a recordkeeping system in conformance with the rule. The Commission estimated that the cost of the software would vary based on the size and complexity of the NRSRO. Also, the Commission estimated that some NRSRO's would not require such software because they already have adequate recordkeeping systems or, given their small size, such software would not be necessary. Based on these estimates, the Commission estimated that the average cost for recordkeeping software across all NRSROs would be approximately \$1000 per firm. Therefore, the one-time cost to the industry would be \$30,000.

⁵⁵⁶ See Section 5 of the Rating Agency Act and 15 U.S.C 78q(a)(1).

⁵⁵⁷ 15 U.S.C. 78o-7.

⁵⁵⁸ See 17 CFR 15c3-1g.

Additionally, the Commission estimated that the average annual amount of time that an NRSRO would spend to make and maintain these records would be approximately 254 hours per year. The estimate for annual hours was based on the Commission's present estimate for the amount of time it would take a broker-dealer to comply with the recordkeeping rule, Rule 17a-4.⁵⁵⁹ Therefore, the Commission estimated that the one-time hour burden for making and preserving the records under proposed Rule 17g-2 would be approximately 9,000 hours⁵⁶⁰ and the total annual hour burden would be approximately 7,620 hours per year.⁵⁶¹

Rule 17g-2 also requires an NRSRO that uses a third-party record custodian to furnish the Commission with an undertaking from the custodian. Based on staff experience, the Commission estimated that approximately five NRSROs would file this undertaking on a one-time basis. The Commission estimated, based on staff experience, it would take an NRSRO approximately 10 hours to process an undertaking prior to

⁵⁵⁹ See 17 CFR 240.17a-4 (recordkeeping requirements for broker-dealers). This rule has previously has been subject to notice and comment and has been approved by OMB. The Commission noted in the proposing release that Rule 17g-2 is based, in part, on Exchange Act Rules 17a-3 (17 CFR 240.17a-3) and 17a-4 (17 CFR 240.17a-4). The annual hour burden estimate for the rule, however, was based only on the PRA estimate for Rule 17a-4. The rule requires substantially less records to be made and maintained than Rules 17a-3 and 17a-4. Therefore, the Commission based its estimate only on the estimate for Rule 17a-4 (as opposed to Rules 17a-3 and 17a-4 combined).

⁵⁶⁰ 300 hours x 30 NRSROs = 9,000 hours.

⁵⁶¹ 254 hours x 30 NRSROs = 7,620 hours.

furnishing it to the Commission.⁵⁶² Therefore, the Commission estimated the total one-time hour burden for these undertakings would be 50 hours.⁵⁶³

The Commission did not receive any comments on these specific burden estimates. The Commission notes that Rule 17g-2 has been modified in certain respects that decrease the burden, but also in other respects that will increase burden. For example, requirements to make records identifying the methodology used to determine each credit rating and how the credit rating was made readily available have been eliminated. Further, the retention periods for all the records have been harmonized and the requirement for a non-resident NRSRO to furnish an undertaking has been eliminated. On the other hand, the rule now requires an NRSRO to document its methodologies for determining credit ratings and, if applicable, to make and retain certain records relating to practices with respect to rating structured products. The Commission believes that these adjustments will largely offset each other or result in a net decrease in burden. For example, the elimination of the requirement to identify the methodology used to determine a credit rating would have impacted all NRSROs and required them to make a record for each credit rating (which could be in the many thousands). Conversely, the requirements with respect to structured products only will impact NRSROs that rate these types of securities, which the Commission estimates is less than five. While the Commission could reduce its burden estimate, it is taking a conservative approach to the net results of these changes. For these reasons, the Commission is retaining the rule's overall burden estimates without revision.

⁵⁶² The estimated 10 hours includes drafting, legal review and receiving corporate authorization to file the undertaking with the Commission.

⁵⁶³ 10 hours x 5 NRSROs = 50 hours.

3. Rule 17g-3

Section 15E(k) of the Exchange Act requires an NRSRO to furnish to the Commission, on a confidential basis and at intervals determined by the Commission, such financial statements and information concerning its financial condition that the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁵⁶⁴ The section also provides that the Commission may, by rule, require that the financial statements be certified by an independent public accountant.⁵⁶⁵

Rule 17g-3 implements this statutory provision by requiring an NRSRO to furnish financial reports to the Commission. We estimated that, on average, it would take an NRSRO approximately 200 hours to prepare for and file the annual financial reports. This estimate was based on the current PRA estimates used for CSEs under Appendix G to Exchange Act Rule 15c3-1, as well the PRA estimates for supervised investment bank holding companies under Rule 17i-5.⁵⁶⁶ Therefore, the Commission estimated that the total annual hour burden to prepare and furnish annual audited financial statements with the Commission would be approximately 6,000 hours.⁵⁶⁷

To comply with Rule 17g-3, an NRSRO would be required to engage the services of independent public accountant. The Commission estimated that cost of hiring an accountant would vary substantially based on the size and complexity of the NRSRO.

⁵⁶⁴ 15 U.S.C. 78o-7(k). An applicant can request that the Commission keep this information confidential. See 17 CFR 200.80 and 17 CFR 200.83.

⁵⁶⁵ Id.

⁵⁶⁶ See 17 CFR 240.15c3-1g and 17 CFR 240.17i-5.

⁵⁶⁷ 200 hours x 30 NRSROs = 6,000 hours.

For example, the Commission noted that, based on staff experience, the annual audit costs of a small broker-dealer generally range from \$3,000 to \$5,000 per year. The Commission estimated that the annual audit costs for a small NRSRO would be comparable. The costs for a large NRSRO would be much greater. However, many of these firms already are audited by a public accountant for other regulatory purposes. For these reasons, the Commission estimated that the average annual cost across all NRSROs to engage the services of an independent public accountant would be approximately \$15,000. Therefore, the annual cost to the industry would be \$450,000.⁵⁶⁸

The Commission did not receive any comments on these specific estimates. The Commission notes that Rule 17g-3 has been modified to decrease the burden. For example, the requirement to comply with all provisions of Regulation S-X has been eliminated, as has the requirement to have the information in the proposed schedules audited. As discussed above, we developed these estimates based on the rule as proposed. We continue to believe the estimates are appropriate for the rule as now modified. Indeed, because we have in a variety of respects narrowed the requirements of the rule, we believe the estimates are likely to be conservative.

4. Rule 17g-4

Section 15E(g)(1) of the Exchange Act⁵⁶⁹ requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act.⁵⁷⁰ Section 15E(g)(2) of the

⁵⁶⁸ \$15,000 x 30 NRSROs = \$450,000.

⁵⁶⁹ 15 U.S.C. 78o-7(g)(1).

⁵⁷⁰ 15 U.S.C. 78a et seq.

Exchange Act provides that the Commission shall adopt rules requiring an NRSRO to establish specific policies and procedures to prevent the misuse of material, non-public information.⁵⁷¹ Rule 17g-4 implements this statutory provision by requiring that an NRSRO's policies and procedures established pursuant to Section 15E(g)(1) of the Exchange Act⁵⁷² include three specific types of procedures.

The Commission assumed that most credit rating agencies already have procedures in place to address the specific misuses of material nonpublic information identified in Rule 17g-4.⁵⁷³ Nonetheless, the Commission anticipated that some NRSROs might need to modify their procedures to comply with the rule. Based on staff experience, the Commission estimated that it would take approximately 50 hours for an NRSRO to establish procedures in conformance with the rule for a total one-time burden of 1,500 hours.⁵⁷⁴ The Commission did not receive any comments on these specific estimates and continues to believe that they are appropriate. Therefore, the Commission is retaining these estimates without revision.

E. Collection of Information Is Mandatory

These recordkeeping and notice requirements are mandatory.

F. Confidentiality

Pursuant to section 15E(a)(1)(B) of the Exchange Act, certain information collected in Form NRSRO required under Rule 17g-1(a) will not be confidential.

⁵⁷¹ 15 U.S.C. 78o-7(g)(2).

⁵⁷² 15 U.S.C. 78o-7(g)(1).

⁵⁷³ For example, the IOSCO Code requires credit rating agencies to develop such procedures.

⁵⁷⁴ 50 hours x 30 NRSROs = 1,500 hours.

However, credit rating agencies and NRSROs may seek confidential treatment of information furnished to the Commission under existing rules, and the Commission will keep this information confidential to the extent permitted by law. The books and records information collected under Rules 17g-2 and 17g-4 will be stored by the NRSRO and made available to the Commission and its representatives as required in connection with examinations, investigations, and enforcement proceedings.

The information collected under Rule 17g-3 (the annual financial reports) will be generated from the internal records of the NRSRO. Pursuant to Section 15E(k) of the Exchange Act, the annual financial reports will be furnished to the Commission on a confidential basis, to the extent permitted by law.⁵⁷⁵

G. Record Retention Period

Paragraph (c) of Rule 17g-2 requires an NRSRO to retain the records for at least three years.

H. Request for Comment

The Commission requested comment on the collections of information in order to: (1) 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; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection

⁵⁷⁵ 15 U.S.C. 78o-7(k).

techniques or other forms of information technology; and (5) evaluate whether the proposed rules would have any effects on any other collection of information not previously identified in this section.

VI. COSTS AND BENEFITS OF THE RULES

The Commission is sensitive to the costs and benefits that result from its rules. The Commission identified certain costs and benefits arising from these rules and requested comment on all aspects of the cost-benefit analysis contained therein, including identification and assessment of any costs and benefits not discussed in the analysis.⁵⁷⁶ The Commission sought comment and data on the value of the benefits identified. The Commission also elicited comment on the accuracy of the cost estimates in each section of the cost-benefit analysis, and requested those commenters to provide data so the Commission could improve the cost estimates, including identification of industry statistics relied on by commenters to reach conclusions on cost estimates. The Commission also sought comment on the extent to which costs were attributable to

⁵⁷⁶ For the purposes of this cost/benefit analysis, the Commission is using salary data from the SIA Report on Management and Professional Earnings in the Securities Industry 2005 (“SIA Management Report 2005”), which provides base salary and bonus information for middle-management and professional positions within the securities industry. The positions in the report are divided into the following categories: Accounting, Administration & Finance, Compliance, Customer Service, Floor/Trading, Human Resources Management, Internal Audit, Legal, Marketing/Corporate Communications, New Business Development, Operations, Research, Systems/Technology, Wealth Management, and Business Continuity Planning. The Commission believes that the salaries for these securities industry positions would be comparable to the salaries of similar positions in the credit rating industry. The Commission also notes that it is using salaries for New York-based employees, which tend to be higher than the salaries for comparable positions located outside of New York. This conservative approach is intended to capture unforeseen costs. Finally, the salary costs derived from the SIA Management Report 2005 and referenced in this cost benefit section, are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

requirements set forth in Section 15E of the Exchange Act,⁵⁷⁷ rather than the rules.

Finally, the Commission requested estimates and views regarding the costs and benefits for particular types of market participants, as well as any other costs or benefits that might result from the rules.

As discussed below, the Commission received very limited comment on the cost-benefit analysis in the proposing release. Except as discussed below, the Commission continues to believe that the specific estimates are appropriate and is retaining these estimates generally without revision.

A. Benefits

The purposes of the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”)⁵⁷⁸ are to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.⁵⁷⁹ As the Senate Report states, the Rating Agency Act establishes “fundamental reform and improvement of the designation process,” and “eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs.”⁵⁸⁰

To these ends, the Rating Agency Act establishes – through statutory provisions and the grant of Commission rulemaking authority – a regulatory program for credit

⁵⁷⁷ 15 U.S.C. 78o-7.

⁵⁷⁸ Pub. L. No. 109-291 (2006).

⁵⁷⁹ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”).

⁵⁸⁰ Id.

rating agencies opting to have their credit ratings qualify for purposes of laws and rules using the term “NRSRO.” Specifically, the Rating Agency Act sets out a voluntary mechanism for credit rating agencies to register with the Commission as an NRSRO.⁵⁸¹ It requires an NRSRO to make public certain information to help users of credit ratings assess the NRSRO’s credibility and compare the NRSRO with other NRSROs.⁵⁸² The Rating Agency Act also requires an NRSRO to furnish the Commission with periodic financial reports.⁵⁸³ Further, the Rating Agency Act requires an NRSRO to implement policies to manage the handling of material non-public information and conflicts of interest.⁵⁸⁴ Pursuant to authority under the Rating Agency Act, the Commission must prohibit certain acts and practices the Commission finds to be unfair, coercive, or abusive.⁵⁸⁵

The rules the Commission is adopting under the Rating Agency Act are being issued pursuant to specific statutory mandates and grants of rulemaking authority. They are designed to further the goals of the Rating Agency Act, including fostering “competition in the credit rating agency business.”⁵⁸⁶ The practice of identifying NRSROs through staff no-action letters has been criticized as a process that lacks

⁵⁸¹ Section 15E of the Exchange Act (15 U.S.C. 78o-7).

⁵⁸² Sections 15E(a)(1) and (b)(1) of the Exchange Act (15 U.S.C. 78o-7(a)(1) and (b)(1)).

⁵⁸³ Section 15E(k) of the Exchange Act (15 U.S.C. 78o-7(k)).

⁵⁸⁴ Sections 15E(g) and (h) of the Exchange Act (15 U.S.C. 78o-7(g) and (h)).

⁵⁸⁵ Section 15E(i) of the Exchange Act (15 U.S.C. 78o-7(i)).

⁵⁸⁶ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”).

transparency and creates a barrier for credit rating agencies seeking wider recognition and market share. The Commission believes that these rules further the goal of increasing competition because they provide credit rating agencies with a transparent process to apply for registration as an NRSRO that does not favor a particular business model or larger, established firms. This will make it easier for more credit rating agencies to apply for registration. Increased competition in the credit ratings business could lower the cost to issuers, obligors, and underwriters of obtaining credit ratings.

In addition, the Rating Agency Act requires NRSROs to make their credit ratings and information about themselves available to the public. Part of the Rating Agency Act's definition of "credit rating agency" is that the entity must be in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee.⁵⁸⁷ Under the Rating Agency Act and the rules adopted thereunder, an NRSRO will be required to disclose information about its credit ratings performance statistics, its methods for determining credit ratings, its organizational structure, its procedures to prevent the misuse of material non-public information, the conflicts of interest that arise from its business activities, its code of ethics, and the qualifications of its credit analysts and credit analyst supervisors. The Commission believes that these disclosures will allow users of the credit ratings to compare the credit ratings quality of different NRSROs. Although the information an NRSRO will provide on its Form NRSRO and to comply with the rules cannot substitute for an investor's due diligence in evaluating a credit rating, it will aid investors by providing a publicly accessible foundation of basic information about an NRSRO.

⁵⁸⁷ Section 3(a)(61) of the Exchange Act (15 U.S.C. 78c(a)(61)).

In addition, the rules implement provisions of the Rating Agency Act that are designed to improve the integrity of NRSROs. For example, the registration of a credit rating agency as an NRSRO will allow the Commission to conduct regular examinations of the credit rating agency to evaluate compliance with the regulatory scheme set forth in Section 15E of the Exchange Act⁵⁸⁸ and the rules thereunder and will subject an NRSRO to disclosure, recordkeeping, and annual financial reporting requirements, as well as requirements regarding the prevention of misuse of material, nonpublic information, the management of conflicts of interest, and certain prohibited acts and practices. Increased confidence in the integrity of NRSROs and the credit ratings they issue could promote participation in the securities markets. Better quality ratings could also reduce the likelihood of an unexpected collapse of a rated issuer or obligor, reducing risks to individual investors and to the financial markets. In addition to improving the quality of credit ratings, increased oversight of NRSROs could increase the accountability of an NRSRO to its subscribers, investors, and other persons who rely on the credibility and objectivity of credit ratings in making an investment decision.

Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO. The rule requires a credit rating agency to apply for registration using Form NRSRO. Form NRSRO requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act and certain additional information.⁵⁸⁹ The additional information will assist the Commission in making the assessment regarding financial and managerial resources required under

⁵⁸⁸ 15 U.S.C. 78o-7.

⁵⁸⁹ See Section 15E(a)(1)(B) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)).

Section 15E(a)(2)(C)(ii)(I) of the Exchange Act.⁵⁹⁰ This section directs the Commission to grant a credit rating agency's application for registration as an NRSRO unless, among other things, the Commission finds that the applicant does not have adequate financial and managerial resources to consistently issue ratings with integrity and to materially comply with its procedures and methodologies disclosed under Sections 15E(a)(1)(B) of the Exchange Act⁵⁹¹ and with the requirements in Sections 15E(g), (h), (i) and (j) of the Exchange Act.⁵⁹² Certain other additional information required to be made public will assist users of credit ratings in assessing the credibility of the NRSRO and in comparing the NRSRO with other NRSROs.

Rule 17g-2 implements the Commission's recordkeeping and rulemaking authority under Section 17(a) of the Exchange Act⁵⁹³ by requiring an NRSRO to make and retain certain records related to its business as a credit rating agency. This recordkeeping rule will assist the Commission in monitoring whether an NRSRO is complying with provisions of Section 15E of the Exchange Act and the rules thereunder by requiring information about each NRSRO's financial condition, management, and operations. This information will permit the Commission to observe differences between NRSROs and changes over time in individual NRSROs. The information also will permit the Commission to review whether an NRSRO is operating consistently with

⁵⁹⁰ See 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

⁵⁹¹ 15 U.S.C. 78o-7(a)(1)(B).

⁵⁹² 15 U.S.C. 78o-7(g), (h), (i) and (j).

⁵⁹³ 15 U.S.C. 78q(a)(1).

the methodologies and procedures it establishes to determine credit ratings and its policies and procedures designed to ensure the impartiality of its credit ratings.

Section 15E(k) of the Exchange Act requires an NRSRO to furnish to the Commission, on a confidential basis and at intervals determined by the Commission, such financial statements and information concerning its financial condition that the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁵⁹⁴ The section also provides that the Commission may, by rule, require that an independent public accountant certify the financial statements.⁵⁹⁵ Rule 17g-3 implements this rulemaking authority by requiring an NRSRO to furnish annual financial reports to the Commission. This rule will enhance Commission oversight of an NRSRO. Specifically, it will aid the Commission in monitoring whether the initiation of a proceeding under Section 15E(d) of the Exchange Act will be appropriate because the NRSRO “fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.”⁵⁹⁶ In addition, the financial reports also will assist the Commission in monitoring potential conflicts of interests of a financial nature arising from the operation of an NRSRO.⁵⁹⁷

⁵⁹⁴ 15 U.S.C. 78o-7(k).

⁵⁹⁵ Id.

⁵⁹⁶ 15 U.S.C. 78o-7(d).

⁵⁹⁷ See, e.g., Rule 17g-5(c)(1) prohibiting an NRSRO from issuing or maintaining a credit rating for a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the NRSRO’s total revenue for the year.

Section 15E(g)(1) of the Exchange Act⁵⁹⁸ requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act.⁵⁹⁹ Section 15E(g)(2) of the Exchange Act provides that the Commission shall adopt rules requiring an NRSRO to establish specific policies and procedures to prevent the misuse of material, nonpublic information.⁶⁰⁰ Rule 17g-4 implements this statutory provision by requiring that an NRSRO's policies and procedures established pursuant to Section 15E(g)(1) of the Exchange Act⁶⁰¹ include three specific types of procedures. These specific procedures establish a baseline for the type of procedures an NRSRO must implement to meet the statutory requirement in Section 15E(g) of the Exchange Act.⁶⁰² By providing this baseline, the rule is designed to ensure that an NRSRO establishes adequate procedures and controls to protect material nonpublic information.

Rule 17g-5 implements Section 15E(h)(2) of the Exchange Act⁶⁰³ by requiring an NRSRO to disclose and manage certain conflicts of interest, as well as specifically prohibiting other conflicts of interest. This rule will promote the disclosure and management of conflicts of interest required by Sections 15E(a)(1)(B)(vi) and 15E(h) of

⁵⁹⁸ 15 U.S.C. 78o-7(g)(1).

⁵⁹⁹ 15 U.S.C. 78a et seq.

⁶⁰⁰ 15 U.S.C. 78o-7(g)(2).

⁶⁰¹ 15 U.S.C. 78o-7(g)(1).

⁶⁰² 15 U.S.C. 78o-7(g).

⁶⁰³ 15 U.S.C. 78o-7(h)(2).

the Exchange Act and mitigate potential undue influences on an NRSRO's credit rating process.⁶⁰⁴

Rule 17g-6 prohibits an NRSRO from engaging in certain unfair, abusive, or coercive acts or practices. These prohibitions are designed to enhance the integrity of NRSROs, promote competition and fulfill a statutory mandate.

The Commission requested comment on available metrics to quantify these benefits and any other benefits the commenter may identify, including the identification of sources of empirical data that could be used for such metrics. The Commission did not receive any comments in response to this request.

B. Costs

The Rating Agency Act requires that the rules and regulations that the Commission may prescribe "be narrowly tailored" to meet its requirements.⁶⁰⁵ The rules being adopted by the Commission are designed to adhere to this statutory mandate and, thereby, keep compliance costs as low as possible.

The cost of compliance to a given NRSRO will depend on its size and the complexity of its business activities. As discussed above, the size and complexity of credit rating agencies varies significantly. Therefore, it is difficult to quantify a cost per NRSRO. Instead, the Commission provided estimates of the average cost per NRSRO taking into consideration the range in size and complexity of NRSROs and the fact that many already may have established policies, procedures, and recordkeeping systems and processes that will comply substantially with the requirements.

⁶⁰⁴ 15 U.S.C. 78o-7(a)(1)(B)(vi) and (h).

⁶⁰⁵ 15 U.S.C. 78o-7(c)(2).

The Commission believes that larger NRSROs generally already have established written policies and procedures and recordkeeping systems that will comply with a substantial portion of the requirements in the rules. Many of the requirements in the rules are consistent with the IOSCO Code principles, which a number of credit rating agencies (including the largest) have implemented. These firms will be required to augment or modify existing policies and procedures and recordkeeping systems to comply with the rules (rather than establish new ones). Some smaller credit rating agencies also have implemented the policies, procedures, and recordkeeping systems necessary to comply with the rules. Moreover, given their smaller size and simpler structure, smaller entities will require less effort and incur less cost to comply with a substantial portion of the requirements in these rules.

For these reasons, the cost estimates represent the average cost across all NRSROs (regardless of size) and take into account that many firms will only be required to augment existing policies, procedures, and recordkeeping systems and processes to come into compliance with the rules. Furthermore, as discussed with respect to the Paperwork Reduction Act of 1995 (“PRA”),⁶⁰⁶ the Commission is requiring additional information in Form NRSRO beyond that prescribed in Section 15E(1)(B) of the Exchange Act.⁶⁰⁷ Therefore, the cost estimates for Rule 17g-1 include estimates that arise from requirements imposed by Section 15E of the Exchange Act.⁶⁰⁸ The intent is to quantify the incremental burden of complying with these statutory requirements as a

⁶⁰⁶ 44 U.S.C. 3501 et seq. 5 CFR 1320.11.

⁶⁰⁷ 15 U.S.C. 78o-7(a)(1)(B).

⁶⁰⁸ 15 U.S.C. 78o-7.

result of the additional information that will be required under Rule 17g-1. Thus, those estimates do not seek to capture costs that are solely attributable to requirements in Section 15E of the Exchange Act.⁶⁰⁹

The Commission requested commenters to provide data for the costs that would be solely attributable to the requirements of Section 15E of the Exchange Act. The Commission received one comment from an entity that the overall cost of complying with the rules would be \$207,515.⁶¹⁰ The commenter did not provide any further detail on how these costs would be solely attributable to the Commission's proposed rules (as opposed to provisions of the Rating Agency Act).⁶¹¹ The commenter also did not identify the specific costs that would arise from each discreet rule provision.⁶¹² The Commission believes that the estimated costs the commenter would incur if registered as an NRSRO are included in the cost estimates discussed below.

Given the estimates set forth below, the Commission estimates that the total one-time estimated cost to NRSROs resulting from these rule proposals would be

⁶⁰⁹ Id.

⁶¹⁰ See Lacey Letter.

⁶¹¹ Id.

⁶¹² Id.

approximately \$4,936,325⁶¹³ and the total estimated annual cost to NRSROs resulting from these rule proposals would be approximately \$3,955,500 per year.⁶¹⁴

1. Rule 17g-1, Form NRSRO and Instructions to Form NRSRO

Section 15E(a)(1) of the Exchange Act requires a credit rating agency applying for registration with the Commission to furnish an application containing certain specified information and such other information as the Commission prescribes as necessary or appropriate in the public interest or for the protection of investors.⁶¹⁵ Rule 17g-1⁶¹⁶ implements this statutory provision by requiring a credit rating agency to furnish an initial application on a completed Form NRSRO to apply to be registered under section 15E of the Exchange Act.⁶¹⁷

NRSROs will incur costs to register under Section 15E of the Exchange Act and Rule 17g-1.⁶¹⁸ As discussed above with respect to PRA, the Commission estimates that an NRSRO will spend approximately 300 hours to complete and furnish an initial Form NRSRO. Also, as discussed with respect to the PRA, the Commission estimates there will be 30 NRSROs. For these reasons, the Commission estimates that the average one-

⁶¹³ This total is derived from the total one-time costs set forth in the order that they appear in the text: \$2,007,000 + \$480,000 + \$25,625 + \$241,200 + \$1,845,000 + \$30,000 + \$307,500 = \$4,936,325.

⁶¹⁴ This total is derived from the total annual costs set forth in the order that they appear in the text: \$307,500 + \$61,500 + \$80,400 + \$1,562,100 + \$1,494,000 + \$450,000 = \$3,955,500.

⁶¹⁵ 15 U.S.C. 78o-7(a)(1).

⁶¹⁶ See paragraphs (a), (c) and (h) of Rule 17g-1.

⁶¹⁷ 15 U.S.C. 78o-7.

⁶¹⁸ There is no filing fee for a Form NRSRO.

time cost to an NRSRO will be \$66,900⁶¹⁹ and the total aggregate one-time cost to the industry will be \$2,007,000.⁶²⁰

Also, as discussed with respect to the PRA, the Commission anticipates that an NRSRO likely will engage outside counsel to assist in the process of completing and submitting a Form NRSRO. The amount of time an outside attorney will spend on this work will depend on the size and complexity of the NRSRO. Therefore, the Commission estimates that, on average, an outside counsel will spend approximately 40 hours assisting an NRSRO in preparing its application for registration. The Commission further estimates that this work will be split between a partner and associate, with an associate performing a majority of the work. Therefore, the Commission estimates that the average hourly cost for an outside counsel will be approximately \$400 per hour. For these reasons, the Commission estimates that the average one-time cost to an NRSRO will be \$16,000⁶²¹ and the one-time cost to the industry will be \$480,000.⁶²²

Under Rule 17g-1, an NRSRO applying to be registered for an additional class of credit ratings will be required to file an amended Form NRSRO with the Commission.⁶²³ As discussed with respect to the PRA, the Commission estimates, on average, an

⁶¹⁹ The Commission estimates that a credit rating agency will have a senior compliance examiner perform these responsibilities. The SIA Management Report 2005 (Senior Compliance Examiner) indicates that the average hourly cost for a senior compliance examiner is \$223. Therefore, the average one-time cost per NRSRO will be approximately \$66,900 [(300 hours) x (\$223 per/hour)].

⁶²⁰ 30 NRSROs x \$66,900 = \$2,007,000.

⁶²¹ \$400 per hour x 40 hours = \$16,000.

⁶²² \$16,000 x 30 NRSROs = \$480,000.

⁶²³ See paragraph (b) of Rule 17g-1.

NRSRO will spend 25 hours completing and furnishing a Form NRSRO for this purpose. The Commission also estimates with respect to the PRA that five of the 30 NRSROs will apply to register for an additional class of credit ratings. For these reasons, the Commission estimates that the average one-time cost to an NRSRO will be \$5,125⁶²⁴ and the total aggregate one-time cost to the industry will be \$25,625.⁶²⁵

Section 15E(b)(1) of the Exchange Act requires an NRSRO to promptly amend its application for registration if any information or document provided in the application becomes materially inaccurate.⁶²⁶ Rule 17g-1 requires an NRSRO to comply with this statutory requirement by furnishing the amendment on Form NRSRO.⁶²⁷ As discussed with respect to the PRA, the Commission estimates that an NRSRO will furnish two amendments on Form NRSRO per year on average. The Commission also estimates with respect to the PRA that it will take approximately 25 hours to prepare and furnish an amendment and that there will be 30 NRSROs. For these reasons, the Commission

⁶²⁴ The Commission estimates an NRSRO will have a senior compliance person perform these responsibilities. The SIA Management Report 2005 (Compliance Officer) indicates that the average hourly cost for a compliance manager is \$205. Therefore, the average cost to an NRSRO will be \$5,125 [(25 hours for one year) x (\$205)].

⁶²⁵ 5 NRSROs x \$5,125 = \$25,625

⁶²⁶ 15 U.S.C. 78o-7(b)(1).

⁶²⁷ See paragraph (e) of Rule 17g-1.

estimates that the average annual cost to an NRSRO will be \$10,250⁶²⁸ and the total aggregate annual cost to the industry will be \$307,500.⁶²⁹

Section 15E(b)(2) of the Exchange Act requires an NRSRO to furnish an annual certification.⁶³⁰ Rule 17g-1 will require an NRSRO to furnish the annual certification on Form NRSRO.⁶³¹ As discussed with respect to the PRA, the Commission estimates an NRSRO will spend approximately 10 hours per year completing and furnishing the annual certification and that there will be 30 NRSROs. For these reasons, the Commission estimates that the average annual cost to an NRSRO will be \$2,050⁶³² and the total aggregate annual cost to the industry will be \$61,500.⁶³³

Section 15E(a)(3) of the Exchange Act requires an NRSRO to make certain information and documents submitted in its application publicly available on its Web site, or through another comparable, readily accessible means.⁶³⁴ Rule 17g-1 requires

⁶²⁸ Based on the PRA estimates, an NRSRO will spend approximately 50 hours each year updating its application on Form NRSRO (25 hours per amendment x two amendments). The Commission estimates an NRSRO will have a senior compliance person perform these responsibilities. The SIA Management Report 2005 (Compliance Officer) indicates that the average hourly cost for a compliance manager is \$205. Therefore, the total average annual cost to an NRSRO to update its registration on Form NRSRO will be \$10,250 [(50 hours per year) x (\$205 per hour)].

⁶²⁹ \$10,250 x 30 NRSROs = \$307,500.

⁶³⁰ 15 U.S.C. 78o-7(b)(2).

⁶³¹ See paragraph (f) Rule 17g-1.

⁶³² The Commission estimates an NRSRO will have a senior compliance person perform these responsibilities. The SIA Management Report 2005 (Compliance Officer) indicates that the average hourly cost for a compliance manager is \$205. Therefore, the average annual cost will be \$2,050 [(10 hours per year) x (\$205 per hour)].

⁶³³ \$2,050 x 30 NRSROs = \$61,500.

⁶³⁴ 15 U.S.C. 78o-7(a)(3).

that this be done within 10 business days of the granting of an NRSRO's application or the furnishing of an amendment to the form or annual certification.⁶³⁵ As discussed with respect to the PRA, the Commission estimates that the average hour burden for an NRSRO to disclose this information on its Web site will be approximately 30 hours on a one-time basis and 10 hours per year. Furthermore, as discussed with respect to the PRA, the Commission estimates that there will be 30 NRSROs. For these reasons, the Commission estimates that an NRSRO will incur an average one-time cost of \$8,040 and an average annual cost of \$2,680.⁶³⁶ Consequently, the total aggregate one-time cost to the industry will be \$241,200⁶³⁷ and total aggregate annual cost to the industry will be \$80,400 per year.⁶³⁸

The Commission believes the requirements in Rule 17g-1 to furnish a notice on Form NRSRO when an NRSRO withdraws its registration will result in de minimis costs.

The Commission requested comment on these cost estimates. We also requested comment on whether there would be costs in addition to those identified above, such as costs arising from systems changes. Comment also was sought on whether these requirements would impose costs on other market participants, including persons who

⁶³⁵ See paragraph (i) of Rule 17g-1.

⁶³⁶ The Commission estimates that an NRSRO will have a Senior Programmer perform this work. The SIA Management Report 2005 (Senior Programmer) indicates that the average hourly cost for a senior programmer is \$268. Therefore, the average one-time cost will be \$8,040 [(30 hours) x (\$268 per hour)] and the average annual cost will be \$2,680 [(10 hours per year) x (\$268 per hour)].

⁶³⁷ \$8,040 x 30 NRSROs = \$241,200.

⁶³⁸ \$2,680 x 30 NRSROs = \$80,400.

use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

2. Rule 17g-2

Section 17(a)(1) of the Exchange Act⁶³⁹ provides the Commission with authority to require an NRSRO to make and maintain such records as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.⁶⁴⁰ Rule 17g-2 implements this rulemaking authority by requiring an NRSRO to make and preserve specified records related to its credit rating business.

As discussed with respect to the PRA, the Commission estimates that an NRSRO, on average, will spend approximately 300 hours on a one-time basis to establish a recordkeeping system and 254 hours each year updating its books and records. For these reasons, the Commission estimates that an NRSRO will incur an average one-time cost of \$61,500 and an average annual cost of \$52,070.⁶⁴¹

⁶³⁹ See Section 5 of the Rating Agency Act and 15 U.S.C 78q(a)(1).

⁶⁴⁰ Id.

⁶⁴¹ The Commission estimates that an NRSRO will have a compliance manager perform these responsibilities. The SIA Management Report 2005 indicates that the average hourly cost for a compliance manager is \$205. Therefore, the average one-time cost will be \$61,500 [(300 hours) x (\$205 per hour)] and the average annual cost will be \$52,070 [(254 hours per year) x (\$205 per hour)].

Consequently, the total aggregate one-time cost to the industry will be \$1,845,000,⁶⁴² and the total aggregate annual cost to the industry will be \$1,562,100 per year.⁶⁴³

Furthermore, as discussed above with respect to the PRA, the Commission also estimates that an NRSRO may be required to purchase recordkeeping system software to establish a recordkeeping system in conformance with the rule. The Commission estimates that the cost of the software will vary based on the size and complexity of the NRSRO. Also, the Commission estimates that some NRSROs will not require such software because they already have adequate recordkeeping systems or, given their small size, such software will not be necessary. Based on these estimates, the Commission estimates that the average cost for recordkeeping software across all NRSROs will be approximately \$1,000 per firm. Therefore, the one-time cost to the industry will be \$30,000.⁶⁴⁴

The Commission requested comment on these cost estimates. We also requested comment on whether there would be costs in addition to those identified above, such as costs arising from restructuring business practices. Comment also was sought on whether these rules would impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

⁶⁴² \$61,500 x 30 NRSROs = \$1,845,000.

⁶⁴³ \$52,070 x 30 NRSROs = \$1,562,100.

⁶⁴⁴ \$1,000 x 30 NRSROs = \$30,000.

3. Rule 17g-3

Section 15E(k) of the Exchange Act requires an NRSRO to furnish to the Commission, on a confidential basis⁶⁴⁵ and at intervals determined by the Commission, such financial statements and information concerning its financial condition that the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁶⁴⁶ The section also provides that the Commission may, by rule, require that the financial statements be certified by an independent public accountant.⁶⁴⁷

Rule 17g-3 implements this statutory provision by requiring an NRSRO to furnish annual financial reports to the Commission. As discussed above with respect to the PRA, the Commission estimates that an NRSRO, on average, will spend approximately 200 hours per year preparing for and furnishing these financial reports. For these reasons, the Commission estimates that the average annual cost to an NRSRO will be \$49,800⁶⁴⁸ and the total aggregate annual cost to the industry will be \$1,494,000.⁶⁴⁹

As noted above, the average one-time and annual costs to NRSROs will vary

⁶⁴⁵ An applicant can request that the Commission keep this information confidential to the extent permitted by law. See 17 CFR 200.80 and 17 CFR 200.83.

⁶⁴⁶ 15 U.S.C. 78o-7(k).

⁶⁴⁷ Id.

⁶⁴⁸ The Commission estimates that a senior internal auditor will perform these responsibilities. The SIA Management Report 2005 (Senior Internal Auditor) indicates that the average hourly cost for a senior internal auditor is \$249. Therefore, the average annual cost will be \$49,800 [(200 hours per year) x (\$249 per hour)].

⁶⁴⁹ \$49,800 x 30 NRSROs = \$1,494,000.

widely depending on the size and complexity of the NRSRO. Moreover, some large credit rating agencies already prepare audited financial statements in accordance with other regulatory requirements. Nonetheless, these credit rating agencies may be required to make changes to their accounting systems to comply with the requirements in Rule 17g-3. The Commission believes these costs will vary depending on the size and complexity of the NRSRO. The Commission sought comment on the costs that would be incurred to make changes to their accounting systems.

The Commission received one comment in response to this specific request from a large credit rating agency.⁶⁵⁰ The commenter stated that it would cost between \$6 and \$8 million to develop a system that could capture revenues received by the credit rating agency and its affiliates from customers in order to create the list of large customers that could be audited.⁶⁵¹ The Commission notes, as an initial matter, that Section 15E(a)(B)(viii) of the Exchange Act requires an NRSRO to create this list with respect to issuers and subscribers.⁶⁵² Consequently, the costs of developing a system that can capture this information can largely be attributed to the statute. Nonetheless, Rule 17g-3 has been modified in ways that the Commission believes will largely reduce these costs. First, an NRSRO is not required to include revenue received by affiliates that are not part of the credit rating organization in determining this list. Second, the list is now a separate financial report that is not required to be audited. Third, the definition of net revenue was modified to refer to revenues “earned” by the NRSRO (as opposed to

⁶⁵⁰ See Fitch Letter.

⁶⁵¹ Id.

⁶⁵² 15 U.S.C. 78o-7(a)(1)(B)(viii).

revenues “received”). This is designed to provide flexibility so that each NRSRO can define “revenues” consistent with how its accounting system recognizes revenues. The Commission believes these modifications significantly reduce the operational difficulties in determining the list of large customers.

As discussed above with respect to the PRA, an NRSRO will be required to engage the services of independent public accountant to comply with Rule 17g-3. The cost of hiring an account will vary substantially based on the size and complexity of the NRSRO. As the noted above, based on staff experience, the annual audit costs of a small broker-dealer generally range from \$3,000 to \$5,000 a year. As the Commission estimated above, the annual audit costs for a small NRSRO will likely be comparable to the costs incurred by a small broker-dealer. The costs for a large NRSRO will be much greater. However, many of these firms already are audited by a public accountant for other regulatory purposes. For these reasons, the Commission estimates that the average annual cost across all NRSROs to engage the services of an independent public account will be approximately \$15,000. Therefore, the annual cost to the industry will be \$450,000.⁶⁵³

The Commission requested comment on these cost estimates. We also requested comment on whether there would be costs in addition to those identified above. Comment was sought on whether these requirements would impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs. Commenters were asked to identify the metrics and sources of any

⁶⁵³ \$15,000 x 30 NRSROs = \$450,000.

empirical data that supported their costs estimates. Other than the one comment discussed above, the Commission did not receive any comments in response to these requests.

4. Rule 17g-4

Section 15E(g)(1) of the Exchange Act⁶⁵⁴ requires an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act.⁶⁵⁵ Section 15E(g)(2) of the Exchange Act provides that the Commission shall adopt rules requiring an NRSRO to establish specific policies and procedures to prevent the misuse of material, non-public information.⁶⁵⁶ Rule 17g-4 implements this statutory provision by requiring that an NRSRO's policies and procedures established pursuant to Section 15E(g)(1) of the Exchange Act⁶⁵⁷ include three specific types of procedures.

As discussed above with respect to PRA, the Commission estimates that it will take approximately 50 hours for an NRSRO to establish procedures in conformance with the rule and that there will be 30 NRSROs. For these reasons, the Commission estimates

⁶⁵⁴ 15 U.S.C. 78o-7(g)(1).

⁶⁵⁵ 15 U.S.C. 78a et seq.

⁶⁵⁶ 15 U.S.C. 78o-7(g)(2).

⁶⁵⁷ 15 U.S.C. 78o-7(g)(1).

that the average one-time cost to an NRSRO will be \$10,250⁶⁵⁸ and the total aggregate one-time cost to the industry will be \$307,500.⁶⁵⁹

The Commission requested comment on these cost estimates. We also requested comment on whether there would be costs in addition to those identified above, such as costs arising from systems changes and restructuring business practices. Comment also was sought on whether these requirements would impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

5. Rules 17g-5 and 17g-6

Rules 17g-5 and 17g-6 are conduct rules that require NRSROs respectively to avoid certain conflicts of interest and unfair, abusive or coercive acts and practices and, consequently, do not require an NRSRO to make records or reports or create recordkeeping or accounting systems. Moreover, 15E(1)(B)(vi) of the Exchange Act requires an NRSRO to disclose any conflicts of interest. Additionally, Section 15E(h) of the Exchange Act requires an NRSRO establish, maintain, and enforce written policies and procedures reasonable designed to address and manage any conflicts of interest that

⁶⁵⁸ The Commission estimates an NRSRO will have a senior compliance person perform these responsibilities. The SIA Management Report 2005 (Compliance Officer) indicates that the average hourly cost for a compliance manager is \$205. Therefore, the average one-time cost to an NRSRO will be \$10,250 [(50 hours) x (\$205)].

⁶⁵⁹ 30 NRSROs x \$10,250 = \$307,500.

can arise from its business. Therefore, the Commission does not anticipate that Rule 17g-5 will result in any significant incremental costs.

Rules 17g-5 and 17g-6 prohibit respectively certain conflicts of interest and unfair, coercive and abusive acts and practices. The Commission believes that most entities that will become NRSROs do not engage in these types of conflicts, acts and practices. Therefore, the Commission estimates that these rules generally will impose de minimis costs. However, the Commission recognizes that an NRSRO may incur costs related to training employees about the requirements in these rules. It also is possible that the rules may require some NRSROs to restructure their business models or activities. The Commission, therefore, requested comment on such training and restructuring costs. The Commission also requested comment on whether there are any other costs associated with these rules. The Commission did not receive any comments on these specific issues.

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

Under Section 3(f) of the Exchange Act,⁶⁶⁰ the Commission must, when engaging in rulemaking that requires the Commission to consider or determine if an action is necessary or appropriate in the public interest, consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act⁶⁶¹ requires the Commission to consider the anticompetitive effects of any rules the Commission adopts under the Exchange Act. Section 23(a)(2) prohibits the Commission

⁶⁶⁰ 15 U.S.C. 78c(f).

⁶⁶¹ 15 U.S.C. 78w(a)(2).

from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission's view is that the rules will promote efficiency, competition, and capital formation. As discussed above with respect to the costs and benefits of the rules, the primary purpose of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act")⁶⁶² is to foster "competition in the credit rating agency business."⁶⁶³ The practice of identifying NRSROs through staff no-action letters has been criticized as a process that lacks transparency and creates a barrier for credit rating agencies seeking wider recognition and market share. The Commission believes that these rules implementing provisions of the Rating Agency Act further the Rating Agency Act's goal of increasing competition because they will provide credit rating agencies with a transparent process to apply for registration as an NRSRO that does not favor a particular business model or larger, established firms. This will make it easier for more credit rating agencies to apply for registration. Increased competition in the credit ratings business may lower the cost to issuers, obligors, and underwriters of obtaining credit ratings.

In addition, the Rating Agency Act requires NRSROs to make their credit ratings and information about themselves available to the public. Part of the definition of "credit rating agency" in the Rating Agency Act is that the entity must be in the business of issuing credit ratings on the Internet or through another readily accessible means, for

⁶⁶² Pub. L. No. 109-291 (2006).

⁶⁶³ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) ("Senate Report").

free or for a reasonable fee.⁶⁶⁴ Under the Rating Agency Act and the rules adopted thereunder, an NRSRO will be required to disclose information about its credit ratings performance statistics, its methods for determining credit ratings, its organizational structure, its procedures to prevent the misuse of material non-public information, the conflicts of interest that arise from its business activities, its code of ethics, and the qualifications of its credit analysts and credit analyst supervisors. The Commission believes that these disclosures will allow users of the credit ratings to compare the ratings quality of different NRSROs. Although the information an NRSRO will provide on its Form NRSRO and to comply with the rules cannot substitute for an investor's due diligence in evaluating a credit rating, it will aid investors by providing a publicly accessible foundation of basic information about an NRSRO.

In addition, the rules implement provisions of the Rating Agency Act that are designed to improve the integrity of NRSROs. For example, the registration of a credit rating agency as an NRSRO will allow the Commission to conduct regular examinations of the credit rating agency to evaluate compliance with the regulatory scheme set forth in Section 15E of the Exchange Act and the rules thereunder and will subject an NRSRO to disclosure, recordkeeping, and annual audit requirements, as well as requirements regarding the prevention of misuse of material, nonpublic information, the management of conflicts of interest, and certain prohibited acts and practices. Increased confidence in the integrity of NRSROs and the credit ratings they issue may promote participation in the securities markets and facilitate capital formation. Better quality credit ratings could also reduce the likelihood of an unexpected collapse of a rated issuer or obligor, reducing

⁶⁶⁴ Section 3(a)(61) of the Exchange Act (15 U.S.C. 78c(a)(61)).

risks to individual investors and to the financial markets. In addition to improving the quality of credit ratings, increased oversight of NRSROs may increase the accountability of an NRSRO to its subscribers, investors, and other persons who rely on the credibility and objectivity of credit ratings in making an investment decision.

The Commission sought comment on these matters. In particular, the Commission solicited comment on whether the rules would have an adverse effect on competition that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act. In addition, comment was sought on whether the rules would promote efficiency, competition, and capital formation. Commenters were requested to provide empirical data and other factual support for their views, if possible.

The Commission received several comments on how the rules will impact competition.⁶⁶⁵ Many commenters weighing in on this issue stated that the rules will further the goals of the Rating Agency Act by fostering more competition.⁶⁶⁶ Other commenters stated that the rules create undue burden and would be a barrier to entry for new or smaller credit rating agencies.⁶⁶⁷ In response to this concern, the Commission notes that the rules have been modified in ways designed to decrease burden. Some of these modifications address specific issues raised by the commenters. For example, one commenter stated that the requirements to provide background information on each credit analyst and for non-resident NRSROs to provide a special undertaking should be

⁶⁶⁵ See, e.g., Gross Letter; AFP Letter; FSR Letter; ICI Letter; AEI Letter.

⁶⁶⁶ See, e.g., Gross Letter; AFP Letter; FSR Letter; ICI Letter.

⁶⁶⁷ See, e.g., AEI Letter.

eliminated.⁶⁶⁸ As discussed above with respect to Form NRSRO and Rule 17g-2, these requirements have been eliminated. As discussed above in the sections on each rule, the Commission believes that the requirements in the rules that have been retained are necessary and narrowly tailored. The Commission believes these requirements represent a proper balance in promoting competition and the quality and integrity of credit ratings, and in fulfilling the Commission's statutory mandate to create a regulatory framework for NRSROs.

Finally, the Commission also notes that most of the commenters that weighed in on the prohibition in Rule 17g-6(a)(4) expressed an opinion as to how the provision, as proposed, would impact competition. For example, many of the commenters stated that the 85% threshold in the proposed rule was too high and, therefore, the prohibition would not achieve the desired goal of increasing competition insomuch as it would maintain the status quo in which the two largest credit rating agencies dominate the market for rating structured products.⁶⁶⁹ On the other side of the issue, as discussed in

⁶⁶⁸ Id.

⁶⁶⁹ See, e.g., DBRS Letter; Fitch Letter; letter dated February 13, 2007 from Janet M. Tavakoli, President, Tavakoli Structured Finance, Inc.; letter dated February 14, 2007 from Gregory G. Raab, Chief Executive Officer, Axon; letter dated February 16, 2007 from Emile Van den Bol, Managing Director, Deutsche Bank; letter dated February 16, 2007 from Kent D. Born, Senior Managing Director, PPM America; letter dated February 23, 2007 from Patti Unti, Managing Director, Capmark Investments LP; letter dated February 23, 2007 from David Lazarus, Managing Director, Capmark Securities, Inc.; letter dated February 28, 2007 from Ronald E. Schrager, Chief Executive Officer, LNR Property Corporation; letter dated March 5, 2007 from David Hynes, Partner, Northcross Capital LLP; letter dated March 6, 2007 from S. Trezevant Moore, Jr., President & COO, Luminent Mortgage Capital, Inc.; letter dated March 7, 2007 from Bruce E. Stern, Chairman, Government Affairs Committee, Association of Financial Guaranty Insurers; letter dated March 8, 2007 from Majorie E. Gross; letter dated March 9, 2007 from Petra Spiegel, Eurohypo AG; letter dated March 9, 2007 from Landon D. Parsons, Managing Director, G-Bass; letter dated March 9, 2007 from Pat G. Halter, Chief Executive Officer, Principal Real Estate Investors; letter dated March 12, 2007 from Charles Covell, Executive Vice President, Citigroup Alternative Investments; letter

the section describing Rule 17g-6, commenters argued that the Commission has insufficient data upon which to make a finding that a specific practice is unfair, abusive, or coercive and, consequently, the prohibition, as proposed, would interfere with natural market forces.⁶⁷⁰

The Commission notes that the rule has been modified to eliminate the 85% threshold. The rule now prohibits the practices where the practice is engaged in for an anticompetitive purpose. In this way, the rule is designed to prohibit conduct that inappropriately stifles competition and, at the same time, avoid the establishment of artificial constraints that could interfere with natural market forces. The Commission recognizes that the two largest credit rating agencies dominate the market for rating structured products. Consequently, the Commission intends – aided by the enhanced recordkeeping requirements around rating structured products – to monitor closely the practices NRSROs employ in this area.

VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission proposed Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5, and 17g-6 and Form NRSRO in the proposing release under Section 15E of the Exchange Act.⁶⁷¹ An Initial Regulatory Flexibility Analysis (“IRFA”) was published in the proposing release. The Commission has prepared the following Final Regulatory Flexibility

dated March 12, 2007 from Rodney J. Dillman, General Counsel, Babson Capital Management LLC; letter dated March 12, 2007 from Louis C. Lucido, Group Managing Director, Trust Company of the West; letter dated March 12, 2007 from Daniel Ivascyn, Managing Director, PIMCO.

⁶⁷⁰ See, e.g., S&P Letter; Moody’s Letter; R&I Letter; FSR Letter; Rutherford Letter; Langohr Letter; AST Letter.

⁶⁷¹ 15 U.S.C. 78o-7.

Analysis (FRFA), in accordance with the provisions of the Regulatory Flexibility Act,⁶⁷² regarding Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5, and 17g-6 and Form NRSRO under Section 15E of Exchange Act.⁶⁷³

A. Need for and Objective of the Rules

The rules implement specific provisions of the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”).⁶⁷⁴ The Rating Agency Act defines the term “nationally recognized statistical rating organization” as a credit rating agency registered with the Commission, provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies, and directs the Commission to issue final implementing rules no later than 270 days after its enactment.

The objectives of the Rating Agency Act are “to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.”⁶⁷⁵ The rules are designed to further these objectives and to: assist the Commission in determining whether an entity should be registered as an NRSRO; assist the Commission in reviewing whether an NRSRO complies with the provisions of the Rating Agency Act and rules thereunder; adhere to the Commission’s statutory mandate to adopt rules to implement the NRSRO

⁶⁷² 5 U.S.C. 603.

⁶⁷³ 15 U.S.C. 78o-7.

⁶⁷⁴ Pub. L. No. 109-291 (2006).

⁶⁷⁵ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”).

regulatory program; and provide information regarding NRSROs to the public and to users of credit ratings.

B. Significant Issues Raised by Commenters

The Commission sought comment with respect to every aspect of the IRFA, including comments with respect to the number of small entities that may be affected by the proposed rules. Commenters were asked to specify the costs of compliance with the proposed rules and suggest alternatives that would accomplish the goals of the rules. The Commission did not receive any specific comments on the IRFA. The Commission did, however, receive a limited number of comments that discussed the effect the rules might have on smaller credit rating agencies, although these commenters did not address whether their comments pertained to entities that would be small businesses for purposes of Regulatory Flexibility Act analysis. For example, one commenter stated that the rules, as proposed, created an undue burden and would be a barrier to entry for new or smaller credit rating agencies.⁶⁷⁶ Several commenters stated that the prohibition in Rule 17g-5 from having a conflict with respect to a client that has provided 10% or more of the NRSRO's annual revenues could prevent smaller credit rating agencies from registering as NRSROs.⁶⁷⁷

C. Legal Basis

The Commission is adopting the rules pursuant to the Exchange Act⁶⁷⁸ and, particularly, Section 15E of the Exchange Act.⁶⁷⁹

⁶⁷⁶ See AEI Letter.

⁶⁷⁷ See, e.g., Fitch Letter; AEI Letter; AST Letter; ASF Letter.

⁶⁷⁸ 15 U.S.C. 78a *et seq.*

D. Small Entities Subject to the Rule

Paragraph (a) of Rule 0-10 provides that for purposes of the Regulatory Flexibility Act, a small entity “[w]hen used with reference to an ‘issuer’ or a ‘person’ other than an investment company” means “an ‘issuer’ or ‘person’ that, on the last day of its most recent fiscal year, had total assets of \$5 million or less.”⁶⁸⁰ The Commission believes that an NRSRO with total assets of \$5 million or less would qualify as a “small” entity for purposes of the Regulatory Flexibility Act.

As noted above, the Commission believes that approximately 30 credit rating agencies will be registered as NRSROs. Moreover, as also noted above, the Senate Report accompanying the Rating Agency Act states that the two largest credit rating agencies have about 80% of the market share as measured by revenues. The Senate Report also states that these two firms rate more than 99% of the debt obligations and preferred stock issues publicly traded in the United States. Given these figures, the Commission believes that the majority of the credit rating agencies registered with the Commission will be “small” entities.⁶⁸¹ Consequently, the Commission estimates that, of the approximately 30 credit rating agencies estimated to be registered with the Commission, approximately 20 would be “small” entities for purposes of the Regulatory Flexibility Act.⁶⁸²

E. Reporting, Recordkeeping, and Other Compliance Requirements

⁶⁷⁹ 15 U.S.C. 78o-7.

⁶⁸⁰ 17 CFR 240.0-10(a).

⁶⁸¹ See 17 CFR 240.0-10(a).

⁶⁸² Id.

A credit rating agency seeking to apply to the Commission for registration as an NRSRO will apply using Form NRSRO.⁶⁸³ The Form elicits certain information and requires the credit rating agency to attach a number of documents as Exhibits (some of which would have to be made publicly available) and certifications from qualified institutional buyers. The public Exhibits consist of information about credit ratings performance data, the credit rating agency's organizational structure, the methods used by the credit rating agency for issuing credit ratings, the policies used by the credit rating agency to manage activities that could potentially risk the impartiality of its credit ratings, and the credit rating agency's credit analysts. To the extent permitted by law, the confidential Exhibits consist of information about the credit rating agency's financial condition, revenues, and credit analyst compensation.

After registration, the credit rating agency (now an NRSRO) generally will be required to promptly update the public information on its Form NRSRO whenever an Item or Exhibit becomes materially inaccurate. To update information, the NRSRO must furnish the Commission with an amendment using Form NRSRO. In addition, the NRSRO must furnish the Commission with an annual certification on Form NRSRO.⁶⁸⁴ In the annual certification, the NRSRO must represent that all information on the Form, as amended, continues to be accurate, list any material changes made during the previous year, and include an update to the public Exhibit relating to the performance statistics of its credit ratings. After its application for registration is approved, the NRSRO must

⁶⁸³ Rule 17g-1.

⁶⁸⁴ Id.

make Form NRSRO and the public Exhibits submitted to the Commission, and all amendments, readily accessible to the public.

NRSROs also are subject to a recordkeeping rule.⁶⁸⁵ This rule requires an NRSRO to make and retain certain records relating to the business of issuing credit ratings. These records will assist the Commission, through its examination process, in monitoring whether the NRSRO continues to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity (as required under the Rating Agency Act) and whether the NRSRO is complying with the provisions of the Rating Agency Act, the rules adopted thereunder, and the NRSRO's disclosed policies and procedures.

On an annual fiscal year basis, an NRSRO must furnish the Commission with audited financial statements.⁶⁸⁶ This requirement is designed to assist the Commission in monitoring whether the NRSRO continues to maintain adequate financial resources to consistently produce credit ratings with integrity. It also is designed to assist the Commission in monitoring whether the NRSRO is complying with provisions of the Rating Agency Act and the rules adopted thereunder regarding potential conflicts of interest arising from dealings with large customers in terms of revenues earned.

Finally, all NRSROs will be subject to requirements designed to protect their impartiality with respect to issuing credit ratings. First, they must establish, maintain, and enforce specific written policies designed to prevent the misuse of material non-

⁶⁸⁵ Rule 17g-2.

⁶⁸⁶ Rule 17g-3.

public information.⁶⁸⁷ Second, an NRSRO is prohibited from having certain general conflicts unless it, as required under the Rating Agency Act, disclosed the conflict and adopted procedures to manage the conflict.⁶⁸⁸ Further certain conflicts of interest – for example, rating a security owned by the NRSRO – are prohibited.⁶⁸⁹ Third, NRSROs are prohibited from engaging in certain practices that the Commission has found to be unfair, coercive, or abusive practices.⁶⁹⁰

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the rules.

G. Significant Alternatives

Pursuant to section 3(a) of the RFA,⁶⁹¹ the Commission must consider certain types of alternatives, including: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

⁶⁸⁷ Rule 17g-4.

⁶⁸⁸ Rule 17g-5.

⁶⁸⁹ Id.

⁶⁹⁰ Rule 17g-6.

⁶⁹¹ 5 U.S.C. 603(c).

The Commission does not believe it is appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rules for small entities; or exempt small entities from coverage of the rules, or any part of the rules. The Rating Agency Act and the rules establish a voluntary program of registration and supervision that allows all NRSROs the flexibility to develop procedures tailored to their specific organizational structures and business models. Further, many of the rules, as adopted, are due to a direct statutory mandate. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the rules as the rules already propose performance standards and do not dictate for entities of any size any particular design standards that must be employed to achieve the objectives of the rules.

As for the comment that the rules will be a barrier to entry for small entities, the Commission notes that the commenter did not specify how the rules would disproportionately burden small entities, nor did it provide cost estimates for small entities.⁶⁹² The Commission believes the burden associated with the rules will impact all NRSROs in a proportionate manner based on their size and complexity. Therefore, the Commission does not believe it would be appropriate to prescribe lesser requirements for small entities, nor have any commenters suggested lesser requirements.

Further, the Commission notes that the rules, as adopted, have been modified in ways designed to decrease burden. Some of these modifications address specific issues

⁶⁹² See AEI letter.

raised by the commenter.⁶⁹³ For example, the commenter stated that the requirements to provide background information on each credit analyst and for non-resident NRSROs to provide a special undertaking should be eliminated.⁶⁹⁴ These requirements have been eliminated. As discussed above in the sections on each rule, the Commission believes that the requirements in the rules that have been retained are necessary and narrowly tailored.

As for the comment that the prohibition on having a conflict with respect to a client that has provided 10% or more of the NRSRO's revenues, the Commission notes that the commenters did not provide any supporting data. In addition, no commenter specifically identifying itself as a small entity raised this prohibition as an issue.⁶⁹⁵ The Commission believes that it would be highly unusual for a small credit rating agency to derive 10% or more of its revenues from a single client and, if this was the case, that it would be very difficult for the credit rating agency to issue an impartial rating requested by the client. The Commission notes that the smaller credit rating agencies tend to use a subscriber fee-based business model. Thus, they are not paid to determine specific credit ratings and, consequently, would not be impacted by this prohibition.

⁶⁹³ Id.

⁶⁹⁴ Id.

⁶⁹⁵ The Commission intends to monitor how the prohibition operates in practice, particularly with respect to structured products. If the prohibition interferes with how NRSROs as a matter of course deal with structured product sponsors, the Commission will evaluate whether the rule should be modified to accommodate this business practice or whether an exemption would be appropriate.

IX. STATUTORY AUTHORITY

The Commission is adopting Form NRSRO and Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5 and 17g-6 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 3(b), 15E, 17, 23(a) and 36.⁶⁹⁶

Text of Rules

List of Subjects

17 CFR Parts 240 and 249b

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission hereby amends Title 17, Chapter II of the Code of Federal Regulation as follows.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES

EXCHANGE ACT OF 1934

1. The authority for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Sections 240.17g-1 through 240.17g-6 are added to read as follows:

Nationally Recognized Statistical Rating Organizations

Sec.

240.17g-1 Application for registration as a nationally recognized statistical rating organization.

⁶⁹⁶ 15 U.S.C. 78c(b), 78o-7, 78q, 78w, and 78mm.

240.17g-2 Records to be made and retained by nationally recognized statistical rating organizations.

240.17g-3 Annual financial reports to be furnished by nationally recognized statistical rating organizations.

240.17g-4 Prevention of misuse of material nonpublic information.

240.17g-5 Conflicts of interest.

240.17g-6 Prohibited acts and practices.

§ 240.17g-1 Application for registration as a nationally recognized statistical rating organization.

(a) Initial application. A credit rating agency applying to the Commission to be registered under section 15E of the Act (15 U.S.C. 78o-7) as a nationally recognized statistical rating organization must furnish the Commission with an initial application on Form NRSRO (§249b.300 of this chapter) that follows all applicable instructions for the Form.

(b) Application to register for an additional class of credit ratings. A nationally recognized statistical rating organization applying to register for an additional class of the credit ratings described in section 3(a)(62)(B) of the Act (15 U.S.C. 78c(a)(62)(B)) must furnish the Commission with an application to add a class of credit ratings on Form NRSRO that follows all applicable instructions for the Form. The application will be subject to the requirements of section 15E(a)(2) of the Act (15 U.S.C. 78o-7(a)(2)).

(c) Supplementing an application prior to final action by the Commission. An applicant must promptly furnish the Commission with a written notice if information submitted to the Commission in an initial application to be registered as a nationally recognized statistical rating organization or in an application to register for an additional

class of credit ratings is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information that was found to be materially inaccurate. The applicant also must promptly furnish the Commission with an application supplement on Form NRSRO that follows all applicable instructions for the Form.

(d) Withdrawing an application. An applicant may withdraw an initial application to be registered as a nationally recognized statistical rating organization or an application to register for an additional class of credit ratings prior to the date of a Commission order granting or denying the application. To withdraw the application, the applicant must furnish the Commission with a written notice of withdrawal executed by a duly authorized person.

(e) Update of registration. A nationally recognized statistical rating organization amending materially inaccurate information in its application for registration pursuant to section 15E(b)(1) of the Act (15 U.S.C. 78o-7(b)(1)) must promptly furnish the Commission with the update of its registration on Form NRSRO that follows all applicable instructions for the Form.

(f) Annual certification. A nationally recognized statistical rating organization amending its application for registration pursuant to section 15E(b)(2) of the Act (15 U.S.C. 78o-7(b)(2)) must furnish the Commission with the annual certification on Form NRSRO that follows all applicable instructions for the Form not later than 90 days after the end of each calendar year.

(g) Withdrawal from registration. A nationally recognized statistical rating organization withdrawing from registration pursuant to section 15E(e)(1) of the Act (15

U.S.C. 78o-7(e)(1)) must furnish the Commission with a notice of withdrawal from registration on Form NRSRO that follows all applicable instructions for the Form. The withdrawal from registration will become effective 45 calendar days after the notice is furnished to the Commission upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors.

(h) Furnishing Form NRSRO. A Form NRSRO submitted under any paragraph of this section will be considered furnished to the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form. Information submitted on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law.

(i) Public availability of Form NRSRO. A nationally recognized statistical rating organization must make its current Form NRSRO and information and documents submitted in Exhibits 1 through 9 to Form NRSRO publicly available on its Web site, or through another comparable, readily accessible means within 10 business days after the date of the Commission order granting an initial application for registration as a nationally recognized statistical rating organization or an application to register for an additional class of credit ratings and within 10 business days after furnishing a Form NRSRO to the Commission under paragraphs (e), (f), or (g) of this section.

§ 240.17g-2 Records to be made and retained by nationally recognized statistical rating organizations.

(a) Records required to be made and retained. A nationally recognized statistical rating organization must make and retain the following books and records, which must be complete and current:

(1) Records of original entry into the accounting system of the nationally recognized statistical rating organization and records reflecting entries to and balances in all general ledger accounts of the nationally recognized statistical rating organization for each fiscal year.

(2) Records with respect to each current credit rating of the nationally recognized statistical rating organization indicating (as applicable):

(i) The identity of any credit analyst(s) that participated in determining the credit rating;

(ii) The identity of the person(s) that approved the credit rating before it was issued;

(iii) Whether the credit rating was solicited or unsolicited; and

(iv) The date the credit rating action was taken.

(3) An account record for each person (for example, an obligor, issuer, underwriter, or other user) that has paid the nationally recognized statistical rating organization for the issuance or maintenance of a credit rating indicating:

(i) The identity and address of the person; and

(ii) The credit rating(s) determined or maintained for the person.

(4) An account record for each subscriber to the credit ratings and/or credit analysis reports of the nationally recognized statistical rating organization indicating the identity and address of the subscriber.

(5) A record listing the general types of services and products offered by the nationally recognized statistical rating organization.

(6) A record documenting the established procedures and methodologies used by the nationally recognized statistical rating organization to determine credit ratings.

(7) A record that lists each security and money market instrument and its corresponding credit rating issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction where the nationally recognized statistical rating organization, in determining the credit rating for the security or money market instrument, treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the nationally recognized statistical rating organization by any or a combination of the following methods:

(i) Determining credit ratings for the unrated assets;

(ii) Performing credit assessments or determining private credit ratings for the unrated assets;

(iii) Determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration the internal credit analysis of another person; or

(iv) Determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration (but not necessarily adopting) the credit ratings of another nationally recognized statistical rating organization.

(b) Records required to be retained. A nationally recognized statistical rating organization must retain the following books and records (excluding drafts of documents) that relate to its business as a credit rating agency:

(1) Significant records (for example, bank statements, invoices, and trial balances) underlying the information included in the annual financial reports furnished by the nationally recognized statistical rating organization to the Commission pursuant to §240.17g-3.

(2) Internal records, including nonpublic information and work papers, used to form the basis of a credit rating issued by the nationally recognized statistical rating organization.

(3) Credit analysis reports, credit assessment reports, and private credit rating reports of the nationally recognized statistical rating organization and internal records, including nonpublic information and work papers, used to form the basis for the opinions expressed in these reports.

(4) Compliance reports and compliance exception reports.

(5) Internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by the internal auditors of the nationally recognized statistical rating organization as necessary to perform the audit of an activity that relates to its business as a credit rating agency.

(6) Marketing materials of the nationally recognized statistical rating organization that are published or otherwise made available to persons that are not associated with the nationally recognized statistical rating organization.

(7) External and internal communications, including electronic communications, received and sent by the nationally recognized statistical rating organization and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating.

(8) Internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another nationally recognized statistical rating organization for the purpose of determining a credit rating for a security or money market instrument issued by an asset pool or part of any asset-backed or mortgage-backed securities transaction.

(9) For each security or money market instrument identified in the record required to be made and retained under paragraph (a)(7) of this section, any document that contains a description of how assets within such pool or as a part of such transaction not rated by the nationally recognized statistical rating organization but rated by another nationally recognized statistical rating organization were treated for the purpose of determining the credit rating of the security or money market instrument.

(10) Form NRSROs (including Exhibits and accompanying information and documents) submitted to the Commission by the nationally recognized statistical rating organization.

(c) Record retention periods. The records required to be retained pursuant to paragraphs (a) and (b) of this section must be retained for three years after the date the record is made or received.

(d) Manner of retention. An original, or a true and complete copy of the original, of each record required to be retained pursuant to paragraphs (a) and (b) of this section must be maintained in a manner that, for the applicable retention period specified in paragraph (c) of this section, makes the original record or copy easily accessible to the principal office of the nationally recognized statistical rating organization and to any other office that conducted activities causing the record to be made or received.

(e) Third-party record custodian. The records required to be retained pursuant to paragraphs (a) and (b) of this section may be made or retained by a third-party record custodian, provided the nationally recognized statistical rating organization furnishes the Commission at its principal office in Washington, DC with a written undertaking of the custodian executed by a duly authorized person. The undertaking must be in substantially the following form:

The undersigned acknowledges that books and records it has made or is retaining for [the nationally recognized statistical rating organization] are the exclusive property of [the nationally recognized statistical rating organization]. The undersigned undertakes that upon the request of [the nationally recognized statistical rating organization] it will promptly provide the books and records to [the nationally recognized statistical rating organization] or the U.S. Securities and Exchange Commission (“Commission”) or its representatives and that upon the request of the Commission it will promptly permit examination by the Commission or its representatives of the records at any time or from time to time during business hours and promptly furnish to the Commission or its representatives a true and complete copy of any or all or any part of such books and records.

A nationally recognized statistical rating organization that engages a third-party record custodian remains responsible for complying with every provision of this section.

(f) A nationally recognized statistical rating organization must promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested, English translations of those records of the nationally recognized

statistical rating organization required to be retained pursuant to paragraphs (a) and (b) this section, or any other records of the nationally recognized statistical rating organization subject to examination under section 17(b) of the Act (15 U.S.C. 78q(b)) that are requested by the Commission or its representatives.

§ 240.17g-3 Annual financial reports to be furnished by nationally recognized statistical rating organizations.

(a) A nationally recognized statistical rating organization must annually, not more than 90 calendar days after the end of its fiscal year (as indicated on its current Form NRSRO), furnish the Commission, at the Commission's principal office in Washington, DC, with the following financial reports as of the end of its most recent fiscal year:

(1) Audited financial statements of the nationally recognized statistical rating organization or audited consolidated financial statements of its parent if the nationally recognized statistical rating organization is a separately identifiable division or department of the parent. The audited financial statements must:

(i) Include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity;

(ii) Be prepared in accordance with generally accepted accounting principles in the jurisdiction in which the nationally recognized statistical rating organization or its parent is incorporated, organized, or has its principal office; and

(iii) Be certified by an accountant who is qualified and independent in accordance with paragraphs (a), (b), and (c)(1), (2), (3), (4), (5) and (8) of §210.2-01 of this chapter. The accountant must give an opinion on the financial statements in accordance with paragraphs (a) through (d) of §210.2-02 of this chapter.

(2) If applicable, unaudited consolidating financial statements of the parent of the nationally recognized statistical rating organization that include the nationally recognized statistical rating organization.

Note to paragraph (a)(2): This financial report must be furnished only if the audited financial statements provided pursuant to paragraph (a)(1) of this section are consolidated financial statements of the parent of the nationally recognized statistical rating organization.

(3) An unaudited financial report providing information concerning the revenue of the nationally recognized statistical rating organization in each of the following categories (as applicable) for the fiscal year:

- (i) Revenue from determining and maintaining credit ratings;
- (ii) Revenue from subscribers;
- (iii) Revenue from granting licenses or rights to publish credit ratings; and
- (iv) Revenue from all other services and products (include descriptions of any major sources of revenue).

(4) An unaudited financial report providing the total aggregate and median annual compensation of the credit analysts of the nationally recognized statistical rating organization for the fiscal year.

Note to paragraph (a)(4): In calculating total and median annual compensation, the nationally recognized statistical rating organization may exclude deferred compensation, provided such exclusion is noted in the report.

(5) An unaudited financial report listing the 20 largest issuers and subscribers that used credit rating services provided by the nationally recognized statistical rating

organization by amount of net revenue attributable to the issuer or subscriber during the fiscal year. Additionally, include on the list any obligor or underwriter that used the credit rating services provided by the nationally recognized statistical rating organization if the net revenue attributable to the obligor or underwriter during the fiscal year equaled or exceeded the net revenue attributable to the 20th largest issuer or subscriber. Include the net revenue amount for each person on the list.

Note to paragraph (a)(5): A person is deemed to have "used the credit rating services" of the nationally recognized statistical rating organization if the person is any of the following: an obligor that is rated by the nationally recognized statistical rating organization (regardless of whether the obligor paid for the credit rating); an issuer that has securities or money market instruments subject to a credit rating of the nationally recognized statistical rating organization (regardless of whether the issuer paid for the credit rating); any other person that has paid the nationally recognized statistical rating organization to determine a credit rating with respect to a specific obligor, security, or money market instrument; or a subscriber to the credit ratings, credit ratings data, or credit analysis of the nationally recognized statistical rating organization. In calculating net revenue attributable to a person, the nationally recognized statistical rating organization should include all revenue earned by the nationally recognized statistical rating organization for any type of service or product, regardless of whether related to credit rating services, and net of any rebates and allowances paid or owed to the person by the nationally recognized statistical rating organization.

(b) The nationally recognized statistical rating organization must attach to each financial report furnished pursuant to paragraph (a) of this section a signed statement by a duly authorized person associated with the nationally recognized statistical rating organization that the person has responsibility for the report and, to the best knowledge of the person, the financial report fairly presents, in all material respects, the financial condition, results of operations, cash flows, revenues, and analyst compensation, as applicable, of the nationally recognized statistical rating organization for the period presented.

(c) The Commission may grant an extension of time or an exemption with respect to any requirements in this section either unconditionally or on specified terms and conditions on the written request of a nationally recognized statistical rating organization if the Commission finds that such extension or exemption is necessary or appropriate in the public interest and consistent with the protection of investors.

§ 240.17g-4 Prevention of misuse of material nonpublic information.

(a) The written policies and procedures a nationally recognized statistical rating organization establishes, maintains, and enforces to prevent the misuse of material, nonpublic information pursuant to section 15E(g)(1) of the Act (15 U.S.C. 78o-7(g)(1)) must include policies and procedures reasonably designed to prevent:

(1) The inappropriate dissemination within and outside the nationally recognized statistical rating organization of material nonpublic information obtained in connection with the performance of credit rating services;

(2) A person within the nationally recognized statistical rating organization from purchasing, selling, or otherwise benefiting from any transaction in securities or money

market instruments when the person is aware of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments; and

(3) The inappropriate dissemination within and outside the nationally recognized statistical rating organization of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.

(b) For the purposes of this section, the term person within a nationally recognized statistical rating organization means a nationally recognized statistical rating organization, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the nationally recognized statistical rating organization or its credit rating affiliates (or any person occupying a similar status or performing similar functions).

§ 240.17g-5 Conflicts of interest.

(a) A person within a nationally recognized statistical rating organization is prohibited from having a conflict of interest relating to the issuance or maintenance of a credit rating identified in paragraph (b) of this section, unless:

(1) The nationally recognized statistical rating organization has disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO in accordance with section 15E(a)(1)(B)(vi) of the Act (15 U.S.C. 78o-7(a)(1)(B)(vi)) and §240.17g-1; and

(2) The nationally recognized statistical rating organization has established and is maintaining and enforcing written policies and procedures to address and manage conflicts of interest in accordance with section 15E(h) of the Act (15 U.S.C. 78o-7(h)).

(b) Conflicts of interest. For purposes of this section, each of the following is a conflict of interest:

(1) Being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.

(2) Being paid by obligors to determine credit ratings with respect to the obligors.

(3) Being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the nationally recognized statistical rating organization to determine a credit rating.

(4) Being paid by persons for subscriptions to receive or access the credit ratings of the nationally recognized statistical rating organization and/or for other services offered by the nationally recognized statistical rating organization where such persons may use the credit ratings of the nationally recognized statistical rating organization to comply with, and obtain benefits or relief under, statutes and regulations using the term nationally recognized statistical rating organization.

(5) Being paid by persons for subscriptions to receive or access the credit ratings of the nationally recognized statistical rating organization and/or for other services offered by the nationally recognized statistical rating organization where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the nationally recognized statistical rating organization.

(6) Allowing persons within the nationally recognized statistical rating organization to directly own securities or money market instruments of, or having other

direct ownership interests in, issuers or obligors subject to a credit rating determined by the nationally recognized statistical rating organization.

(7) Allowing persons within the nationally recognized statistical rating organization to have a business relationship that is more than an arms length ordinary course of business relationship with issuers or obligors subject to a credit rating determined by the nationally recognized statistical rating organization.

(8) Having a person associated with the nationally recognized statistical rating organization that is a broker or dealer engaged in the business of underwriting securities or money market instruments.

(9) Any other type of conflict of interest relating to the issuance of credit ratings by the nationally recognized statistical rating organization that is material to the nationally recognized statistical rating organization and that is identified by the nationally recognized statistical rating organization in Exhibit 6 to Form NRSRO in accordance with section 15E(a)(1)(B)(vi) of the Act (15 U.S.C. 78o-7(a)(1)(B)(vi)) and §240.17g-1.

(c) Prohibited conflicts. A nationally recognized statistical rating organization is prohibited from having the following conflicts of interest relating to the issuance or maintenance of a credit rating as a credit rating agency:

(1) The nationally recognized statistical rating organization issues or maintains a credit rating solicited by a person that, in the most recently ended fiscal year, provided the nationally recognized statistical rating organization with net revenue (as reported under §240.17g-3) equaling or exceeding 10% of the total net revenue of the nationally recognized statistical rating organization for the fiscal year;

(2) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the nationally recognized statistical rating organization, a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating;

(3) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to a person associated with the nationally recognized statistical rating organization; or

(4) The nationally recognized statistical rating organization issues or maintains a credit rating where a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, is an officer or director of the person that is subject to the credit rating.

(d) For the purposes of this section, the term person within a nationally recognized statistical rating organization means a nationally recognized statistical rating organization, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the nationally recognized statistical rating organization or its credit rating affiliates (or any person occupying a similar status or performing similar functions).

§ 240.17g-6 Prohibited acts and practices.

(a) Prohibitions. A nationally recognized statistical rating organization is prohibited from engaging in any of the following unfair, coercive, or abusive practices:

(1) Conditioning or threatening to condition the issuance of a credit rating on the

purchase by an obligor or issuer, or an affiliate of the obligor or issuer, of any other services or products, including pre-credit rating assessment products, of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(2) Issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the nationally recognized statistical rating organization's established procedures and methodologies for determining credit ratings, based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(3) Modifying, or offering or threatening to modify, a credit rating in a manner that is contrary to the nationally recognized statistical rating organization's established procedures and methodologies for modifying credit ratings based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(4) Issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the nationally recognized statistical rating organization,

where such practice is engaged in by the nationally recognized statistical rating organization for an anticompetitive purpose.

PART 249b— FURTHER FORMS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 249b continues to read in part as follows.

Authority: 15 U.S.C. 78a et seq., unless otherwise noted;

* * * * *

4. Section 249b.300 and Form NRSRO are added to read as follows:

§249b.300 FORM NRSRO, application for registration as a nationally recognized statistical rating organization pursuant to section 15E of the Securities Exchange Act of 1934 and §240.17g-1 of this chapter.

This Form shall be used for an initial application for and an application to add a class of credit ratings to, a supplement to an initial application for and an application to add a class of credit ratings to, an update and amendment to an application for, and a withdrawal from a registration as a nationally recognized statistical rating organization pursuant to section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7) and §240.17g-1 of this chapter.

Note: The text of Form NRSRO will not appear in the Code of Federal Regulations.

Form NRSRO

OMB APPROVAL
OMB Number: 3235-0625
Expires: May 31, 2010
Estimated average burden hours per response: 300

**APPLICATION FOR REGISTRATION AS A
NATIONALLY RECOGNIZED STATISTICAL
RATING ORGANIZATION (NRSRO)**

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1541 (2-07)

**APPLICATION FOR REGISTRATION AS A
NATIONALLY RECOGNIZED
STATISTICAL RATING ORGANIZATION (NRSRO)**

- | | |
|--|--|
| <input type="checkbox"/> INITIAL APPLICATION

<input type="checkbox"/> APPLICATION TO ADD CLASS OF CREDIT RATINGS

<input type="checkbox"/> APPLICATION SUPPLEMENT
Items and/or Exhibits Supplemented:
_____ | <input type="checkbox"/> ANNUAL CERTIFICATION

<input type="checkbox"/> UPDATE OF REGISTRATION
Items and/or Exhibits Amended:

<input type="checkbox"/> WITHDRAWAL FROM REGISTRATION |
|--|--|

Important: Refer to Form NRSRO Instructions for General Instructions, Item-by-Item Instructions, an Explanation of Terms, and the Disclosure Reporting Page (NRSRO). "You" and "your" mean the person furnishing this Form NRSRO to the Commission. "Applicant" and "NRSRO" mean the person furnishing this Form NRSRO to the Commission and any credit rating affiliate identified in Item 3.

1. A. Your full name:

B. (i) Name under which your credit rating business is primarily conducted, if different from Item 1A:

(ii) Any other name under which your credit rating business is conducted and where it is used (other than the name of a credit rating affiliate identified in Item 3):

C. Address of your principal office (do not use a P.O. Box):

 (Number and Street) (City) (State/Country) (Zip/Postal Code)

D. Mailing address, if different:

 (Number and Street) (City) (State/Country) (Zip/Postal Code)

E. Contact person (See Instructions):

 (Name and Title)

 (Number and Street) (City) (State/Country) (Zip/Postal Code)

CERTIFICATION:

The undersigned has executed this Form NRSRO on behalf of, and on the authority of, the Applicant/NRSRO. The undersigned, on behalf of the Applicant/NRSRO, represents that the information and statements contained in this Form, including Exhibits and attachments, all of which are part of this Form, are accurate in all significant respects. If this is an ANNUAL CERTIFICATION, the undersigned, on behalf of the NRSRO, represents that the NRSRO's application on Form NRSRO, as amended, is accurate in all significant respects.

 (Date)

 (Name of the Applicant/NRSRO)

By: _____

(Signature)

 (Print Name and Title)

2. A. Your legal status:

Corporation Limited Liability Company Partnership Other (specify) _____

B. Month and day of your fiscal year end: _____

C. Place and date of your formation (i.e., state or country where you were incorporated, where your partnership agreement was filed, or where you otherwise were formed):

State/Country of formation: _____ Date of formation: _____

3. Your credit rating affiliates (See Instructions):

(Name)	(Address)

4. The designated compliance officer of the Applicant/NRSRO (See Instructions):

(Name and Title) _____
 (Number and Street) (City) (State/Country) (Postal Code)

5. Describe in detail how this Form NRSRO and Exhibits 1 through 9 to this Form NRSRO will be made publicly available on Web site of the Applicant/NRSRO, or through another comparable, readily accessible means (See Instructions):

6. COMPLETE ITEM 6 ONLY IF THIS IS AN INITIAL APPLICATION, APPLICATION SUPPLEMENT, OR APPLICATION TO ADD A CLASS OF CREDIT RATINGS.

A. Indicate below the classes of credit ratings for which the Applicant/NRSRO is applying to be registered. For each class, indicate the approximate number of credit ratings the Applicant/NRSRO presently has outstanding in that class as of the date of this application and the approximate date the Applicant/NRSRO began issuing credit ratings as a "credit rating agency" in that class on a continuous basis through the present (See Instructions):

Class of credit ratings	Applying for registration	Approximate number currently outstanding	Approximate date issuance commenced
financial institutions as that term is defined in section 3(a)(46) of the Exchange Act (15 U.S.C. 78c(a)(46)), brokers as that term is defined in section 3(a)(4) of the Exchange Act (15 U.S.C. 78c(a)(4)), and dealers as that term is defined in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5))	<input type="checkbox"/>		
insurance companies as that term is defined in section 3(a)(19) of the Exchange Act (15 U.S.C. 78c(a)(19))	<input type="checkbox"/>		
corporate issuers	<input type="checkbox"/>		

<u>issuers of asset-backed securities</u> as that term is defined in 17 CFR 229.1101(c)	<input type="checkbox"/>		
<u>issuers of government securities</u> as that term is defined in section 3(a)(42) of the Exchange Act (15 U.S.C. 78c(a)(42)), <u>municipal securities</u> as that term is defined in section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)), and <u>foreign government securities</u>	<input type="checkbox"/>		

B. Briefly describe how the Applicant/NRSRO makes the credit ratings in the classes indicated in Item 6A readily accessible for free or for a reasonable fee (See Instructions):

C. Check the applicable box and attach certifications from qualified institutional buyers, if required (See Instructions):

- The Applicant/NRSRO is attaching _____ certifications from qualified institutional buyers to this application. Each is marked "Certification from Qualified Institutional Buyer."
- The Applicant/NRSRO is exempt from the requirement to submit certifications from qualified institutional buyers pursuant to section 15E(a)(1)(D) of the Exchange Act.

Note: You are not required to make a Certification from a Qualified Institutional Buyer submitted with this Form NRSRO publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep these certifications confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the certifications confidential upon request to the extent permitted by law.

7. DO NOT COMPLETE ITEM 7 IF THIS IS AN INITIAL APPLICATION.

A. Indicate below the classes of credit ratings for which the NRSRO is currently registered. For each class, indicate the approximate number of credit ratings the NRSRO had outstanding in that class as of the most recent calendar year end and the approximate date the NRSRO began issuing credit ratings as a "credit rating agency" in that class on a continuous basis through the present (See Instructions):

Class of credit rating	Currently registered	Approximate number outstanding as of the most recent calendar year end	Approximate date issuance commenced
<u>financial institutions</u> as that term is defined in section 3(a)(46) of the Exchange Act (15 U.S.C. 78c(a)(46)), <u>brokers</u> as that term is defined in section 3(a)(4) of the Exchange Act (15 U.S.C. 78c(a)(4)), and <u>dealers</u> as that term is defined in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)) .	<input type="checkbox"/>		
<u>insurance companies</u> as that term is defined in section 3(a)(19) of the Exchange Act (15 U.S.C. 78c(a)(19))	<input type="checkbox"/>		
corporate issuers	<input type="checkbox"/>		
<u>issuers of asset-backed securities</u> as that term is	<input type="checkbox"/>		

defined in 17 CFR 229.1101(c)			
<u>issuers of government securities</u> as that term is defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), <u>municipal securities</u> as that term is defined in section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)), and <u>foreign government securities</u>	<input type="checkbox"/>		

B. Briefly describe how the NRSRO makes the credit ratings in the classes indicated in Item 7A readily accessible for free or for a reasonable fee (See Instructions):

<p>8. Answer each question. Provide information that relates to a "Yes" answer on a Disclosure Reporting Page (NRSRO) and submit the Disclosure Reporting Page with this form (See Instructions). You are not required to make any disclosure reporting pages submitted with this Form NRSRO publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep any disclosure reporting pages confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the disclosure reporting pages confidential upon request to the extent permitted by law.</p>		
	YES	NO
<p>A. Has the Applicant/NRSRO or any person within the Applicant/NRSRO committed or omitted any act, or been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Securities Exchange Act of 1934, been convicted of any offense specified in section 15(b)(4)(B) of the Securities Exchange Act of 1934, or been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Securities Exchange Act of 1934 in the ten years preceding the date of the initial application of the Applicant/NRSRO for registration as an NRSRO or at any time thereafter?</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>B. Has the Applicant/NRSRO or any person within the Applicant/NRSRO been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Securities Exchange Act of 1934, or been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction in the ten years preceding the date of the initial application of the Applicant/NRSRO for registration as an NRSRO or at any time thereafter?</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>C. Is any person within the Applicant/NRSRO subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO?</p>	<input type="checkbox"/>	<input type="checkbox"/>

9. Exhibits (See Instructions).

<p>Exhibit 1. Credit ratings performance measurement statistics.</p> <p><input type="checkbox"/> Exhibit 1 is attached and made a part of this Form NRSRO.</p>
<p>Exhibit 2. A description of the procedures and methodologies used in determining credit ratings.</p> <p><input type="checkbox"/> Exhibit 2 is attached and made a part of Form NRSRO.</p>
<p>Exhibit 3. Policies or procedures adopted and implemented to prevent the misuse of material, nonpublic information.</p> <p><input type="checkbox"/> Exhibit 3 is attached and made a part of this Form NRSRO.</p>

Exhibit 4. Organizational structure.

Exhibit 4 is attached to and made a part of this Form NRSRO.

Exhibit 5. The code of ethics or a statement of the reasons why a code of ethics is not in effect.

Exhibit 5 is attached to and made a part of this Form NRSRO.

Exhibit 6. Identification of conflicts of interests relating to the issuance of credit ratings.

Exhibit 6 is attached to and made a part of this Form NRSRO.

Exhibit 7. Policies and procedures to address and manage conflicts of interest.

Exhibit 7 is attached to and made a part of this Form NRSRO.

Exhibit 8. Certain information regarding the credit rating agency's credit analysts and credit analyst supervisors.

Exhibit 8 is attached to and made a part of this Form NRSRO.

Exhibit 9. Certain information regarding the credit rating agency's designated compliance officer.

Exhibit 9 is attached to and made a part of this Form NRSRO.

Exhibit 10. A list of the largest users of credit rating services by the amount of net revenue earned from the user during the fiscal year ending immediately before the date of the initial application.

Exhibit 10 is attached to and made a part of this Form NRSRO.

Note: You are not required to make this Exhibit publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 11. Audited financial statements for each of the three fiscal or calendar years ending immediately before the date of the initial application.

Exhibit 11 is attached to and made a part of this Form NRSRO.

Note: You are not required to make this Exhibit publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 12. Information regarding revenues for the fiscal or calendar year ending immediately before the date of the initial application.

Exhibit 12 is attached to and made a part of this Form NRSRO.

Note: You are not required to make this Exhibit publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 13. The total and median annual compensation of credit analysts.

Exhibit 13 is attached and made a part of this Form NRSRO.

Note: You are not required to make this Exhibit publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

FORM NRSRO INSTRUCTIONS

A. GENERAL INSTRUCTIONS.

1. Form NRSRO is the Application for Registration as a Nationally Recognized Statistical Rating Organization ("NRSRO") under Section 15E of the Securities Exchange Act of 1934 ("Exchange Act") and Exchange Act Rule 17g-1. Exchange Act Rule 17g-1 requires an Applicant/NRSRO to use Form NRSRO to furnish the U.S. Securities and Exchange Commission ("Commission") with:
 - An initial application to be registered as an NRSRO;
 - An application to register for an additional class of credit ratings;
 - An application supplement;
 - An update of registration pursuant to Section 15E(b)(1) of the Exchange Act;
 - An annual certification pursuant to Section 15E(b)(2) of the Exchange Act; and
 - A withdrawal of registration pursuant to Section 15E(e) of the Exchange Act.
2. Exchange Act Rule 17g-1(c) requires that an Applicant/NRSRO promptly provide the Commission with a written notice if information submitted to the Commission in an initial application for registration or in an application to register for an additional class of credit ratings is found to be or becomes materially inaccurate before the Commission has granted or denied the application. The notice must identify the

information found to be materially inaccurate. The Applicant/NRSRO must also promptly furnish the Commission with accurate and complete information as an application supplement on Form NRSRO.

3. Pursuant to Exchange Act Rule 17g-1(i), an NRSRO must make its current Form NRSRO and information and documents furnished in Exhibits 1 through 9 to Form NRSRO publicly available on its Web site, or through another comparable, readily accessible means within 10 business days after the date of the Commission Order granting an initial application for registration as an NRSRO or an application to register for an additional class of credit ratings and within 10 business days after submitting an update of registration, annual certification, or withdrawal from registration to the Commission on Form NRSRO. The certifications from qualified institutional buyers, disclosure reporting pages, and Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Rule 17g-1(i). An Applicant/NRSRO may request that the Commission keep confidential the certifications from qualified institutional buyers, the disclosure reporting pages, and the information and documents in Exhibits 10 – 13 submitted to the Commission. An Applicant/NRSRO seeking confidential treatment for these submissions should mark each page “Confidential Treatment” and comply with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep this information confidential to the extent permitted by law.

4. Section 15E(a)(2) of the Exchange Act prescribes time periods and requirements for the Commission to grant or deny an initial application for registration as an NRSRO. These time periods also apply to an application to register for an additional class of credit ratings.
5. Type or clearly print all information. Use only the current version of Form NRSRO or a reproduction of it.
6. Section 15E of the Exchange Act (15 U.S.C. 78o-7) authorizes the Commission to collect the Information on Form NRSRO from an Applicant/NRSRO. The principal purposes of Form NRSRO are to determine whether an Applicant should be granted registration as an NRSRO, whether an NRSRO should be granted registration in an additional class of credit ratings, whether an NRSRO continues to meet the criteria for registration as an NRSRO, to withdraw a registration, and to provide information about an NRSRO to users of credit ratings. Intentional misstatements or omissions may constitute federal criminal violations under 18 U.S.C. 1001.

The information collection is in accordance with the clearance requirements of Section 3507 of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507). The Commission may not conduct or sponsor, and

you are not required to respond to, a collection of information unless it displays a valid Office of Management and Budget (OMB) control number. The time required to complete and furnish this form will vary depending on individual circumstances. The estimated average time to complete an initial application is displayed on the facing page of this Form. Send comments regarding this burden estimate or suggestions for reducing the burden to Director, Office of Information Technology, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

7. Under Exchange Act Rule 17g-2(b)(10), an NRSRO must retain copies of all Form NRSROs (including Exhibits, accompanying information, and documents) submitted to the Commission. Exchange Act Rule 17g-2(c) requires that these records be retained for three years after the date the record is made.

8. ADDRESS - The mailing address for Form NRSRO is:
U. S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

9. A Form NRSRO will be considered furnished to the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form.

B. INSTRUCTIONS FOR AN INITIAL APPLICATION

An Applicant applying to be registered with the Commission as an NRSRO must furnish the Commission with an initial application on Form NRSRO. To complete an initial application:

- Check the "INITIAL APPLICATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 6, and 8. (See Instructions below for each Item). Enter "None" or "N/A" where appropriate.
- Unless exempt from the requirement, attach certifications from qualified institutional buyers, marked "Certification from Qualified Institutional Buyer" (See Instructions below for Item 6C).
- Attach Exhibits 1 through 13 (See Instructions below for each Exhibit).
- Execute the Form.

The Applicant must promptly furnish the Commission with a written notice if information submitted to the Commission in an initial application is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information found to be

materially inaccurate. The Applicant also must promptly furnish the Commission with an application supplement on Form NRSRO (See instructions below for an application supplement).

C. INSTRUCTIONS FOR AN APPLICATION TO ADD A CLASS OF CREDIT RATINGS

An NRSRO applying to register for an additional class of credit ratings must furnish the Commission with an application on Form NRSRO. To complete an application to register for an additional class of credit ratings:

- Check the "APPLICATION TO ADD CLASS OF CREDIT RATINGS" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 6, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on the previously furnished Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- Unless exempt from the requirement, attach certifications from qualified institutional buyers for the additional class of credit ratings marked "Certification from Qualified Institutional Buyer" (See Instructions below for Item 6C).
- If any information in an Exhibit previously furnished is materially inaccurate, update that information.
- Execute the Form.

The Applicant must promptly furnish the Commission with a written notice if information submitted to the Commission in an application to add a class of credit ratings is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information found to be materially inaccurate. The Applicant also must promptly furnish the Commission with an application supplement on Form NRSRO (See instructions below for an application supplement).

D. INSTRUCTIONS FOR AN APPLICATION SUPPLEMENT

An Applicant must furnish an application supplement to the Commission on Form NRSRO if information submitted to the Commission in a pending initial application for registration as an NRSRO or a pending application to register for an additional class of credit ratings is found to be or becomes materially inaccurate. To complete an application supplement:

- Check the "APPLICATION SUPPLEMENT" box at the top of Form NRSRO.
- Indicate on the line provided under the box the Item(s) or Exhibit(s) being supplemented.
- Complete Items 1, 2, 3, 4, 5 and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If supplementing an initial application, also complete Item 6. If supplementing an application for registration in an additional class of credit ratings, also complete Items 6 and 7. If any information in an Item on the previously furnished Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- If a certification from a qualified institutional buyer is being updated or a new certification is being added, attach the updated or new certification.
- If an Exhibit is being updated, attach the updated Exhibit.
- Execute the Form.

E. INSTRUCTIONS FOR AN UPDATE OF REGISTRATION

After registration is granted, Section 15E(b)(1) of the Exchange Act requires that an NRSRO must promptly amend its application for registration if information or documents provided in the previously furnished Form NRSRO become materially inaccurate. This requirement does not apply to Item 7 and Exhibit 1, which only are required to be updated annually with the annual certification. It also does not apply to Exhibits 10 – 13 and the certifications from qualified institutional buyers, which are not required to be updated on Form NRSRO after registration. An NRSRO amending its application for registration must furnish the Commission with an update of its registration on Form NRSRO. To complete an update of registration:

- Check the "UPDATE OF REGISTRATION" box at the top of Form NRSRO.
- Indicate on the line provided under the box the Item(s) or Exhibit(s) being updated.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on the previously furnished Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- If an Exhibit is being updated, attach the updated Exhibit.
- Execute the Form.

F. INSTRUCTIONS FOR ANNUAL CERTIFICATIONS

After registration is granted, Section 15E(b)(2) of the Exchange Act requires that an NRSRO furnish the Commission with an annual certification not later than 90 days after the end of each calendar year. The annual certification must be furnished to the Commission on Form NRSRO and must include an update of the information in Item 7 and the credit ratings performance measurement statistics furnished in Exhibit 1, a certification that the information and documents furnished on or with Form NRSRO continue to be accurate (use the certification on the Form), and a list of material changes to the application for registration that occurred during the previous calendar year. To complete an annual certification:

- Check the "ANNUAL CERTIFICATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on the previously furnished Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- If any information in an Exhibit previously furnished is materially inaccurate, update that information.
- Attach a list of all material changes made to the information or documents in the application for registration of the NRSRO that occurred during the previous calendar year.
- Execute the Form.

G. INSTRUCTIONS FOR A WITHDRAWAL FROM REGISTRATION

Section 15E(e)(1) of the Exchange Act provides that an NRSRO may voluntarily withdraw its registration with the Commission. To withdraw from registration, an NRSRO must furnish the Commission with a notice of withdrawal from registration on Form NRSRO. The withdrawal from registration will become effective 45 calendar days after the withdrawal from registration is furnished to the Commission upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors. To complete a withdrawal from registration:

- Check the "WITHDRAWAL FROM REGISTRATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information on the previously furnished Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.

- Execute the Form.

H. INSTRUCTIONS FOR SPECIFIC LINE ITEMS

Item 1A. Provide the name of the person (e.g., XYZ Corporation) that is furnishing the Form NRSRO to the Commission. This means the name of the person that is applying for registration as an NRSRO or is registered as an NRSRO and not the name of the individual that is executing the Form.

Item 1E. The individual listed as the contact person must be authorized to receive all communications and papers from the Commission and must be responsible for their dissemination within the Applicant/NRSRO.

Certification. The certification must be executed by the Chief Executive Officer or the President of the person that is furnishing the Form NRSRO to the Commission or an individual with similar responsibilities.

Item 3. Identify credit rating affiliates that issue credit ratings on behalf of the person furnishing the Form NRSRO to the Commission in one or more of the classes of credit ratings identified in Item 6 or Item 7. A “credit rating affiliate” is a separate legal entity or a separately identifiable department or division thereof that determines credit ratings that are credit ratings of the person furnishing the Form NRSRO to the Commission. The information in Items 4 – 8 and all the Exhibits must incorporate information about the credit ratings, methodologies, procedures, policies, financial condition, results of operations, personnel, and organizational structure of each credit rating affiliate identified in Item 3, as applicable. Any credit rating determined by a credit rating affiliate identified in Item 3 will be treated as a credit rating issued by the person furnishing the Form NRSRO to the Commission for purposes of Section 15E of the Exchange Act and the Commission’s rules thereunder. The terms “Applicant” and “NRSRO” as used on Form NRSRO and the Instructions for the Form mean the person furnishing the Form NRSRO to the Commission and any credit rating affiliate identified in Item 3.

Item 4. Section 15E(j) of the Exchange Act requires an NRSRO to designate a compliance officer responsible for administering the policies and procedures of the NRSRO established pursuant to Sections 15E(g) and (h) of the Exchange Act (respectively, to prevent the misuse of material nonpublic information and address and manage conflicts of interest) and for ensuring compliance with applicable securities laws, rules, and regulations.

Item 5. Section 15E(a)(3) of the Exchange Act and Exchange Act Rule 17g-1(i) require an NRSRO to make Form NRSRO and Exhibits 1 – 9 to Form NRSRO furnished to the Commission publicly available on the NRSRO’s Web site, or through another comparable, readily accessible means within 10 business days after the date of the Commission order granting an initial application for registration as an NRSRO or an application to register for an additional class of credit ratings and within 10 business days after furnishing the Commission with an amendment,

annual certification, or withdrawal of registration on Form NRSRO. The certifications from qualified institutional investors, Disclosure Reporting Pages, and Exhibits 10 through 13 are not required to be made publicly available on the NRSRO's Web site, or through another comparable, readily accessible means. Describe how the current Form NRSRO and Exhibits 1 – 9 will be made publicly available. If they will be posted on a Web site, for example, give the Internet address and link to the Form and Exhibits.

Item 6. Complete Item 6 only if furnishing an initial application for registration, an application to be registered in an additional class of credit ratings, or an application supplement.

Item 6A. Pursuant to Section 15E(a)(1)(B)(vii) of the Exchange Act, an Applicant applying for registration as an NRSRO must disclose in the application the classes of credit ratings for which the Applicant/NRSRO is applying to be registered. Indicate these classes by checking the appropriate box or boxes. For each class of credit ratings, provide in the appropriate box the approximate number of credit ratings the Applicant/NRSRO presently has outstanding as of the date of the application. Pursuant to the definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act, an Applicant/NRSRO must have been in business as a "credit rating agency" for at least the 3 consecutive years immediately preceding the date of its application for registration as an NRSRO. For each class of credit ratings, also provide in the appropriate box the approximate date the Applicant/NRSRO began issuing and making readily accessible credit ratings in the class on a continuous basis through the present as a "credit rating agency," as that term is defined in Section 3(a)(61) of the Exchange Act. If there was a period when the Applicant/NRSRO stopped issuing credit ratings in a particular class or stopped operating as a credit rating agency, provide the approximate date the Applicant/NRSRO resumed issuing and making readily accessible credit ratings in that class as a credit rating agency. Refer to the definition of "credit rating agency" in the instructions below (also at 15 U.S.C. 78c(a)(61)) to determine when the Applicant/NRSRO began operating as a "credit rating agency."

Item 6B. To meet the definition of "credit rating agency" pursuant to Section 3(a)(61)(A) of the Exchange Act, the Applicant must, among other things, issue "credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee." Briefly describe how the Applicant/NRSRO makes the credit ratings in the classes indicated in Item 6A readily accessible for free or for a reasonable fee. If a person must pay a fee to obtain a credit rating made readily accessible by the Applicant/NRSRO, provide a fee schedule or describe the price(s) charged.

Item 6C. If the Applicant/NRSRO is required to furnish qualified institutional buyer certifications, under Section 15E(a)(1)(C) of the Exchange Act, submit a minimum of 10 certifications from qualified institutional buyers, none of which is affiliated with the Applicant/NRSRO. Each certification may address more than one class of credit ratings.

To be registered as an NRSRO for a class of credit ratings identified in Item 6A under "Applying for Registration," the Applicant/NRSRO must submit at least two certifications that address the class of credit ratings. If this is an application of an NRSRO to be registered in one or more additional classes of credit ratings, furnish at least two certifications that address each additional class of credit ratings.

The required certifications must be signed by a person duly authorized by the certifying entity, must be notarized, must be marked "Certification from Qualified Institutional Buyer," and must be in substantially the following form:

"I, [Executing official], am authorized by [Certifying entity] to execute this certification on behalf of [Certifying entity]. I certify that all actions by stockholders, directors, general partners, and other bodies necessary to authorize me to execute this certification have been taken and that [Certifying entity]:

(i) Meets the definition of a 'qualified institutional buyer' as set forth in section 3(a)(64) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(64)) pursuant to the following subsection(s) of 17 CFR

230.144A(a)(1) [insert applicable citations];

(ii) Has seriously considered the credit ratings of [the Applicant/NRSRO] in the course of making some of its investment decisions for at least the three years immediately preceding the date of this certification, in the following classes of credit ratings: [Insert applicable classes of credit ratings]; and

(iii) Has not received compensation either directly or indirectly from [the Applicant/NRSRO] for executing this certification.

[Signature _____]

Print Name and Title

You are not required to make a Certification from a Qualified Institutional Buyer submitted with this Form NRSRO publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep these certifications confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the certifications confidential upon request to the extent permitted by law.

Item 7. An Applicant furnishing Form NRSRO to apply for registration as an NRSRO should not complete Item 7. An NRSRO furnishing Form NRSRO for any other reason must complete Item 7. The information in Item 7 must be updated on an annual basis with the furnishing of the annual certification.

Item 7A. Indicate the classes of credit ratings for which the NRSRO is currently registered by checking the appropriate box or boxes. For each class of credit ratings, provide in the appropriate box the approximate number of credit ratings the NRSRO had outstanding as of the end of the most recently ended calendar year. For each class of credit ratings, also provide in the appropriate box the approximate date the NRSRO began issuing and making readily accessible credit ratings in the class on a continuous basis through the present as a "credit rating agency," as that term is defined in Section 3(a)(61) of the Exchange Act. If there was a period when the NRSRO stopped issuing credit ratings in a particular class or stopped operating as a credit rating agency, provide the approximate date the NRSRO resumed issuing and making readily accessible credit ratings in that class as a credit rating agency. Refer to the definition of "credit rating agency" in the instructions below (also at 15 U.S.C. 78c(a)(61)) to determine when the NRSRO began operating as a "credit rating agency."

Item 7B. Briefly describe how the NRSRO makes the credit ratings in the classes indicated in Item 7A readily accessible for free or for a reasonable fee. If a person must pay a fee to obtain a credit rating made readily accessible by the NRSRO, provide a fee schedule or describe the price(s) charged.

Item 8. Answer each question by checking the appropriate box. Refer to the definition of "person within an Applicant/NRSRO" set forth below to determine the persons to which the questions apply. Information that relates to an affirmative answer must be provided on a Disclosure Reporting Page (NRSRO) and furnished with Form NRSRO. Submit a separate Disclosure Reporting Page (NRSRO) for each person that: (a) has committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Securities Exchange Act of 1934, has been convicted of any offense specified in section 15(b)(4)(B) of the Securities Exchange Act of 1934, or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Securities Exchange Act of 1934; (b) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Securities Exchange Act of 1934, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; or (c) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO. The Disclosure Reporting Page (NRSRO) is attached to these instructions. Note: the

definition of "person within an Applicant/NRSRO" is narrower than the definition of "person associated with a nationally recognized statistical rating organization" in Section 3(a)(63) of the Exchange Act.

You are not required to make any disclosure reporting pages submitted with this Form NRSRO publicly available on your Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i).

You may request that the Commission keep any disclosure reporting pages confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the disclosure reporting pages confidential upon request to the extent permitted by law.

Item 9. Exhibits. Section 15E(a)(1)(B) of the Exchange Act requires a credit rating agency's application for registration as an NRSRO to contain certain specific information and documents and, pursuant to Section 15E(a)(1)(B)(x), any other information and documents concerning the applicant and any person associated with the applicant that the Commission requires as necessary or appropriate in the public interest or for the protection of investors. If any information or document required to be included with any Exhibit is maintained in a language other than English, provide a copy of the original document and a version of the document translated into English. Attach a certification by an authorized person that the translated version is a true, accurate, and complete English translation of the information or document. Attach the Exhibits to Form NRSRO in numerical order. Bind each Exhibit separately, and mark each Exhibit or bound volume of the Exhibit with the appropriate Exhibit number. The information provided in the Exhibits must be sufficiently detailed to allow for verification. The information and documents provided in Exhibits 1 through 9 must be made publicly available on the NRSRO's Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). The information and documents required to be provided in Exhibits 10 through 13 are not required to be made publicly available on the NRSRO's Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep these Exhibits confidential by marking each page of them "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in these Exhibits confidential upon request to the extent permitted by law.

Exhibit 1. Provide in this Exhibit performance measurement statistics of the credit ratings of the Applicant/NRSRO over short-term, mid-term, and long-term periods (as applicable) through the most recent calendar year-end, including, as applicable: historical down-grade and default rates within each of the credit rating categories, notches, grades, or rankings used by the Applicant/NRSRO as an indicator of the

assessment of the creditworthiness of an obligor, security, or money market instrument. As part of this Exhibit, define the credit rating categories, notches, grades, and rankings used by the Applicant/NRSRO and explain the performance measurement statistics, including the inputs, time horizons, and metrics used to determine the statistics.

Exhibit 2. Provide in this Exhibit a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings, including unsolicited credit ratings within the classes of credit ratings for which the Applicant/NRSRO is seeking registration or is registered. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the Applicant/NRSRO in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; the quantitative and qualitative models and metrics used to determine credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. An Applicant/NRSRO may provide in Exhibit 2 the location on its Web site where additional information about the procedures and methodologies is located.

Exhibit 3. Provide in this Exhibit a copy of the written policies and procedures established, maintained, and enforced by the Applicant/NRSRO to prevent the misuse of material, nonpublic information pursuant to Section 15E(g) of the Exchange Act and 17 CFR 240.17g-4. Do not include any information that is proprietary or that would diminish the effectiveness of a specific policy or procedure if made publicly available.

Exhibit 4. Provide in this Exhibit information about the organizational structure of the Applicant/NRSRO, including, as applicable, an organizational chart that identifies, as applicable, the ultimate and sub-holding companies, subsidiaries, and material affiliates of the Applicant/NRSRO; an organizational chart showing the

divisions, departments, and business units of the Applicant/NRSRO; and an organizational chart showing the managerial structure of the Applicant/NRSRO, including the designated compliance officer identified in Item 4.

Exhibit 5. Provide in this Exhibit a copy of the written code of ethics the Applicant/NRSRO has in effect or a statement of the reasons why the Applicant/NRSRO does not have a written code of ethics in effect.

Exhibit 6. Identify in this Exhibit the types of conflicts of interest relating to the issuance of credit ratings by the Applicant/NRSRO that are material to the Applicant/NRSRO. First, identify the conflicts described in the list below that apply to the Applicant/NRSRO. The Applicant/NRSRO may use the descriptions below to identify an applicable conflict of interest and is not required to provide any further details. Second, briefly describe any other type of conflict of interest relating to the issuance of credit ratings by the Applicant/NRSRO that is not covered in the descriptions below that is material to the Applicant/NRSRO (for example, one the Applicant/NRSRO has established specific policies and procedures to address):

- The Applicant/NRSRO is paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.
- The Applicant/NRSRO is paid by obligors to determine credit ratings of the obligors.
- The Applicant/NRSRO is paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the Applicant/NRSRO to determine a credit rating.
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons may use the credit ratings of the Applicant/NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term "nationally recognized statistical rating organization."
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the Applicant/NRSRO.
- The Applicant/NRSRO allows persons within the Applicant/NRSRO to:
 - Directly own securities or money market instruments of, or have other direct ownership interests in, obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.

- Have business relationships that are more than arms length ordinary course business relationships with obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.
- A person associated with the Applicant/NRSRO is a broker or dealer engaged in the business of underwriting securities or money market instruments (identify the person).
- The Applicant/NRSRO has any other material conflict of interest that arises from the issuances of credit ratings (briefly describe).

Exhibit 7. Provide in this Exhibit a copy of the written policies and procedures established, maintained, and enforced by the Applicant/NRSRO to address and manage conflicts of interest pursuant to Section 15E(h) of the Exchange Act. Do not include any information that is proprietary or that would diminish the effectiveness of a specific policy or procedure if made publicly available.

Exhibit 8. Provide in this Exhibit the following information about the Applicant/NRSRO's credit analysts (See definition below) and the persons who supervise the credit analysts:

- The total number of credit analysts.
- The total number of credit analyst supervisors.
- A general description of the minimum qualifications required of the credit analysts, including education level and work experience (if applicable, distinguish between junior, mid, and senior level credit analysts).
- A general description of the minimum qualifications required of the credit analyst supervisors, including education level and work experience.

Exhibit 9. Provide in this Exhibit the following information about the designated compliance officer (identified in Item 4) of the Applicant/NRSRO:

- Name.
- Employment history.
- Post secondary education.
- Whether employed by the Applicant/NRSRO full-time or part-time.

Exhibit 10. Provide in this Exhibit a list of the largest users of credit rating services of the Applicant by the amount of net revenue earned by the Applicant attributable to the person during the fiscal year ending immediately before the date of the initial application. First, determine and list the 20 largest issuers and

subscribers in terms of net revenue. Next, add to the list any obligor or underwriter that, in terms of net revenue during the fiscal year, equaled or exceeded the 20th largest issuer or subscriber. In making the list, rank the persons in terms of net revenue from largest to smallest and include the net revenue amount for each person. For purposes of this Exhibit:

Net revenue means revenue earned by the Applicant for any type of service or product provided to the person, regardless of whether related to credit rating services, and net of any rebates and allowances the Applicant paid or owes to the person; and

Credit rating services means any of the following: rating an obligor (regardless of whether the obligor or any other person paid for the credit rating); rating an issuer's securities or money market instruments (regardless of whether the issuer, underwriter, or any other person paid for the credit rating); and providing credit ratings, credit ratings data, or credit ratings analysis to a subscriber.

An NRSRO is not required to make this Exhibit publicly available on its Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 11. Provide in this Exhibit the financial statements of the Applicant, which must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity, audited by an independent public accountant, for each of the three fiscal or calendar years ending immediately before the date of the Applicant's initial application to the Commission, subject to the following: If the Applicant is a division, unit, or subsidiary of a parent company, the Applicant may provide audited consolidated financial statements of its parent company.

If the Applicant does not have audited financial statements for one or more of the three fiscal or calendar years ending immediately before the date of the initial application, the Applicant can provide unaudited financial statements for the applicable year or years, but must provide audited financial statements for the fiscal or calendar year ending immediately before the date of the initial application. Attach to the unaudited financial statements a certification by a person duly authorized by the Applicant to make the certification that the person has responsibility for the financial statements and that to the best knowledge of the person making

the certification the financial statements fairly present; in all material respects, the Applicant's financial condition, results of operations, and cash flows for the period presented.

An NRSRO is not required to make this Exhibit publicly available on its Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 12. Provide in this Exhibit the following information, as applicable, and which is not required to be audited, regarding the Applicant's aggregate revenues for the fiscal or calendar year ending immediately before the date of the initial application:

- Revenue from determining and maintaining credit ratings;
- Revenue from subscribers;
- Revenue from granting licenses or rights to publish credit ratings; and
- Revenue from all other services and products offered by your credit rating organization (include descriptions of any major sources of revenue).

An NRSRO is not required to make this Exhibit publicly available on its Web site or, through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

Exhibit 13. Provide in this Exhibit the approximate total and median annual compensation of the Applicant's credit analysts for the fiscal or calendar year ending immediately before the date of this initial application. In calculating total and median annual compensation, the Applicant may exclude deferred compensation, provided such exclusion is noted in the Exhibit.

An NRSRO is not required to make this Exhibit publicly available on its Web site, or through another comparable, readily accessible means pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying

with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.

F. EXPLANATION OF TERMS.

1. COMMISSION - The U. S. Securities and Exchange Commission.
2. CREDIT RATING [Section 3(a)(60) of the Exchange Act] - An assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.
3. CREDIT RATING AGENCY [Section 3(a)(61) of the Exchange Act] - Any person:
 - engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;
 - employing either a quantitative or qualitative model, or both to determine credit ratings; and
 - receiving fees from either issuers, investors, other market participants, or a combination thereof.
4. NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION [Section 3(a)(62) of the Exchange Act] - A credit rating agency that:
 - has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration as an NRSRO;
 - issues credit ratings certified by qualified institutional buyers in accordance with section 15(a)(1)(B)(ix) of the Exchange Act with respect to:
 - financial institutions, brokers, or dealers;
 - insurance companies;
 - corporate issuers;
 - issuers of asset-backed securities;
 - issuers of government securities, municipal securities, or securities issued by a foreign government; or
 - a combination of one or more of the above; and
 - is registered as an NRSRO.

6. PERSON - An individual, partnership, corporation, trust, company, limited liability company, or other organization (including a separately identifiable department or division).
7. PERSON WITHIN AN APPLICANT/NRSRO – The person furnishing Form NRSRO identified in Item 1, any credit rating affiliates identified in Item 3, and any partner, officer, director, branch manager, or employee of the person or the credit rating affiliates (or any person occupying a similar status or performing similar functions).
8. SEPARATELY IDENTIFIABLE DEPARTMENT OR DIVISION - A unit of a corporation or company:
 - that is under the direct supervision of an officer or officers designated by the board of directors of the corporation as responsible for the day-to-day conduct of the corporation's credit rating activities for one or more affiliates, including the supervision of all employees engaged in the performance of such activities; and
 - for which all of the records relating to its credit rating activities are separately created or maintained in or extractable from such unit's own facilities or the facilities of the corporation, and such records are so maintained or otherwise accessible as to permit independent examination and enforcement by the Commission of the Exchange Act and rules and regulations promulgated thereunder.
8. QUALIFIED INSTITUTIONAL BUYER [Section 3(a)(64) of the Exchange Act] - An entity listed in 17 CFR 230.144A(a) that is not affiliated with the credit rating agency.

DISCLOSURE REPORTING PAGE (NRSRO)

This Disclosure Reporting Page (DRP) is to be used to provide information concerning affirmative responses to **Item 8** of Form NRSRO.

Submit a separate DRP for each person that: (a) has committed or omitted any act, or been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Securities Exchange Act of 1934, has been convicted of any offense specified in section 15(b)(4)(B) of the Securities Exchange Act of 1934, or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Securities Exchange Act of 1934; (b) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Securities Exchange Act of 1934, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; or (c) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO.

Name of Applicant/NRSRO

Date

Check Item being responded to:

- Item 8A
- Item 8B
- Item 8C

Full name of the person for whom this DRP is being submitted:

If this DRP provides information relating to a "Yes" answer to Item 8A, describe the act(s) that was (were) committed or omitted; or the order(s) or finding(s); or the injunction(s) (provide the relevant statute(s) or regulation(s)) and provide jurisdiction(s) and date(s):

If this DRP provides information relating to a "Yes" answer to Item 8B, describe the crime(s) and provide jurisdiction(s) and date(s):

If this DRP provides information relating to a "Yes" answer to Item 8C, attach the relevant Commission order(s) and provide the date(s):

By the Commission.



Florence E. Harmon
Deputy Secretary

Date: June 5, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55863 / June 5, 2007

Admin. Proc. File No. 3-12475

In the Matter of

FUELNATION, INC.,
SDT HOLDING CORP.,
SAMESSA HOLDING CORP.,
SILVER QUEST, INC., and
SYTRON, INC.

ORDER DISMISSING PROCEEDING BASED ON LACK OF REGISTRATION

On November 8, 2006, the Commission instituted an administrative proceeding against FuelNation, Inc. ("FuelNation") and four other respondents under Section 12(j) of the Securities Exchange Act of 1934. ^{1/} In the order instituting proceedings ("OIP"), the Division of Enforcement alleged that FuelNation had "a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g)" and was "delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2004." The Commission instituted the proceeding to determine whether the allegations were true and whether it was "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" FuelNation. ^{2/}

On December 6, 2006, the Division moved to dismiss FuelNation from the proceeding. According to the Division, at the time the Commission issued the OIP, the Division "believed that FuelNation was registered under Exchange Act Section 12(g) based on the issuer's most recent filings with the Commission that represented that it was so registered." In its motion, the Division stated that it "recently discovered . . . that FuelNation no longer had any class of securities registered pursuant to Exchange Act Section 12" and that "[b]ecause FuelNation

^{1/} 15 U.S.C. § 78l(j).

^{2/} See *id.* (authorizing the Commission, "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 . . . that the issuer of such security has failed to comply with any provision of [the Exchange Act] or the rules and regulations thereunder").

currently has no classes of equity securities registered pursuant to Exchange Act Section 12, this proceeding is moot and should be dismissed by the Commission." We agree.

FuelNation's predecessor, International Pizza Corporation, filed a Form 8-A on September 15, 1993, registering its common stock and warrants under Exchange Act Section 12(b) for listing on the Boston Stock Exchange. On February 17, 1998, however, the Commission's Division of Market Regulation, acting pursuant to delegated authority, entered an order on behalf of the Commission striking the common stock and warrants from listing on the Boston Stock Exchange and from registration under Exchange Act Section 12(b). ^{3/} A registrant, however, "may have section 12(g) reporting obligations following its termination of registration of a class of equity securities under section 12(b) . . . under Exchange Act Rule 12g-2." ^{4/} Under Exchange Act Rule 12g-2,

[a]ny class of securities which would have been required to be registered pursuant to section 12(g)(1) of the Act except for the fact that it was exempt from such registration by section 12(g)(2)(A) because it was listed and registered on a national securities exchange . . . shall upon the termination of the listing and registration of such class . . . and without the filing of an additional registration statement be deemed to be registered pursuant to said section 12(g)(1) if at the time of such termination . . . securities of the class are not exempt from such registration pursuant to section 12 or rules thereunder . . . and all securities of such class are held of record by 300 or more persons. ^{5/}

The Division represents that, as of February 17, 1998, FuelNation's transfer agent listed 110 shareholders of record for FuelNation's common stock. In a Form 10-KSB filed on July 10, 1998, Regensis, another predecessor corporation to FuelNation, stated that, as of March 31, 1998, "there were 112 holders of record of" its common stock. According to the Division, FuelNation's transfer agent indicated that there were just thirty-one holders of record of the warrants in 1998 and that the warrants expired in September 1998.

The Division thus moved to dismiss the proceeding against FuelNation because it "no longer had any class of securities registered pursuant to Exchange Act Section 12." FuelNation has not responded to the Division's motion. Because revocation or suspension of registration are

^{3/} Securities Exchange Act Rel. No. 39674 (Feb. 17, 1998), 66 SEC Docket 1707.

^{4/} See Exchange Act Rel. No. 55005 (Dec. 22, 2006), __ SEC Docket __, __ n.27.

^{5/} 17 C.F.R. § 240.12g-2.

the only remedies available in a proceeding instituted under Section 12(j) of the Exchange Act, we find that it is appropriate to dismiss the proceeding against FuelNation. ^{6/}

Accordingly, it is ORDERED that this proceeding be, and it hereby is, dismissed with respect to FuelNation, Inc.

By the Commission.

Nancy M. Morris
Secretary



Florence E. Harmon
Deputy Secretary

^{6/} Cf. Enamelon, Inc., Exchange Act Rel. No. 52956 (Dec. 15, 2005), 86 SEC Docket 2944 (dismissing Section 12(j) proceeding with respect to respondent Semiconductor Laser International Corp. where respondent "no longer ha[d] a class of securities registered under Section 12 of the Exchange Act").

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55867 / June 6, 2007

Admin. Proc. File No. 3-12329

In the Matter of

AMERICA'S SPORTS VOICE, INC.
(N/K/A MILAGRO HOLDINGS, INC.)
c/o Samy M. Salem, Interim President
53 Finch Drive
Roslyn, New York 11576

ORDER DENYING MOTION FOR RECONSIDERATION

I.

On March 22, 2007, we issued an opinion and order revoking the registration of all classes of the registered securities of America's Sports Voice, Inc., n/k/a Milagro Holdings, Inc. (the "Company"). 1/ We found there that the Company had violated Section 13(a) of the Securities Exchange Act of 1934 2/ and Exchange Act Rules 13a-1 3/ and 13a-13 4/ by failing to file annual or quarterly reports for any period after June 30, 2001 and, based on that finding, concluded that the protection of investors required the revocation of the registration of the Company's securities pursuant to Exchange Act Section 12(j). 5/ The Company has now filed a motion for reconsideration. For the reasons discussed below, we have determined to deny the Company's motion.

1/ America's Sports Voice, Inc., Securities Exchange Act Rel No. 55511 (Mar. 22, 2007), __ SEC Docket ____.

2/ 15 U.S.C. § 78m(a).

3/ 17 C.F.R. § 240.13a-1.

4/ 17 C.F.R. § 240.13a-13.

5/ 15 U.S.C. § 78l(j).

II.

We review the Company's motion to reconsider under Rule 470 of the Commission's Rules of Practice. 6/ A motion for reconsideration is designed to correct manifest errors of law or fact or to permit the presentation of newly discovered evidence, 7/ but may not be used to repeat arguments previously made. 8/ The Company's motion does not meet the rigorous standard that such motions are subject to and thus affords no basis for reconsideration of our opinion and order. 9/

The Company's arguments in the motion are, for the most part, simply reiterations of arguments and facts previously presented. For example, our opinion considered and rejected the Company's argument that the public interest favors its continued registration because such registration was supported by a majority of its stockholders. Similarly, the Company supports its reconsideration motion by stating that "[o]ver 85% of the current stockholders are aware of the present situation of the Company as well as the position of the Commission and yet continue to give their support to the Company's endeavors for continued registration." As we held in our earlier opinion, however, "regard must be had not only for existing stockholders of the issuer, but also for potential investors . . ." and that, "[i]n any event, both existing and prospective shareholders are harmed by the continuing lack of current and reliable financial information for the Company." 10/

6/ 17 C.F.R. § 201.470.

7/ Leslie A. Arouh, Securities Exchange Act. Rel. No. 51254 (Feb. 25, 2005), 84 SEC Docket 3652, 3653. See also KPMG Peat Marwick LLP, Order Denying Request for Reconsideration, 55 S.E.C. 1, 3 n.7 (2001) (specifying that efficiency and fairness concerns embodied in federal court practice of rejecting motions for reconsideration unless correction of manifest errors of law or fact or presentation of newly discovered evidence is sought "likewise inform our review of motions for reconsideration under Rule 470").

8/ Arouh, 84 SEC Docket at 3653 (holding that respondents cannot use motions for reconsideration "to reiterate arguments previously made or to cite authorities previously available").

9/ Compare Robert Sayegh, Order Granting Request for Reconsideration, 54 S.E.C. 289 (1999) (granting motion for reconsideration in order to take into account change in applicable law).

10/ America's Sports Voice, Inc., ___ SEC Docket at ___ (citation omitted).

The Company also now asserts that it has all "information necessary to file all past and present requirements and intends to do so regardless of the eventual final decision." 11/ It further claims that it has made "arrangements to secure enough funds and assets to comply with past and present Federal and State requirements as well as the necessary final resources required to move forward." However, as we held in our earlier opinion, given the Company's long history of failing to file its annual and quarterly reports, a failure that has continued through its change of management, the institution of these proceedings, and our June 2006 order temporarily suspending trading in the Company's stock, we are not persuaded by its promises to comply at some unspecified point in the future. 12/ Under the circumstances, we see no basis for altering our earlier conclusion that revocation of the Company's securities registration is necessary for the protection of investors.

Accordingly, IT IS ORDERED that the motion for reconsideration filed by America's Sports Voice, Inc., n/k/a Milagro Holdings, Inc., be, and it hereby is, DENIED.

By the Commission.

Nancy M. Morris
Secretary



Florence E. Harmon
Deputy Secretary

11/ In its earlier appeal, the Company had conditioned its offer to comply upon our agreeing not to revoke its registration and to "grant[ing] the Company 90 days" to complete its deficient reports. The Company explained, in its earlier briefs, that it "did not want to expend these funds [needed to file the deficient reports] unless it was given a 90-day window" to return to compliance.

12/ We note in this connection that, as we observed in the opinion in this case, revocation may still be warranted notwithstanding the fact that an issuer, which had violated reporting requirements, "had taken significant steps to return to compliance." America's Sports Voice, Inc., __ SEC Docket at ____ n.21.

/

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55869 / June 6, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12653

In the Matter of

CHRIS G. GUNDERSON, Esq.

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS AND
IMPOSING TEMPORARY SUSPENSION
PURSUANT TO RULE 102(e)(3) OF THE
COMMISSION'S RULES OF PRACTICE**

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 Rule 102(e)(3)¹ of the Commission's Rules of Practice against Chris G. Gunderson ("Respondent" or "Gunderson").

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . attorney . . . who has been by name . . . (A) permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating . . . any provision of the Federal securities laws or of the rules and regulations thereunder; or (B) found in any court of competent jurisdiction in an action brought by the Commission to which he or she is a party . . . to have violated (unless the violation was found not to have been willful) . . . any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

The Commission finds that:

A. RESPONDENT

1. Gunderson is and has been an attorney licensed to practice in the State of New York. He is currently the General Counsel of Universal Express, Inc., a position he has held since 1995.

B. COURT FINDINGS & INJUNCTION

2. On February 21, 2007, the U.S. District Court for the Southern District of New York issued an order finding that Gunderson deliberately, or at least recklessly, violated Sections 5 and 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. On April 2, 2007 the court entered final judgment against Gunderson, permanently enjoining him from future violations of those securities laws. Securities and Exchange Commission v. Universal Express Inc., et al., Civil Action Number 04-2322.

3. The court found that Gunderson and others issued and distributed more than 500 million shares of unregistered shares in violation of Section 5 of the Securities Act of 1933. To create the appearance that the issuances qualified for registration on Form S-8, the court found that Gunderson prepared questionable "consulting agreements." The court also found that Gunderson told Universal Express's transfer agent that the stock was validly registered, even though it was not.

4. The court also found that Gunderson and others engaged in a fraudulent scheme to defraud investors by issuing false or misleading press releases announcing large funding commitments that would enable Universal Express to acquire other companies. The court found that Gunderson drafted or edited the press releases and then reviewed and approved them before their release, and that the statements in the releases were "at best misleading and sometimes wholly fantastical." Each of these press releases was followed by a substantial increase in Universal Express's share price and trading volume, permitting several of the defendants to dispose of large amounts of the unregistered shares.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has permanently enjoined Gunderson, an attorney, from violating the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) of the Commission's Rules of Practice. The Commission also finds that a court of competent jurisdiction has found that Gunderson, an attorney, violated the Federal securities laws within the meaning of Rule 102(e)(3)(i)(B) of the Commission's Rules of Practice. In view of these findings, the Commission deems it appropriate and in the public interest that Gunderson be temporarily suspended from appearing or practicing before the Commission.

IT IS HEREBY ORDERED that Gunderson be, and hereby is, temporarily suspended from appearing or practicing before the Commission. This Order will be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Gunderson may, within thirty days after service of this Order, file a petition with the Commission to lift the temporary suspension. If the Commission receives no petition within thirty days after service of the Order, the suspension will become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission will, within thirty days after the filing of the petition, either lift the temporary suspension, or set the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Gunderson personally or by certified mail at his last known address.

By the Commission.

Nancy M. Morris
Secretary


By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55871; File No. SR-CBOE-2006-84)

June 6, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 5 to a Proposed Rule Change to List and Trade Credit Default Options; and Order Granting Accelerated Approval of the Proposed Rule Change, as Modified by Amendment Nos. 3, 4, and 5, and Designating Credit Default Options as Standardized Options under Rule 9b-1 of the Securities Exchange Act of 1934

I. Introduction

On October 26, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² to permit CBOE to list and trade cash-settled, binary call options based on credit events in one or more debt securities of an issuer, referred to as credit default options.

On December 21, 2006, CBOE filed Amendment No. 1 to the proposed rule change; on January 16, 2007, CBOE filed Amendment No. 2 to the proposed rule change; on February 2, 2007, CBOE filed Amendment No. 3 to the proposed rule change;³ and on February 7, 2007, CBOE filed Amendment No. 4 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on February 14, 2007.⁴ The Commission received no comments on the proposal. On March 28, 2007, CBOE filed Amendment No. 5 to the proposed rule change (“Amendment No. 5”). This notice and order notices Amendment No. 5; solicits comments from interested persons on Amendment No. 5; approves the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 3 replaced the original filing, as modified by Amendment Nos. 1 and 2, in its entirety.

⁴ See Securities Exchange Act Release No. 55251 (February 7, 2007) (SR-CBOE-2006-84), 72 FR 7091 (“CBOE Proposal”).

change, as amended, on an accelerated basis; and designates credit default options as “standardized options” pursuant to Rule 9b-1 under the Act.⁵

II. Description of the CBOE Proposal

A. Generally

CBOE proposes to list and trade credit default options, which are cash-settled, binary options⁶ that are automatically exercised upon the occurrence of specified credit events or expire worthless. A credit default option would be referenced to the debt securities issued by a specified public company (“Reference Entity”)⁷ and would either have a fixed payout or expire worthless, depending upon whether or not a credit event (as described below) occurs during the life of the option. Upon confirmation of a credit event prior to the last day of trading of a credit default option series,⁸ the options positions existing as of that time would be automatically exercised and the holders of long options positions would receive a fixed cash payment of

⁵ See 17 CFR 240.9b-1. Pursuant to Rule 9b-1(a)(4) under the Act, the Commission may, by order, designate as “standardized options” securities that do not otherwise meet the definition for “standardized options.” Standardized options are defined in Rule 9b-1(a)(4) as: “[O]ptions contracts trading on a national securities exchange, an automated quotations system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.” 17 CFR 240.9b-1(a)(4).

⁶ A binary option is a style of option having only two possible payoff outcomes: either a fixed amount or nothing at all.

⁷ Proposed CBOE Rule 29.1(f) also includes as a “Reference Entity” the guarantor of the debt security underlying the credit default option.

⁸ Proposed CBOE Rule 29.9 requires that CBOE confirm the occurrence of a credit event through at least two sources, which may include announcements published via newswire services or information service companies, the names of which would be announced to the membership via a CBOE regulatory circular, or information contained in any order, decree, or notice of filing, however described, of or filed with the courts, the Commission, an exchange, an association, the Options Clearing Corporation (“OCC”), or another regulatory agency or similar authority.

\$100,000 per contract.⁹ If no credit event is confirmed during the life of the option, the final settlement price would be \$0.

Credit events that would trigger automatic exercise include a failure to make payment pursuant to the terms of the underlying debt security and any other event of default specified by CBOE at the time the Exchange initially lists a particular class of credit default options. The events of default that CBOE may specify must be defined in accordance with the terms of the debt security underlying the credit default option (“Reference Obligation”) or any other debt security of the Reference Entity (collectively with the Reference Obligation, “Relevant Obligations”).¹⁰

B. Listing Standards

A credit default option must conform to the initial and continued listing standards under proposed CBOE Chapter XXIX. CBOE may list and trade a credit default option that overlies a debt security of a Reference Entity, provided that such issuer or guarantor, or its parent if a wholly owned subsidiary, has at least one class of securities that is registered under the Act and is an “NMS stock”¹¹ as defined in Rule 600 of Regulation NMS under the Act.¹² The registered equity securities issued by the Reference Entity also would have to satisfy the requirements of CBOE Rule 5.4 for continued options trading, which requires, among other things, that an equity

⁹ The settlement amount would be \$100,000 per contract unless adjusted pursuant to proposed CBOE Rule 29.4, as discussed below.

¹⁰ See proposed CBOE Rule 29.1(c).

¹¹ “NMS stock” means any security, or class of securities, other than an option for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transaction in listed options. See 17 CFR 242.600(b)(46) and (47).

¹² See proposed CBOE Rule 5.3.11.

security underlying an option be itself widely held and actively traded.¹³ The requirement that the equity securities of an issuer of a debt security underlying a credit default option meet the criteria of Rule 5.4 is designed to ensure that the issuer's securities enjoy widespread investor interest. The requirement that the Reference Entity be an issuer of a registered NMS stock will help ensure that investors have access to comprehensive public information about the issuer, including the registration statement filed under the Securities Act of 1933 ("Securities Act") and other periodic reports.¹⁴

A credit default option could not be exercised at the discretion of the investor, but instead would have an automatic payout only upon the occurrence of a credit event. The expiration date would be the fourth business day after the last day of trading of the series, which would be the third Friday of the expiration month.¹⁵ A credit default option generally would expire up to 123 months from the time it is listed, and the Exchange usually would open one to four series for each year up to 10.25 years from the current expiration.¹⁶

¹³ CBOE Rule 5.4 provides that, absent exceptional circumstances, an underlying security will not be deemed to meet the Exchange's requirements for continued approval when: (a) there are fewer than 6,300,000 shares of the underlying security held by persons other than those who are required to report their security holdings under Section 16(a) of the Act (15 U.S.C. 78p); (b) there are fewer than 1,600 holders of the underlying security; (c) the trading volume (in all markets in which the underlying security is traded) was less than 1,800,000 shares in the preceding twelve months; (d) the market price per share of the underlying security closed below \$3 on the previous trading day as measured by the closing price reported in the primary market in which the underlying security traded; or (e) the underlying security ceases to be an NMS stock.

¹⁴ Section 13 of the Act, 15 U.S.C. 78m, requires that any issuer of a security registered pursuant to Section 12 of the Act, 15 U.S.C. 78l, would file with the Commission annual reports and information and documents necessary to keep reasonably current the information in its Section 12 registration statement.

¹⁵ If a credit event is confirmed, the expiration date would be the second business day after the confirmation of a credit event. See proposed CBOE Rule 29.1(d) and (e).

¹⁶ See proposed CBOE Rule 29.2(b)(1) and (2).

C. Trading

Credit default options will trade on CBOE's Hybrid Trading System from 8:30 a.m. to 3:00 p.m. (Central Time)¹⁷ in a manner similar to the trading of equity options. With limited distinctions, as described more fully in the proposal, CBOE's equity option trading rules will apply to credit default options.¹⁸ Also, credit default options will be eligible for trading as Flexible Exchange Options ("FLEX Options"). A FLEX Option that is a credit default option would be cash-settled and the exercise-by-exception provisions of OCC Rule 805¹⁹ would not apply. Market-makers shall be appointed to credit default options pursuant to CBOE's existing requirements,²⁰ as supplemented by proposed CBOE Rule 29.17. Additionally, CBOE represents that there will be a maximum of one series per quarterly expiration in a given credit default option class, and that it, and the Options Price Reporting Authority ("OPRA"), have the necessary systems capacity to handle the additional quote volume anticipated to be associated with credit default options.

Once a particular credit default option class has been approved for listing and trading, the Exchange would, from time to time, open for trading a series of that class. If a credit default option initially approved for trading no longer meets the Exchange's requirements for continued approval, the Exchange would not open for trading any additional series of options and, as provided in CBOE Rule 5.4, could prohibit any opening purchase transactions in such series. The proposed trading rules for credit default options are designed to create an environment that takes into account the small number of transactions likely to occur, while providing price

¹⁷ See proposed CBOE Rule 29.11.

¹⁸ See proposed CBOE Rules 29.11-29.17 and 29.19.

¹⁹ OCC Rule 805 sets forth the expiration date exercise procedures for options cleared and settled by the OCC.

²⁰ See Chapter VIII of CBOE's Rules.

improvement and the transparency benefits of competitive Exchange floor bidding, as compared to the over-the-counter (“OTC”) market.

Upon the confirmation of a credit event or the redemption of all Relevant Obligations, the applicable credit default option class would cease trading and all outstanding contracts in that class would be subject to automatic exercise. In addition, the CBOE’s trading halt procedures applicable to equity options shall apply to credit default options.²¹ When determining whether to institute a trading halt in credit default options, CBOE floor officials would consider whether current quotations for the Relevant Obligation(s) or other securities of the Reference Entity are unavailable or have become unreliable. The Exchange’s board of directors shall also have the power to impose restrictions on transactions or exercises in one or more series of credit default options as the board, in its judgment, determines advisable in the interests of maintaining a fair and orderly market or otherwise deems advisable in the public interest or for the protection of investors.²²

D. Clearance and Settlement

Because credit default options do not have an exercise price, they do not, by their terms, meet the definition of “standardized options” for purposes of Rule 9b-1 under the Act.²³ However, as discussed herein, the Commission today is using its authority pursuant to Rule 9b-1 to designate credit default options as “standardized options” under Rule 9b-1. Consequently, credit default option transactions would be eligible for clearance and settlement by the OCC in

²¹ See CBOE Rules 6.3 and 6.3B; proposed CBOE Rule 29.13.

²² See proposed CBOE Rule 29.8.

²³ See 17 CFR 240.9b-1.

accordance with procedures that are substantially similar to existing systems and procedures for the clearance and settlement of exchange-traded options.²⁴

E. Adjustments

Credit default options will be subject to adjustments in two circumstances.²⁵ First, if the original Reference Entity is succeeded by another entity in accordance with the terms of the underlying debt security, the related credit default options would be replaced by one or more credit default options derived from the debt securities of the successor entity or entities. To the extent necessary and appropriate for the protection of investors and the public interest, all other terms and conditions of the successor options would be the same as the original credit default options.

Second, if the specific debt security (the Reference Obligation) is redeemed during the life of the credit default option, another debt security of the Reference Entity would be specified as the new Reference Obligation. In the event that all debt securities of the Reference Entity (i.e., all Relevant Obligations) are redeemed during the life of the credit default option, the option would cease trading and, assuming that CBOE has not confirmed a credit event, the contract payout would be \$0.

²⁴ On February 13, 2007, the OCC filed with the Commission pursuant to Section 19(b)(1) of the Act, 15 U.S.C. 78s(b)(1), and Rule 19b-4 thereunder, 17 CFR 240.19b-4, a proposed rule change to enable it to clear and settle credit default options proposed to be listed by CBOE. The proposed rule change was published for comment in the Federal Register on February 27, 2007. Securities Exchange Act Release No. 55362, 72 FR 9826 (March 5, 2007). On March 7, 2007, the OCC filed Amendment No. 1 to the proposed rule change. See SR-OCC-2007-01 (as amended, the "OCC Proposal"). The Commission has not yet taken action on the OCC proposal.

²⁵ See CBOE Proposed Rule 29.4.

F. Position Limits

Pursuant to proposed CBOE Rule 29.5, credit default options will be subject to a position limit equal to 5,000 contracts on the same side of the market. Credit default options shall not be aggregated with option contracts on the same underlying security and will not be subject to the hedge exemption to CBOE's standard position limits. Instead, the following hedge exemption strategies and positions shall be exempt from CBOE's position limits: (i) a credit default option position "hedged" or "covered" by an appropriate amount of cash to meet the cash settlement amount obligation (e.g., \$100,000 for a credit default option with an exercise settlement value of \$100 multiplied by a contract multiplier of 1,000); and (ii) a credit default option position "hedged" or "covered" by an amount of an underlying debt security(ies) that serves as a Relevant Obligation(s) or other securities, instruments, or interests related to the Reference Entity that is sufficient to meet the cash settlement amount obligation.²⁶ Also, CBOE's market-maker and firm facilitation exemptions to position limits will apply.²⁷

G. Margin

The margin (both initial and maintenance) required for writing short and long positions in credit default options will be as follows:²⁸

- For a qualified customer²⁹ carrying a long position in credit default options, the margin requirement will be 20% of the current market value of the credit default option.

²⁶ See proposed CBOE Rule 29.5.

²⁷ Proposed CBOE Rule 29.5 requires that for purposes of its market-maker hedge exemption (CBOE Rule 4.11.05) the position must be within 20% of the applicable limit before and exemption would be granted. With respect to CBOE's firm facilitation exemption (CBOE Rule 4.11.06), proposed CBOE Rule 29.5 provides that the aggregate exemption position could not exceed three times the standard limit of 5,000 contracts.

²⁸ See proposed CBOE Rule 12.3(l); Amendment No. 5.

- For a non-qualified customer carrying a long position in a credit default option, the margin requirement will be 100% of the current market value of the credit default option.
- For a non-qualified customer carrying a short position in a credit default option, the margin requirement will be the cash settlement amount, i.e., \$100,000 per contract.
- For a qualified customer carrying a short position in a credit default option, the margin requirement will be the lesser of the current market value plus 20% of the cash settlement amount or the cash settlement amount.

These requirements may be satisfied by a deposit of cash or marginable securities. These requirements may not be satisfied by presentation to the member organization carrying the customer's account of a letter of credit meeting the requirements of proposed CBOE Rule 12.3(l)(1)(iii).³⁰

A credit default option carried short in a customer's account will be deemed a covered position, and eligible for the cash account, provided any one of the following is either held in the account at the time the option is written or is received into the account promptly thereafter: (i) cash or cash equivalents equal to 100% of the cash settlement amount or (ii) an escrow agreement. The Exchange believes that these requirements strike the appropriate balance and adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in credit default options. In addition, in Amendment No. 5, the

²⁹ Proposed CBOE Rule 12.3(l)(1)(i) defines "qualified customer" as a person or entity that owns and invests on a discretionary basis no less than \$5,000,000 in investments.

³⁰ In Amendment No. 5, CBOE deletes from proposed rule 12.3(l)(1)(iii) the option of using a letter of credit to satisfy margin requirements applicable to credit default options and makes non-substantive corrections to the formatting of proposed CBOE Rule 12.3(l)(1)(iii) and the "Interpretations and Policies" heading that accompanies CBOE Rule 12.3.

Exchange notes that, in accordance with CBOE Rule 12.3(a)(3), an escrow agreement must be issued in a form acceptable to the Exchange, and that it has traditionally recognized as acceptable the escrow agreement forms of the OCC and the New York Stock Exchange.

In Amendment No. 5, the Exchange also represents the following:

“As part of its regulatory oversight of member organizations, the Exchange generally reviews member organizations’ compliance with margin requirements applicable to customer accounts. In the future, the Exchange will include [c]redit [d]efault [o]ption margin requirements as part of this review. Additionally, the Exchange will review member organizations’ internal procedures for managing credit risk associated with extending margin to customers trading [c]redit [d]efault [o]ptions. The Exchange also notes that, pursuant to CBOE Rule 12.10, the Exchange may at any time impose higher margin requirements when it deems such higher margin requirements advisable.”

Lastly, in Amendment No. 5, the Exchange makes non-substantive changes to the text of CBOE Rule 12.5, to clarify that a credit default option that is carried for the account of a qualified investor may be deemed to have market value for the purposes of CBOE Rule 12.3(c).

H. Surveillance

The Exchange has represented that it will have in place adequate surveillance procedures to monitor trading in credit default options prior to listing and trading such options.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 5, including whether Amendment No. 5 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-84 on the subject line.

Paper comments:

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

All submissions should refer to Amendment No. 5 to File Number SR-CBOE-2006-84. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>).

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to Amendment No. 5 of File Number SR-CBOE-2006-84 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.³¹ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,³² which requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general to protect investors and the public interest. The CBOE's proposal, by enabling CBOE to offer a security that will be listed and traded on the Exchange, as opposed to the OTC market, would extend to investors the benefits of a listed exchange market, which include: a centralized market center; an auction market with posted, transparent market quotations and transaction reporting; standardized contract specifications; and the guarantee of the OCC.

As a threshold matter, the Commission finds that the credit default options proposed by CBOE are securities. Section 3(a)(10) of the Act³³ defines security to include, in part, "any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)." After careful analysis, the

³¹ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³² 15 U.S.C. 78f(b)(5).

³³ 15 U.S.C. 78c(a)(10).

Commission finds that credit default options are options³⁴ based on the value of a security or securities and, therefore, securities under Section 3(a)(10) of the Act;³⁵ in addition, the Commission finds that credit default options are options on an interest in, or based on the value of an interest in, a security or securities and, therefore, are securities under Section 3(a)(10) of the Act.³⁶

The Commission interprets “based on the value [of a security or securities]” in Section 3(a)(10) of the Act³⁷ to include options whose pricing in the secondary market moves in relation to the value of the underlying security or securities of the option in question. Thus the fact that the payout of a cash-settled option will not increase or decrease based on the price movement of the underlying security of that option is not dispositive.³⁸

³⁴ Although credit default options do not share every feature of a classic option, the Commission nonetheless finds that credit default options are option contracts. In particular, the Commission notes that the buyer of a credit default option pays to the seller a nonrefundable premium, has rights but no further obligations under the contract, and has no further risk exposure because the seller bears all the risk of the credit event occurring. See United States v. Bein, 728 F.2d 107, 112 (2d Cir. 1984) (highlighting characteristics that distinguish options from futures contracts).

³⁵ 15 U.S.C. 78c(a)(10).

³⁶ 15 U.S.C. 78c(a)(10). In determining whether a derivative is a security, the Commission and the courts have looked to the economic reality of the product. See Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002), quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) (“In searching for the meaning and scope of the word ‘security’ . . . the emphasis should be on economic reality”). Construing the definition of a security in this manner permits the Commission and the courts “sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition.” Reves v. Ernst & Young, 494 U.S. 56, 63 n.2 (1990).

³⁷ Id.

³⁸ In addressing whether a “digital option” or a “binary option” with a fixed payout is an option based on the value of a security or securities, the court in Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F.Supp.2d 580, 596-97 (S.D.N.Y. 2005), held that the issue ultimately turned on questions of fact and declined to decide the issue on a motion to dismiss. However, the court’s analysis made clear that the existence of a fixed payout that is not tied in a proportionate manner to the price of an underlying security is not a determining factor in deciding whether an instrument is an option on a security.

Because credit default options are not currently traded, there is no empirical data regarding their pricing in the secondary market. However, credit default options are essentially exchange-traded equivalents of single-name, OTC credit default swaps.³⁹ A single-name credit default swap is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon the occurrence of a credit event with respect to one or more reference obligations of a reference entity. Credit events typically include one or more of the following: (1) bankruptcy, (2) obligation acceleration, (3) obligation default, (4) a failure to pay, (5) repudiation or moratorium, or (6) restructuring. Similarly, as explained above, each credit default option shall specify (a) the Reference Entity, (b) the specific debt security or securities that serve as its Reference Obligation or other Relevant Obligations, and

Rather, the court accepted that, in evaluating the economic reality of an instrument, it is appropriate to consider whether the resale value of the instrument moves in relation to the movement of an underlying reference.

³⁹ Despite the similarities between credit default options and OTC credit default swaps, the Commission wishes to make two things clear. First, because credit default options will be exchange-traded and not individually negotiated (and not necessarily between eligible contract participants), they are not qualifying swap agreements under Section 206A of the Gramm-Leach-Bliley Act (“GLBA”), 15 U.S.C. 78c note, and, therefore, not excluded from the definition of security by Section 3A of the Act, 15 U.S.C. 78c-1. Second, certain OTC credit default swaps are not securities. The finding that credit default options are securities because they are options based on the value of a security might suggest that OTC credit default swaps are also options based on the value of a security or securities and, therefore, excluded from the definition of swap agreement because Section 206A(b)(1) of the GLBA, 15 U.S.C. 78c note, excludes from the definition of swap agreement “any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof.” However, Congress specifically enumerated “credit default swaps” (without defining the term) as one example of a qualifying swap agreement. See Section 206A(a)(3) of the GLBA, 15 U.S.C. 78c note. The Commission views the specific enumeration of “credit default swaps” as reflecting the intention of Congress to exclude certain OTC credit default swaps from the definition of security pursuant to Sections 206B & C of the GLBA, 15 U.S.C. 78c note. Credit default swaps that involve terms similar to credit default options, but that are otherwise excluded from the definition of security because they are qualifying swap agreements, remain subject to the Commission’s antifraud jurisdiction (including authority over insider trading) as “security-based swap agreements” under Section 206B of the GLBA, 15 U.S.C. 78c note.

(c) the applicable events of default that trigger payout (as determined in accordance with the terms of the Reference Obligation or other Relevant Obligations), which could include such events as a failure to pay, obligation acceleration or default, and restructuring. Hence, credit default options have essentially the same structure as credit default swaps.

In the case of a credit default swap, the amount the buyer pays for protection is based on a quoted spread expressed in basis points on a notional amount specified in the swap agreement. This quoted spread is often referred to as a “CDS spread” and is principally based on the probability that the Reference Entity will default (*i.e.*, its creditworthiness). More specifically, the CDS spread represents the price required by a swap counterparty to compensate it for the credit risk associated with the potential default on a particular reference obligation or obligations of an issuer. Similarly, the value of a debt security is a function of the issuer’s creditworthiness, which is expressed in terms of a “yield spread” (sometimes called “credit spread”). The yield (or credit) spread is the difference between the yield on the debt instrument and the yield on a debt security of similar maturity whose yield represents pure interest rate risk, such as U.S. Treasuries,⁴⁰ and represents the additional yield required by an investor to compensate it for the credit risk associated with the potential default on the particular debt instrument of an issuer.⁴¹ As a consequence of this relationship between debt securities and credit default swaps, the credit default swap market enables more wide-spread trading in an issuer’s creditworthiness than was previously possible.

⁴⁰ Some academics have hypothesized that there may be some deviation between the yield on U.S. Treasuries and pure interest rate risk because bond interest is subject to state tax but U.S. Treasuries are not. See, e.g., Haibin Zhu, An Empirical Comparison of Credit Spreads between the Bond Market and the Credit Default Swap Market, BIS Working Papers No. 160 (August 2004) (also noting that transparency and the widespread use of U.S. Treasuries as collateral could explain apparent deviations).

⁴¹ While the terms of both corporate securities and credit default swaps are established when parties enter into the respective contracts, the fair market value of these contracts can vary over the life of the contracts in response to changing perceptions of the creditworthiness of an issuer.

There is a close empirical correlation between the price of a credit default swap (as expressed in the CDS spread) and the yield (or credit) spread of the specific reference obligation or obligations of that credit default swap.⁴² This correlation is to be expected because the valuation of credit default swaps and debt securities are each based on credit risk, and because of the potential for arbitrage between the secondary bond market and the credit default swap market.⁴³ Similarly, because credit default options are exchange-traded equivalents of credit default swaps, the Commission expects that there will be a close empirical correlation between the pricing of a specific credit default option during the life of the contract and the yield spread of the Reference Obligation or other Relevant Obligations of that credit default option.

We further note, more generally, that credit default options expressly reference in their payout conditions a term of an underlying security that is material to the value of that security. A credit default option will pay out if there is a failure to pay or other default event under the terms of the underlying debt security.

For these reasons, credit default options are options “based on the value [of a security or securities]” and, therefore, securities.

In addition, the Commission has determined that credit default options are options on an “interest in,” or based on the value of an interest in, a security or securities within the meaning of Section 3(a)(10) of the Act.⁴⁴ A security is a collection of rights (and obligations) running between the issuer and the holder of the security. The concept of an “interest in” a security

⁴² See, e.g., Roberto Blanco, Simon Brennan, and Ian W. Marsh, An Empirical Analysis of the Dynamic Relation between Investment-Grade Bonds and Credit Default Swaps, *The Journal of Economics*, Volume LX, No. 5 (Oct. 2005) (finding credit default swap spreads to be quite close to bond yield spreads).

⁴³ See Zhu, An Empirical Comparison of Credit Spreads between the Bond Market and the Credit Default Swap Market, supra note 40.

⁴⁴ 15 U.S.C. 78c(a)(10).

plainly includes rights generating a pecuniary interest in a security, such as the right to a dividend payment or bond (coupon) payment. One relevant “interest in” a debt security underlying a credit default option is the right to receive (coupon) payments under the terms of that debt security. When a (coupon) payment is not made, impairing the value of that interest, the protection seller must make a payment to the protection buyer. Similarly, a specified default event may trigger other rights of a holder of the debt security. The default events that trigger exercise and payment under the credit default option are meaningful only because they are material terms of a security, essential to the debt holder’s rights and interests in that security.⁴⁵ The credit default option payout is contingent on these security-dependent events. For these reasons, credit default options are options on an interest in, or based on the value of an interest in, a security or securities.⁴⁶

Moreover, the economic reality of credit default options supports the conclusion that credit default options are securities. Taking a short position (*i.e.*, taking on the role of a protection seller) via credit default options would be akin to purchasing the corporate bond that is the Reference Obligation or other Relevant Obligations of that credit default option with the interest rate risk fully hedged. Both give the investor the same risk exposure to creditworthiness of an issuer. Indeed, credit default options may even more closely reflect the financial condition of an SEC-registered

⁴⁵ Although certain default events trigger the exercise and payment of a credit default option, it would not be accurate to describe these options as options on “an event”. There is no event delivered upon exercise of the option, rather a payment is delivered. The crucial question is what causes the option to be in-the-money and pay out. In the case of credit default options, it is an event that is created by a security.

⁴⁶ It is important to note that merely because the option does not transfer ownership of the interest or right in a security – but instead becomes in-the-money and provides a cash payment if certain security rights are triggered – does not mean the option is not on an interest in a security. *Cf. Caiola*, 295 F.3d 312 (2d Cir. 2002) (including within the definition of “security” an option that did not deliver an actual security or interest in a security, but merely a cash payment).

issuer because, unlike corporate bonds, which reflect both an issuer's creditworthiness and general interest rate risk, credit default options would only reflect an issuer's creditworthiness. That ability to isolate and transfer credit risk, backed by the guarantee of a central counterparty and the transparency of an exchange, should provide investors with additional opportunities to gain exposure to the public debt market.

For these reasons, the Commission finds that credit default options are options based on the value of, and options on interests in or based on the value of interests in, a security or securities of the Reference Entity and, therefore, securities under Section 3(a)(10) of the Act.⁴⁷

Further, the Commission believes that the listing rules proposed by CBOE for credit default options are reasonable and consistent with the Act. The Commission notes in particular that a credit default option must be based on a Reference Obligation issued by an entity that issues registered equity securities that are NMS stocks and that meet the Exchange's standards for listing an equity option. These requirements are reasonably designed to facilitate investors' access to information about the Reference Entity that may be necessary to price a credit default option appropriately.

The Commission believes that the proposed position limits and margin rules for credit default options are reasonable and consistent with the Act. The proposed position limit of 5,000 contracts in any credit default option class appears to reasonably balance the promotion of a free and open market for these securities with minimization of incentives for market manipulation and insider trading. The proposed margin rules appear reasonably designed to deter a member or its customer from assuming an imprudent position in credit default options.

In support of this proposal, the Exchange made the following representations:

⁴⁷ 15 U.S.C. 78c(a)(10).

- The Exchange will have in place adequate surveillance procedures to monitor trading in credit default options prior to listing and trading such options, thereby helping to ensure the maintenance of a fair and orderly market for trading in credit default options.
- The Exchange and the OPRA will have the necessary systems capacity to accommodate the additional volume associated with credit default options as proposed.

This approval order is conditioned on CBOE's adherence to these representations.

For the foregoing reasons, the Commission finds that the proposed rule is consistent with the Act.

V. Accelerated Approval

The Commission finds good cause for approving the proposed rule change, as modified by Amendment No. 5, prior to the thirtieth day after publishing notice of Amendment No. 5 in the Federal Register pursuant to Section 19(b)(2) of the Act.⁴⁸ In Amendment No. 5, CBOE: (1) modified the text of the proposed margin requirements applicable to credit default options contained in proposed Rules 12.3 and 12.5; (2) made corresponding changes to the discussion sections of the Form 19b-4 and the Exhibit 1 thereto; and (3) inserted information in the discussion sections of the Form 19b-4 and the Exhibit 1 thereto regarding the form of escrow agreements and the Exchange's supervision of member organizations that extend margin to customers trading Credit Default Options.⁴⁹ The Commission believes that Amendment No. 5

⁴⁸ 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

⁴⁹ The changes pursuant to Amendment No. 5 are discussed more fully in Section II.G,

raises no significant regulatory issues. The Commission therefore finds good cause exists to accelerate approval of the proposed change, as modified by Amendment No. 5, pursuant to Section 19(b)(2) of the Act.

VI. Designation of Credit Default Options Pursuant to Rule 9b-1

Rule 9b-1 establishes a disclosure framework for standardized options that are traded on a national securities exchange and cleared through a registered clearing agency. Under this framework, the exchange on which a standardized option is listed and traded must prepare an Options Disclosure Document (“ODD”) that, among other things, identifies the issuer and describes the uses, mechanics, and risks of options trading, in language that can be easily understood by the general investing public. The ODD is treated as a substitute for the traditional prospectus. A broker-dealer must provide a copy of the ODD to each customer at or before approving of the customer’s account for trading any standardized option.⁵⁰ Any amendment to the ODD must be distributed to each customer whose account is approved for trading the options class for which the ODD relates.⁵¹

Under Rule 9b-1, use of the ODD is limited to “standardized options” for which there is an effective registration statement on Form S-20 under the Securities Act or that are exempt from registration.⁵² The Commission specifically reserved in Rule 9b-1 the ability to designate as

supra.

⁵⁰ See 17 CFR 240.9b-1(d)(1).

⁵¹ See 17 CFR 240.9b-1(d)(2).

⁵² See 17 CFR 240.9b-1(b)(1) and (c)(8). See also 17 CFR 230.238. Rule 238 under the Securities Act provides an exemption from the Securities Act for any standardized option, as defined by Rule 9b-1(a)(4) under the Act, with limited exceptions. Rule 238 does not exempt standardized options from the antifraud provisions of Section 17 of the Securities Act, 15 U.S.C. 77q. Also, offers and sales of standardized options by or on behalf of the issuer of the underlying security or securities, an affiliate of the issuer, or an underwriter, will constitute an offer or sale of the underlying security or securities as

standardized options other securities “that the Commission believes should be included within the options disclosure framework.”⁵³

The Commission hereby designates credit default options, as defined in the OCC Proposal,⁵⁴ as standardized options for purposes of Rule 9b-1 under the Act. Credit default options do not meet the definition of “standardized options,” because they do not have an exercise price. However, they resemble standardized options in other significant respects. Credit default options have an underlying security and an expiration date. Like other standardized options, credit default options have standardized terms relating to exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions, and other matters pertaining to the rights and obligations of holders and writers. Further, credit default options are designed to provide market participants with the ability to hedge their exposure to an underlying security. The fact that credit default options lack a specified exercise

defined in Section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3). See also Securities Act Release No. 8171 (December 23, 2002), 68 FR 188 (January 2, 2003) (Exemption for Standardized Options From Provisions of the Securities Act of 1933 and From Registration Requirements of the Exchange Act of 1934).

⁵³ See Securities Exchange Act Release No. 19055 and Securities Act Release No. 6426 (September 16, 1982), 47 FR 41950, 41954 (September 23, 1982).

⁵⁴ For purposes of its proposal, OCC would define the term “credit default option” as an option that is automatically exercised upon receipt by the OCC of a credit event confirmation with respect to the reference obligation(s) of a reference entity. Credit default options have only two possible payoff outcomes: either a fixed automatic exercise settlement amount or nothing at all. See proposed Section 1.C.(2) of Article XIV of the OCC By-Laws.

“Credit event” would be as defined in the rules of the exchange on which the credit default options are listed, with respect to a reference obligation for such option. See proposed Section 1.C.(3) of Article XIV of the OCC By-Laws.

“Reference entity” would mean the issuer or guarantor of the reference obligation(s). See proposed Section 1.R.(1) of Article XIV of the OCC By-Laws.

“Reference obligations” would mean one or more debt securities the terms of which define a credit event for a class of credit default options, as provided in the rules of the listing exchange. See id.

price does not detract from this option-like benefit. The Commission believes that the fact that the OCC, the clearing agency for all standardized options, is willing to serve as issuer of credit default options supports the view that adding credit default options to the standardized option disclosure framework is reasonable.

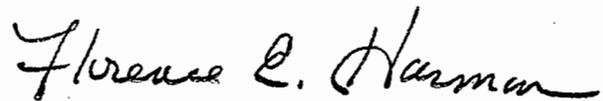
Therefore, the Commission hereby designates credit default options, such as those proposed by CBOE, as standardized options for purposes of Rule 9b-1 under the Act.

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁵ that the proposed rule change (SR-CBOE-2006-84) as modified by Amendment Nos. 3, 4, and 5, be, and hereby is approved on an accelerated basis.

IT IS FURTHER ORDERED, pursuant to Rule 9b-1(a)(4) under the Act, the credit default options, as defined in proposed rule change (SR-OCC-2007-01) are designated as standardized options.

By the Commission.



Florence E. Harmon
Deputy Secretary

⁵⁵ 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-55876; File No. PCAOB-2007-02)

June 7, 2007

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on May 25, 2007, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons. The text of the proposed rules consist of proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and conforming amendments to its auditing standards.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On May 24, 2007, the Board adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements ("Auditing Standard No. 5"); Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting, and conforming amendments to its auditing standards. The proposed rule text is set out below.

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Auditing Standard No. 5 –

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

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Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment^{1/} of the effectiveness of internal control over financial reporting ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.^{2/}

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.^{3/} If one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective.^{4/}

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform

^{1/} Terms defined in Appendix A, Definitions, are set in **boldface type** (italics in the Federal Register printing) the first time they appear.

^{2/} This auditing standard supersedes Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements, and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

^{3/} See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

^{4/} See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

the audit to obtain competent evidence that is sufficient to obtain reasonable assurance^{5/} about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

4. The general standards^{6/} are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.^{7/}

^{5/} See AU sec. 230, Due Professional Care in the Performance of Work, for further discussion of the concept of reasonable assurance in an audit.

^{6/} See AU sec. 150, Generally Accepted Auditing Standards.

^{7/} See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the

audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee^{8/} or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

^{8/} If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a

company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.^{9/}

^{9/} The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.^{10/} As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

^{10/} See paragraphs .19 through .42 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, regarding identifying risks that may result in material misstatement due to fraud.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher

the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.^{11/}

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

^{11/} See AU sec. 312, Audit Risk and Materiality in Conducting an Audit, which provides additional explanation of materiality.

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting.

The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be

prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;
- Controls over management override;

Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

25. Control Environment. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. Period-end Financial Reporting Process. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.

Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include^{12/} –

- Existence or occurrence

- Completeness

- Valuation or allocation

- Rights and obligations

^{12/} See AU sec. 326, Evidential Matter, which provides additional information on financial statement assertions.

- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.^{13/}

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

^{13/} This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant

accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. Performing Walkthroughs. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, detective control).

Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

43. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the

risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;

- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its

control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual

control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. Nature of Tests of Controls. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. Timing of Tests of Controls. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test

the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. Extent of Tests of Controls. The more extensively a control is tested, the greater the evidence obtained from that test.

55. Roll-Forward Procedures. When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on —

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure.

The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgment required to determine the amount involved;

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency;
- and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;^{14/}

^{14/} For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;^{15/}
- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted

Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

^{15/} See Financial Accounting Standards Board Statement No. 154, Accounting Changes and Error Corrections, regarding the correction of a misstatement.

accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.^{16/}

^{16/} See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3 through C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

- a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;
- b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;
- c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as

part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

- d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;
- e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;
- f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

- g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 77 and 79 have been resolved*, and specifically identifying any that have not; and
- h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU sec. 333, Management Representations, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

PCAOB staff have told the Commission staff that the references to paragraphs 77 and 79 in paragraph 75.g. of the proposed rule should instead refer to paragraphs 78 and 80, and that this typographical error will be corrected. Telephone conversation between Sharon Virag, Associate Chief Auditor, PCAOB, and Brian Croteau, Associate Chief Accountant, SEC, on June 4, 2007.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are significant deficiencies and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, Consideration of Fraud in a Financial Statement Audit, AU sec. 317, Illegal Acts by Clients, and Section 10A of the Securities Exchange Act of 1934.^{17/}

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements^{18/} –

- a. A title that includes the word independent;

^{17/} See 15 U.S.C. § 78j-1.

^{18/} See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

- b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;
- c. An identification of management's report on internal control;
- d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;
- e. A definition of internal control over financial reporting as stated in paragraph A5;
- f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;
- h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on

the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

- i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;
- j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;
- k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;
- l. The manual or printed signature of the auditor's firm;
- m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and
- n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]. W Company's management is responsible for these financial statements, for maintaining

effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[Scope paragraph]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[Definition paragraph]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."].

[Signature]

[City and State or Country]

[Date]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinion].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting] expressed [include nature of opinion].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62 through 70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.^{19/}

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the

^{19/} See paragraph C3 for direction when the scope of the engagement has been limited.

presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,
- Regulatory agency reports on the company's internal control over financial reporting, and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, Subsequent Events, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her

report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A control objective provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. Financial statements and related disclosures refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. Internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that --

- (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.^{1/}

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. Management's assessment is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.^{2/}

^{1/} See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

A7. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies ("FAS 5").^{3/}

A8. Controls over financial reporting may be preventive controls or detective controls. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

^{2/} See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

^{3/} See FAS 5, paragraph 3.

A9. A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

APPENDIX B – Special Topics

Integration of Audits

B1. Tests of Controls in an Audit of Internal Control. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective

related to expressing an opinion on the financial statements, as discussed in the following section.

B4. Tests of Controls in an Audit of Financial Statements. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. Effect of Tests of Controls on Substantive Procedures. If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to

be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.

- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate

whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. Special Situations. The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, Interim Financial Information. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU sec. 324, Service Organizations, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

- a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and
- b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

- a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

- b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).
- c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU sec. 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if

the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, Part of Audit Performed by Other Independent Auditors.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.

- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated

application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.
- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

APPENDIX C – Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

- a. Elements of management's annual report on internal control are incomplete or improperly presented,
- b. There is a restriction on the scope of the engagement,
- c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,
- d. There is other information contained in management's annual report on internal control over financial reporting, or
- e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented. If the auditor determines that

elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. Scope Limitations. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A7.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to

management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. Opinions Based, in Part, on the Report of Another Auditor. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, Part of Audit Performed by Other Independent Auditors, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by

the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.^{1/}

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information. Management's annual report on internal control over

^{1/} See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, Illegal Acts by Clients and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.^{2/}

Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

^{2/} See 15 U.S.C. § 78j-1.

C15. Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,^{3/} the auditor should follow the communication responsibilities as described in AU sec. 722 Interim Financial Information, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, Filings Under Federal Securities Statutes, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on internal control over

^{3/} See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Rule 3525: Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

- (a) describe, in writing, to the audit committee of the issuer the scope of the service;
- (b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal

control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

- (c) document the substance of its discussion with the audit committee of the issuer.

Conforming Amendments to PCAOB Auditing Standards

AU sec. 230, "Due Professional Care in the Performance of Work"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

- a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. The third bullet point of paragraph .06 is replaced with –

Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the

scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

- b. The eighth bullet point of paragraph .06 is amended as follows –

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following

–

To the board of directors – any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Under Audit of financial statements, the last sub-bullet is replaced with the following –

To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is amended as follows –

- a. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 20 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- c. The note to paragraph 12 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, regarding planning considerations and materiality, respectively.

- d. Within the note to paragraph 18, the reference to Appendix B, Additional Performance Requirements and Directions; Extent-of-Testing Examples of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 6-8 and paragraphs B1-B5 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52-53 of

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

The last sentence of paragraph 16 is replaced with –

Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, Using the Work of a Specialist, nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, or paragraphs 16-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is amended as follows –

- a. The note to paragraph 2 is replaced with –

Note: Refer to paragraph A9 of Appendix A, Definitions, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements for the definition of a relevant assertion and paragraphs 28-33 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements for discussion of identifying relevant assertions.

- b. Within the note to paragraph 9, the reference to Appendix B, Additional Performance Requirements and Directions; Extent of Testing Examples, of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- c. The last sentence of paragraph 33 is deleted.

- d. The note to paragraph 65 is deleted.
- e. The note to paragraph 83 is deleted.
- f. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 54 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- g. The appendix at paragraph 110 is deleted.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows –

- a. Within the note to paragraph 1, the reference to paragraphs 108-126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- b. The note to paragraph 20 is deleted.

- c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to Appendix B, Additional Performance Requirements and Directions; Extent-of-Testing Examples, of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B17-B27 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"^{1/}

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

- a. The first bullet point before paragraph 1 is amended as follows –

The reference to paragraphs 207-214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78-84 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- b. The first bullet point in paragraph 1 is replaced with –

A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- c. Paragraph 2 is replaced with –

^{1/} When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 78-84 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, now supersede SAS No. 60 in the context of an integrated audit.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

- d. The notes to paragraph 2 are deleted.
- e. Paragraph 3 is replaced with –

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.

Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62-70 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- f. Paragraph 5 is replaced with –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

- g. The last sentence of paragraph 9 is replaced with –

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows –

- The note prior to paragraph 1 is replaced with –

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, Definitions, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), is amended as follows –

The first sentence of paragraph 41 is replaced with –

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date^{7/}

^{7/} The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, Subsequent Events.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended as follows –

The note to paragraph 11 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, states "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Within the note to paragraph 5, the reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75-77 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The second sentence of paragraph 9 is replaced with –

Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows –

a. The last sentence of paragraph 4 is replaced with –

What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with –

Interpretation – Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The second sentence of paragraph 2 is replaced with –

The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended as follows –

a. Subparagraph c. of paragraph 10 is replaced with –

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with –

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows –

Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85-98 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Appendix C, Special Reporting Situations, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements. The sentence that reads "In addition, see Appendix A, Illustrative Reports on Internal Control Over Financial Reporting, of PCAOB Auditing Standard No. 2, which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements which includes an illustrative combined audit report."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

- a. Paragraph .01 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.

Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

- b. Paragraph .05 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__," except for Note __, as to which the date is March 1, 20__," or may date

the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

- c. Within the heading before paragraph .03, the reference to "completion of field work" is replaced with "the date of the independent auditor's report."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8-C11 of Appendix C, Special Reporting Situations, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows –

a. Within the note to paragraph .01, the reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93-97 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The second sentence of paragraph .12 is replaced with –

These procedures should be performed at or near the date of the auditor's report.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

- a. Within the note to paragraph 2, the reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, Special Reporting Situations, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- b. The third sentence of paragraph 10 is replaced with –

The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows –

- a. The following is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain

quarterly and annual certifications with respect to the company's internal control over financial reporting.^{2/}

^{2/} See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

- b. The note to paragraph 3 is deleted.
- c. The following is added to the end of paragraph 7 –

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial

reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

- d. The following lettered section is added to the end of paragraph 18 –
- g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –
- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
 - Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and
 - Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably

likely to materially affect, the company's internal control over financial reporting.

- e. Paragraph 29 is replaced with –

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

- a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;
- b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and
- c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

- f. Paragraph 32 is replaced with –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, Consideration of Fraud in a Financial Statement Audit, AU sec. 317, Illegal Acts by Clients, and Section 10A of the Securities Exchange Act of 1934.^{1/}

^{1/} See 15 U.S.C. § 78j-1

- g. Within paragraph 33, the third sentence is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, Audit Documentation

Auditing Standard No. 3, Audit Documentation is amended as follows –

Within footnote 2 to paragraph 6, the reference to paragraphs 68-70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28-33 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist is amended as follows –

- a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- e. Paragraph 9 is replaced with –

The terms internal control over financial reporting, deficiency, significant deficiency, and material weakness have the same meanings as the definitions of those terms in Appendix A, Definitions, of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- f. The first sentence of paragraph 10 is replaced with –

Paragraph 5 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, states “[t]he auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.”

- g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and the last sentence is amended as follows –

More information about the COSO framework is included within the COSO report.

- h. Paragraph 11 is replaced with –

The terms relevant assertion and control objective have the same meaning as the definitions of those terms in Appendix A, Definitions, of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- i. Paragraph 13 is replaced with –

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.^{2/}

^{2/} See paragraph 42 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal

Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- l. Within paragraph 21, the last sentence is deleted.
- m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements. Additionally, the second sentence is deleted.
- n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- q. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 22-27 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- r. Subparagraph b. of paragraph 26 is replaced with –

Perform the procedures described in paragraphs 34-38 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.
- s. The note to subparagraph b. of paragraph 26 is deleted.
- t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- u. The note to paragraph 28 is deleted.
- v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42-43

of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- w. Paragraph 32 is replaced with –

Consistent with the direction in paragraphs 44-45 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50-54 of Auditing Standard No. 5.

- x. Paragraph 33 is replaced with –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any

of those described in paragraphs 22-24 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

y. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, Special Topics, of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

aa. The second sentence of paragraph 37 is replaced with –

Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.

bb. The first two sentences of paragraph 38 are replaced with –

Paragraphs 18-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with –

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with –

Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of

management's most recent annual assessment of internal control over financial reporting.

- gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.
- kk. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, Interim Financial Information.

- ii. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, Interim Financial Information.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rules

(a) Purpose

In 2002, Congress passed the Act, which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Board, to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of

Financial Statements ("Auditing Standard No. 2"). The SEC approved Auditing Standard No. 2 on June 17, 2004.

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged. First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2. On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, that would replace Auditing Standard No. 2. After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the

most important matters. The Board adopted the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2.

Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." Rule 3525 would further implement the Act's pre-approval requirement by requiring auditors to take certain steps as part of seeking audit committee pre-approval of internal control related non-audit services. These steps are intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Rule 3525 requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee.

The conforming amendments update the Board's other auditing standards in light of Auditing Standard No. 5, move information contained in Auditing Standard No. 2 to the Board's interim standards, and change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion." This change is consistent with a recent change adopted by both the

International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I and II and Section 404 of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons. Moreover, Auditing Standard No. 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rules for public comment in Release No. 2006-007 (December 19, 2006). A copy of Release No. 2006-007 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board received 175 written comments. The Board

also discussed the proposals with its Standing Advisory Group on February 22, 2007.^{1/} The Board has clarified and modified certain aspects of the proposed rules in response to the comments it received, as discussed below.

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on

^{1/} A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/02-22/SAG_Transcript.pdf.

evaluating internal control at the same time that the Board issued its proposals.^{2/} In addition to its role in implementing Section 404(a) of the Act, the SEC must approve new PCAOB auditing standards before they can become effective.^{3/} On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard ... with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";
- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";
- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and

^{2/} See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

^{3/} See Section 107 of the Act.

- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."^{4/}

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.^{5/}

Notable Areas of Change in the Final Standard

The Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Additional discussion of comments received on the proposals and the Board's response is included below.

Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters

^{4/} See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

^{5/} As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's

standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.^{6/} Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit – the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a

^{6/} These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard – the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.^{7/}

Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these

^{7/} See paragraph 21.

matters in assessing risk throughout the top-down approach.^{8/} Incorporating the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.^{9/} Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.^{10/}

Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach – specifically by identifying and testing the most important controls – and to effective internal control. Additionally, the proposed standard emphasized that these controls might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating

^{8/} See paragraphs 14 and 15.

^{9/} See paragraph 11.

^{10/} See paragraph 14.

in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.^{11/}

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is because the auditor obtains some of the supporting evidence related to a control from an

^{11/} See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.^{12/} Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose.

The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.^{13/} While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to

^{12/} See paragraph 34, which describes these objectives.

^{13/} See paragraph 34.

communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.^{14/} The Board continues to believe that the standard should require auditors to provide relevant information about important control deficiencies – even those less severe than a material weakness – to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit

^{14/} The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.^{15/}

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to

^{15/} See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a stand-alone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.^{16/} As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would

^{16/} See paragraph 9.

lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled Considering and Using the Work of Others in an Audit that would have superseded the Board's interim standard AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel – not just internal auditors – and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision.

At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.^{17/}

In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends,

^{17/} See paragraph 17.

in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.^{18/} Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others – not just internal auditors – to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.^{19/} The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As

^{18/} See paragraph 18.

^{19/} See paragraph 17.

proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible.

Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

Additional Discussion of Comments and the Board's Response

Alignment of Board's Internal Control Auditing Standard and the SEC's

Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed above, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described above, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become *de facto* guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully above, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated –

Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's

standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed above, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the

objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.^{20/}

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach – specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.^{21/} The Board believes that establishing more

^{20/} See paragraph 27 of AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

^{21/} See paragraph 49.

detailed requirements in this area is not necessary, because application of the general principle in the standard will depend on the particular facts and circumstances presented.

Assessing Risk

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control, and that element of the guidance was incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach, including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive

appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can

appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to "more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event

occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition – as well as Auditing Standard No. 2 – established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding

of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.^{22/}

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a

^{22/} The provisions in the final standard relating to significant deficiencies are discussed above. As discussed above, the Board also made minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.^{23/} The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically, under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.^{24/} Including them in the list of indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

^{23/} The Board included as an indicator the proposed standard's requirement to determine the level of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

^{24/} One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

Additional Scoping and Materiality Issues

The proposed standard clarified that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the Board should provide additional guidance

on scoping and extent of control testing decisions, such as guidance on sample sizes related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.^{25/}

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed above, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

^{25/} The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

Scaling the Audit for Smaller Companies

As discussed above, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed above, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;
- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;
- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;
- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;
- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;

- That the emphasis on entity-level controls might not be appropriate; and
- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed above, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319, Consideration of Internal Control in a Financial Statement Audit. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit.

and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing, and extent of testing by describing certain additional factors for the auditor to evaluate in

subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation – which exempts some important controls from testing each year – of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multi-year rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit,

control testing plays a supporting role – to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control. Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.^{26/} After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able

^{26/} See paragraph 55.

to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.^{27/} Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required that the auditor express only one opinion on internal control – a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information – specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act

^{27/} Although Auditing Standard No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal control evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated.

requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.^{28/} The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.^{29/} Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

^{28/} The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

^{29/} In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer" Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures ... provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles"

Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rule; or
- (b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2007-02 on the subject line.

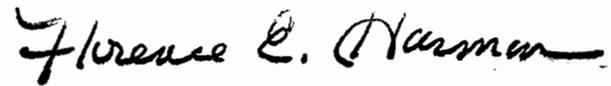
Paper comments:

- 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 No. PCAOB-2007-02. This file number should be included on the subject line if e-mail is used. To help process and review your comments more efficiently, please use only one method. The Commission will post all comments

on the Commission's Internet Website (<http://www.sec.gov>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 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. All submissions should refer to File Number PCAOB-2007-02. In light of the significant public interest in the implementation of section 404 of the Sarbanes-Oxley Act, the Commission is providing a 30-day comment period. Comments should be submitted on or before **[insert date 30 days from publication in the Federal Register]**. The Commission intends to act on the proposed rule no later than 45 days after publication in the Federal Register.

By the Commission.



Florence E. Harmon
Deputy Secretary

*Commissioner Nazareth
Not Participating*

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55887 / June 8, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2615 / June 8, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12655

In the Matter of

RAYMOND L. MATHIASEN, CPA

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO RULE
102(e) OF THE COMMISSION'S RULES OF
PRACTICE, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Raymond L. Mathiasen ("Respondent" or "Mathiasen") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.¹

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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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. Mathiasen is a resident of Los Angeles, California and was the former chief accounting officer of Tenet Healthcare Corporation ("Tenet"). Mathiasen joined Tenet (then known as National Medical Enterprises) in 1985 as a vice president in its accounting department. He became Tenet's chief accounting officer in March 1996. He remained in that position until at least November 2002. Mathiasen retired from Tenet in April 2004. Mathiasen has been licensed as a CPA in California since 1969. His license is currently inactive.

2. Tenet is a Nevada corporation with its principal executive offices in Dallas, Texas. During the relevant time period, Tenet maintained its principal executive offices in Santa Barbara, California. Tenet is one of the largest publicly traded healthcare companies in the United States.

3. On April 2, 2007, the Commission filed a complaint against Mathiasen in SEC v. Tenet Healthcare Corp., et al., in the United States District Court for the Central District of California (the "Court") (Civil Action No. CV 07-2144 RGK (AGRx)). On April 16, 2007, the Court entered a Final Judgment Of Permanent Injunction And Other Relief Against Defendant Raymond L. Mathiasen ("Judgment") which (a) permanently enjoins Mathiasen from future violations of Section 17(a) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rules 10b-5 and 13b2-1 thereunder, and aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 promulgated thereunder; (b) orders Mathiasen to pay \$1 in disgorgement and a \$240,000 civil penalty; and (c) prohibits Mathiasen from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act for a period of five years. Mathiasen consented to the entry of the Judgment without admitting or denying any of the allegations in the complaint.

4. The Commission alleged that Mathiasen participated in a fraudulent scheme, in which Tenet made misleading disclosures in the Form 10-K that it filed with the Commission for its year ended May 31, 2002 and in the Form 10-Q that it filed with the

Commission for Tenet's first quarter of its fiscal year 2003 ending August 30, 2002. Mathiasen signed each filing and substantially participated in the preparation of these filings. Mathiasen also knew, or was reckless in not knowing, that each filing was misleading because it failed to disclose the material impact that Tenet's increases in gross charges was having on the company's Medicare outlier revenue, and thereby on its earnings. The complaint further alleged that Mathiasen authorized improper manual adjustments to Tenet's contractual allowance reserve accounts from fiscal year 2000 through fiscal year 2003, in violation of Generally Accepted Accounting Principles. As a result of Mathiasen's conduct, Tenet had to restate its financial statements from fiscal year 2000 through fiscal year 2004.

IV.

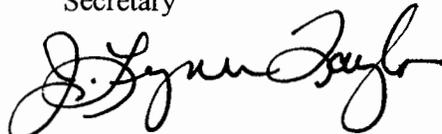
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent's Offer.

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

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

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 ACT OF 1933
Release No. 8808 / June 8, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 55889 / June 8, 2007

In the Matter of

BARCLAYS BANK PLC

**ORDER UNDER SECTION 27A(b) OF
THE SECURITIES ACT OF 1933 AND
SECTION 21E(b) OF THE
SECURITIES EXCHANGE ACT OF
1934 GRANTING WAIVERS OF THE
DISQUALIFICATION PROVISIONS
OF SECTION 27A(b)(1)(A)(ii) OF THE
SECURITIES ACT OF 1933 AND
SECTION 21E(b)(1)(A)(ii) OF THE
SECURITIES EXCHANGE ACT OF
1934**

Barclays Bank PLC ("Barclays") has submitted a letter dated March 30, 2007, requesting waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from Barclays' settlement of a federal injunctive proceeding commenced by the Commission.

On June 6, 2007, the United States District Court for the Southern District of New York entered a Final Judgment permanently enjoining Barclays from violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. The Final Judgment also ordered Barclays to disgorge ill-gotten gains (plus prejudgment interest thereon), and to pay civil money penalties pursuant to Section 21A of the Exchange Act. Barclays consented to the terms of the Final Judgment without admitting or denying the Commission's allegations that Barclays illegally traded securities on the basis of material nonpublic information obtained through membership on bankruptcy creditors committees.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of the issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated

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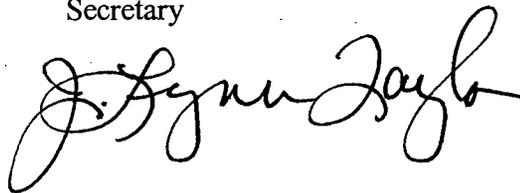
the antifraud provisions of the securities laws[.]” Securities Act, Section 27A(b)(1)(A)(ii); Exchange Act, Section 21E(b)(1)(A)(ii). These disqualifications may be waived “to the extent otherwise specifically provided by rule, regulation, or order of the Commission.” Securities Act, Section 27A(b); Exchange Act, Section 21E(b).

Based upon the representations set forth in Barclays’ March 30, 2007 request, the Commission has determined that under the circumstances, the request for waivers of the disqualifications resulting from entry of the Final Judgment is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that waivers from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act resulting from entry of the Final Judgment are hereby granted.

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 Act of 1933
Release No. 8807 / June 8, 2007

In the Matter of

BARCLAYS BANK PLC

ORDER UNDER RULE 602(e) OF THE
SECURITIES ACT OF 1933 GRANTING A
WAIVER OF THE RULE 602(c)(2)
DISQUALIFICATION PROVISION

I.

Barclays Bank PLC ("Barclays") has submitted a letter dated May 3, 2007, requesting waiver of a Rule 602(c)(2) disqualification from the registration exemption under Regulation E arising from Barclays' settlement of an injunctive action commenced by the Commission.

II.

On June 6, 2007, the United States District Court for the Southern District of New York entered a Final Judgment permanently enjoining Barclays from violation of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 10b-5 thereunder. Barclays consented to the terms of the Final Judgment without admitting or denying the Commission's allegations that Barclays illegally traded securities on the basis of material nonpublic information obtained through membership on bankruptcy creditors committees.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if, among other things, any investment adviser or underwriter of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." 17 C.F.R. § 230.602(c)(2). Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

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IV.

Based upon the representations set forth in Barclays' request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Final Judgment.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from application of the disqualification provision of Rule 602(c)(2) under the Securities Act resulting from entry of the Final Judgment is hereby granted.

By the Commission.

Nancy M. Morris
Secretary

A handwritten signature in black ink, appearing to read "J. Lynn Taylor". The signature is written in a cursive, flowing style.

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 13, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12658

In the Matter of

Laminaire Corp.
(n/k/a Cavico Corp.),
TAM Restaurants, Inc.
(n/k/a Aerofoam Metals, Inc.), and
Upside Development, Inc.
(n/k/a Amorocorp),

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. Laminaire Corp. (n/k/a Cavico Corp.) ("CVCP") (CIK No. 934379) is a Delaware corporation located in Rahway, New Jersey with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). CVCP is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1999. On May 16, 2000, CVCP filed for bankruptcy under Chapter 11, which was subsequently converted to a Chapter 7 proceeding, in the U. S. Bankruptcy Court for the District of New Jersey. On July 8, 2002, the Chapter 7 trustee reported that the estate had no property available for distribution and asked that he be discharged. The bankruptcy proceeding terminated on January 24, 2007. On April 10, 2004, CVCP changed its name to Agent 155 Media Group, Inc. On May 2, 2006, CVCP again changed its name to Cavico Corp. Neither of these changes were reported to the Commission, but should have been, as required by Commission rule. On May 12, 2006, CVCP implemented a 1 for 300 reverse stock split. As of

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June 8, 2007, the common stock of CVCP was quoted on the Pink Sheets, had twenty-one market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). CVCP's common stock had an average daily trading volume of 151,952 shares during the six months ended January 9, 2007.

2. TAM Restaurants, Inc. (n/k/a Aerofoam Metals, Inc.) ("AFML") (CIK No. 1048796) is a Delaware corporation located in Staten Island, New York with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). AFML is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 27, 2001. On May 19, 2003, AFML filed for bankruptcy under Chapter 11 in the U.S. Bankruptcy Court for the Southern District of New York. The bankruptcy proceeding was dismissed on October 7, 2004. On March 21, 2006, AFML changed its name to Aerofoam Metals, Inc., but failed to report that change to the Commission, but should have, as required by Commission rule. On June 15, 2006, AFML implemented a 1 for 1,000 reverse stock split. As of June 8, 2007, the common stock of AFML was quoted on the Pink Sheets, had twenty-one market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). AFML's common stock had an average daily trading volume of 97,320 shares during the six months ended January 9, 2007.

3. Upside Development, Inc. (n/k/a Amorocorp) ("AORO") (CIK No. 1020367) is a Delaware corporation located in West Bend, Wisconsin with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). AORO is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001. In May 2006, AORO changed its name in the Pink Sheets to Amorocorp, but failed to report that change to the Commission, but should have, as required by Commission rule. On May 25, 2006, AORO implemented a 1 for 300 reverse stock split. As of June 8, 2007, the common stock of AORO 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). AORO's common stock had an average daily trading volume of 455 shares during the six months ended January 9, 2007.

B. DELINQUENT PERIODIC FILINGS

4. As discussed in more detail above, all of the respondents are delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1). All of the respondents also engaged in reverse stock splits, 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 requesting compliance with their periodic filing obligations or, through their failure to maintain a current address on file with the Commission as required by Commission rules, did not receive such letters.

5. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers with classes 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 to institute public administrative proceedings to determine:

A. Whether the allegations in Section II are true and, in connection therewith, 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 revoke the registration of each class of securities of the Respondents identified in Section II registered pursuant to Section 12 of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS FURTHER ORDERED that Respondents shall file Answers to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice [17 C.F.R. § 201.220].

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

This Order shall be served forthwith upon Respondents personally, by certified or express 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 not 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

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

Appendix 1

Chart of Delinquent Filings

In the Matter of Laminaire Corp. (n/k/a Cavico Corp.), et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Laminaire Corp. (n/k/a Cavico Corp.)	10-KSB	12/31/99	03/30/00	Not filed	87
	10-QSB	03/31/00	05/15/00	Not filed	85
	10-QSB	06/30/00	08/14/00	Not filed	82
	10-QSB	09/30/00	11/14/00	Not filed	79
	10-KSB	12/31/00	04/02/01	Not filed	74
	10-QSB	03/31/01	05/15/01	Not filed	73
	10-QSB	06/30/01	08/14/01	Not filed	70
	10-QSB	09/30/01	11/14/01	Not filed	67
	10-KSB	12/31/01	04/01/02	Not filed	62
	10-QSB	03/31/02	05/15/02	Not filed	61
	10-QSB	06/30/02	08/14/02	Not filed	58
	10-QSB	09/30/02	11/14/02	Not filed	55
	10-KSB	12/31/02	03/31/03	Not filed	51
	10-QSB	03/31/03	05/15/03	Not filed	49
	10-QSB	06/30/03	08/14/03	Not filed	46
	10-QSB	09/30/03	11/14/03	Not filed	43
	10-KSB	12/31/03	03/30/04	Not filed	39
	10-QSB	03/31/04	05/17/04	Not filed	37
	10-QSB	06/30/04	08/16/04	Not filed	34
	10-QSB	09/30/04	11/15/04	Not filed	31
	10-KSB	12/31/04	03/31/05	Not filed	27
	10-QSB	03/31/05	05/16/05	Not filed	25
	10-QSB	06/30/05	08/15/05	Not filed	22
	10-QSB	09/30/05	11/14/05	Not filed	19
	10-KSB	12/31/05	03/31/06	Not filed	15
	10-QSB	03/31/06	05/15/06	Not filed	13
	10-QSB	06/30/06	08/14/06	Not filed	10
	10-QSB	09/30/06	11/14/06	Not filed	7
	10-KSB	12/31/06	04/02/07	Not filed	2
	10-QSB	03/31/07	05/15/07	Not filed	1
Total Filings Delinquent		30			

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
TAM Restaruant, Inc.					
(n/k/a Aerofoam Metals, Inc.)					
	10-KSB	09/26/01	12/25/01	Not filed	66
	10-QSB	12/26/01	02/11/02	Not filed	64
	10-QSB	03/27/02	05/13/02	Not filed	61
	10-QSB	06/26/02	08/12/02	Not filed	58
	10-KSB	09/25/02	12/24/02	Not filed	54
	10-QSB	12/25/02	02/10/03	Not filed	52
	10-QSB	03/26/03	05/12/03	Not filed	49
	10-QSB	06/25/03	08/11/03	Not filed	46
	10-KSB	09/24/03	12/23/03	Not filed	42
	10-QSB	12/31/03	02/17/04	Not filed	40
	10-QSB	03/31/04	05/17/04	Not filed	37
	10-QSB	06/30/04	08/16/04	Not filed	34
	10-KSB	09/29/04	12/28/04	Not filed	30
	10-QSB	12/29/04	02/14/05	Not filed	28
	10-QSB	03/30/05	05/16/05	Not filed	25
	10-QSB	06/29/05	08/15/05	Not filed	22
	10-KSB	09/28/05	12/27/05	Not filed	18
	10-QSB	12/28/05	02/13/06	Not filed	16
	10-QSB	03/29/06	05/15/06	Not filed	13
	10-QSB	06/28/06	08/14/06	Not filed	10
	10-KSB	09/27/06	12/26/06	Not filed	6
	10-QSB	12/27/06	02/12/07	Not filed	4
	10-QSB	03/28/07	05/14/07	Not filed	1
Total Filings Delinquent		23			

Upside Development, Inc.
(n/k/a Amorocorp)

10-KSB	12/31/01	04/01/02	Not filed	62
10-QSB	03/31/02	05/15/02	Not filed	61
10-QSB	06/30/02	08/14/02	Not filed	58
10-QSB	09/30/02	11/14/02	Not filed	55
10-KSB	12/31/02	03/31/03	Not filed	51
10-QSB	03/31/03	05/15/03	Not filed	49
10-QSB	06/30/03	08/14/03	Not filed	46
10-QSB	09/30/03	11/14/03	Not filed	43
10-KSB	12/31/03	03/30/04	Not filed	39
10-QSB	03/31/04	05/17/04	Not filed	37

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Upside Development, Inc. (n/k/a Amorocorp) (continued)	10-QSB	06/30/04	08/16/04	Not filed	34
	10-QSB	09/30/04	11/15/04	Not filed	31
	10-KSB	12/31/04	03/31/05	Not filed	27
	10-QSB	03/31/05	05/16/05	Not filed	25
	10-QSB	06/30/05	08/15/05	Not filed	22
	10-QSB	09/30/05	11/14/05	Not filed	19
	10-KSB	12/31/05	03/31/06	Not filed	15
	10-QSB	03/31/06	05/15/06	Not filed	13
	10-QSB	06/30/06	08/14/06	Not filed	10
	10-QSB	09/30/06	11/14/06	Not filed	7
	10-KSB	12/31/06	04/02/07	Not filed	2
	10-QSB	03/31/07	05/15/07	Not filed	1
	Total Filings Delinquent		22		

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 13, 2007

In the Matter of

Global Datatel, Inc.
(n/k/a Xcana Petroleum, Inc.),
Laminaire Corp.
(n/k/a Cavico Corp.),
Military Communications Technologies, Inc.
(n/k/a Carbon Race Corporation),
TAM Restaurants, Inc.
(n/k/a Aerofoam Metals, Inc.), and
Upside Development, Inc.
(n/k/a Amorocorp),

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 Global Datatel, Inc. (n/k/a Xcana Petroleum, Inc.) because it has not filed any periodic reports since the period ended March 31, 2001, nor has it provided the public with current financial information since the deregistration of its stock on October 9, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Laminaire Corp. (n/k/a Cavico Corp.) because it has not filed any periodic reports since the period ended September 30, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Military Communications Technologies, Inc. (n/k/a Carbon Race Corporation) because it has not filed any periodic reports since the period ended March 31, 2004, nor has it provided the public with current financial information since the deregistration of its stock on October 9, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of TAM Restaurants, Inc. (n/k/a Aerofoam Metals, Inc.) because it has not filed any periodic reports since the period ended June 27, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Upside Development, Inc. (n/k/a Amorocorp) because it has not filed any periodic reports since the period ended September 30, 2001.

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The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on June 13, 2007, through 11:59 p.m. EDT on June 26, 2007.

By the Commission.

Nancy M. Morris
Secretary

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

Commissioner Campos &
Nazareth Not Participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55909 / June 14, 2007

Admin. Proc. File No. 3-12384

In the Matter of the Application of
NASDAQ STOCK MARKET, LLC
For Review of Action Taken by the
CONSOLIDATED TAPE ASSOCIATION

ORDER ACCEPTING JURISDICTION AND ESTABLISHING PROCEDURES

The Nasdaq Stock Market, LLC ("Nasdaq"), a member of the Consolidated Tape Association ("CTA"), has filed a petition for review, pursuant to Section 11A(b)(5) of the Securities Exchange Act of 1934 1/ and Exchange Act Rule 608(d), 2/ (formerly Exchange Act Rule 11Aa3-2(e)), 3/ of action taken by the CTA Operating Committee. On March 23, 2006, the Operating Committee voted to impose a new participant entry fee of \$833,862 for Nasdaq to join

- 1/ 15 U.S.C. § 78k-1(b)(5) (providing that, upon application by an aggrieved person, any prohibition or limitation of access to services by a registered securities information processor "shall" be subject to Commission review). The CTA is registered as an exclusive securities information processor. See Securities Exchange Act Rel. No. 12035 (Jan. 22, 1976), 8 SEC Docket 1099 (granting registration to the CTA).
- 2/ 17 C.F.R. § 242.608(d) (providing that the Commission "may, in its discretion," entertain appeals in connection with the implementation or operation of any effective national market system plan). The Commission has held that its authority to review national market system plan action pursuant to Rule 608(d)'s predecessor, Rule 11Aa3-2(e), is discretionary. American Stock Exchange, Inc., 54 S.E.C. 491, 497-99 (2000).
- 3/ In June 2005, Rule 11Aa3-2(e) was redesignated as Rule 608(d) without any change in substance. See Regulation NMS, Exchange Act Rel. No. 51808 (June 9, 2005), 85 SEC Docket 2264, 2338 (stating that, while Rule 608 renumbers Rule 11Aa3-2, the substance of the provision "remains largely intact").

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the CTA Plan. ^{4/} Nasdaq alleges that the Operating Committee improperly calculated the fee by, among other things, including historical costs of operating the CTA's systems that were incurred before Nasdaq joined the Plan. Nasdaq alleges that the resulting fee is excessive and constitutes a denial of access to the CTA's systems. Nasdaq seeks a reversal of the Operating Committee's March 23, 2006, action, and an order that the entry fee be assessed at \$233,132. ^{5/} Because we find the record at this stage to be insufficient to permit the necessary determinations, we have decided that the best procedure under the circumstances is to designate an administrative law judge to preside over this matter and to conduct further proceedings consistent with this Order.

I.

Background

In 1975, Congress directed the Commission, through enactment of Exchange Act Section 11A, to facilitate the establishment of a national market system for securities. ^{6/} Congress found that a national market system would link together the individual markets that trade securities. ^{7/} Congress contemplated that a national market system would encourage centralized trading and fair competition among markets. ^{8/}

The Commission adopted a rule that required every national securities exchange and the NASD to file a plan for collecting, processing, and disseminating on a consolidated basis reports of completed transactions ("last sale reports") in securities registered or admitted to trading on an

^{4/} Nasdaq also joined the Consolidated Quotation ("CQ") Plan, pursuant to which the participants disseminate bid/ask quotation information for listed securities. The Operating Committee of that Plan is not a registered securities information processor. However, the entry fee that is the subject of Nasdaq's petition for review also entitles Nasdaq to join the CQ Plan as a new participant in that Plan. Thus, Nasdaq also contests the application of the entry fee to Nasdaq's entry into the CQ Plan.

^{5/} In addition, Nasdaq requests that any costs incurred by the CTA in defending this action, including the costs of counsel, be apportioned among the CTA Plan participants other than Nasdaq. We lack the authority to award costs. Cf. Richard J. Rouse, 51 S.E.C. 581, 587 n.20 (1993) (rejecting respondent's request for attorney fees in appeal of NASD disciplinary action; stating that "[n]o statutory basis exists for the award of attorney fees and other costs in the context of appeals to the Commission of disciplinary action by self-regulatory organizations").

^{6/} 15 U.S.C. § 78k-1(a)(2).

^{7/} 15 U.S.C. § 78k-1(a)(1)(D).

^{8/} 15 U.S.C. § 78k-1(a)(1)(C).

exchange or over-the-counter. To meet those requirements, various self-regulatory organizations filed with the Commission a joint industry plan (the "CTA Plan") governing the implementation and operation of the consolidated reporting system. ^{9/} The CTA Plan establishes the terms, conditions, and procedures under which last sale reports are made available. The CTA Plan also engages the Securities Industry Automation Corporation, or SIAC, as the central processor of last sale information for inclusion in the consolidated tape. ^{10/} The CTA Plan is administered by the CTA, which currently consists of eleven participants, all of whom are competitors. ^{11/}

In 1993, the Commission approved an amendment to the CTA Plan that added criteria for calculating the entry fee to be paid by new participants to the Plan. ^{12/} The amendment required a new entrant to pay the current participants an amount that "attributes an appropriate value to the assets, both tangible and intangible, that CTA has created and will make available to such new [p]articipant." The CTA Plan allowed the participants to consider one or more of six factors in assessing an appropriate entry fee.

In 2002, Nasdaq expressed interest in joining the CTA and CQ Plans and inquired about the amount of the entry fee. The CTA Participants engaged Deloitte & Touche to determine a proposed new entrant's fee. In a report dated October 16, 2002, Deloitte & Touche concluded that the new entrant fee could be set at \$3,307,000, consisting of \$2,400,000 for "Historical Cost of the System," \$612,000 for a new processor, and \$295,000 for modifications to the existing processor.

^{9/} Exchange Act Rel. No. 15250 (Oct. 20, 1978), 15 SEC Docket 1355, 1356.

^{10/} 15 SEC Docket at 1356. The CTA Plan provides for the collection and dissemination of "last sale" price information in "eligible securities." The CTA Plan participants report to SIAC last sale prices relating to transactions in eligible securities. SIAC disseminates the data for a fee to vendors who, in turn, distribute the data to broker-dealers, investors, and other members of the public. The CTA Plan provides for the sharing of net income from the fees charged to vendors and others for the receipt or use of the CTA systems' last sale price information. Each CTA Plan participant is entitled to receive its "annual share" of revenue, which is calculated according to the relative percentage of last sale transactions reported by that participant.

^{11/} The current participants are the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange ("CBOE"), Chicago Stock Exchange, International Securities Exchange ("ISE"), Nasdaq Stock Market, NASD, National Stock Exchange (formerly the Cincinnati Stock Exchange), New York Stock Exchange, NYSE Arca, and the Philadelphia Stock Exchange.

^{12/} See Exchange Act Rel. No. 33319 (Dec. 10, 1993), 55 SEC Docket 2062.

In 2003, the Division of Market Regulation (“Division”) expressed its concern to the CTA that the amount of the new entrant fee that the participants were considering might impose unnecessary competitive burdens on new entrants. 13/ In 2004, the Division twice urged the CTA to amend the CTA Plan to include “solely objective standards” for determining a new entry fee. 14/

On December 3, 2004, the CTA Plan participants proposed to amend the CTA Plan to include new standards for assessing a new entrant fee (the “Entry Fee Amendments”). 15/ The proposed Entry Fee Amendments provided, in pertinent part:

In determining the amount of the Participation Fee to be paid by any new Participant, the Participants shall consider one or both of the following:

- the portion of costs previously paid by CTA for the development, expansion and maintenance of CTA’s facilities which, under generally accepted accounting principles, could have been treated as capital expenditures and, if so treated, would have been amortized over the five years preceding the admission of the new Participant (and for this purpose all such capital expenditures shall be deemed to have a five-year amortizable life); and
- previous Participation Fees paid by other new Participants.

The Participant Fee shall be paid to the Participants in this CTA Plan and the “Participants” in the CQ Plan. A single Participation Fee allows the new Participant to participate in both Plans. If a new Participant does not agree with the calculation of the “Participation Fee,” it may subject the calculation to review by the Commission pursuant to Section 11A(b)(5) of the [Exchange] Act. (Emphasis supplied).

13/ See Order Approving the Seventh Substantive Amendment to the Second Restatement of the Consolidated Tape Association Plan and the Fifth Substantive Amendment to the Restated Consolidated Quotation Plan, Exchange Act Rel. No. 51391 (Mar. 17, 2005), 84 SEC Docket 4136, 4137 n.10.

14/ Id. at 4137 n.12.

15/ The proposal represented the seventh substantive amendment to the Second Restatement of the CTA Plan and the fifth substantive amendment to the Restated CQ Plan. Exchange Act Rel. No. 51012 (Jan. 10, 2005), 84 SEC Docket 2508.

In addition, the Entry Fee Amendments required new participants to reimburse the Plan processor for the costs incurred in modifying the CTA's systems to accommodate the new participant and for any additional capacity costs.

On March 17, 2005, the Commission, by delegated authority, approved the Entry Fee Amendments, 16/ which were incorporated into the CTA Plan as Section III(c). In its adopting release, the Commission stated that "the main purpose of a participation fee is to require each new party to the [CTA and CQ] Plans to pay a fair share of the costs previously paid by the CTA for the development, expansion, and maintenance of CTA's facilities." 17/ It stated further that the CTA and CQ Plan participants "should only consider the costs of tangible assets that could have been treated as capital expenditures under GAAP in the fee calculation, and if so treated, would have been amortized for a five-year period preceding the new party's admission to the Plans." 18/ However, the Commission cautioned that participants "must not consider any historical costs of operating the systems prior to the time a new party joins the Plans, or any subjective or intangible costs such as 'good will' or any future benefits to the new party." 19/ The Commission concluded that "the proposed new standards, if appropriately employed by the [p]articipants, should foster a fair and reasonable method for determining the amount of a new [p]articipant's entrance fee to be paid to the Plans." 20/

II.

Facts

In 2005, Nasdaq requested approval to join the CTA. The last entrant in the CTA Plan had been the CBOE in 1991. Nasdaq's request thus presented the first occasion for the CTA to calculate a new entrant fee based on the criteria set forth in the Entry Fee Amendments. The CTA directed SIAC to calculate a new entrant fee. In a presentation to the CTA dated October 12, 2005, SIAC calculated that Nasdaq's entry fee should be assessed at \$947,035,

16/ Order Approving the Seventh Substantive Amendment to the Second Restatement of the Consolidated Tape Association Plan and the Fifth Substantive Amendment to the Restated Consolidated Quotation Plan, Exchange Act Rel. No. 51391 (Mar. 17, 2005), 84 SEC Docket 4136.

17/ Id. at 4138.

18/ Id.

19/ Id. (Emphasis supplied).

20/ Id.

consisting of \$308,488 in “development amortization” costs and \$638,547 in “production amortization” costs. 21/ SIAC calculated the “development amortization” costs by

- totaling CTA development costs for 2000 through 2004;
- identifying “included” development costs that could be capitalized under Generally Accepted Accounting Principles (“GAAP”);
- amortizing included development costs over five years;
- adjusting that amortized amount by the Consumer Price Index (“CPI”); and
- dividing the result by ten, the then-current number of CTA Plan participants. 22/

SIAC calculated the “production amortization” costs in the same manner. In its presentation, SIAC quoted the language of the Entry Fee Amendments, but did not address the Commission’s admonition in the March 2005 adopting release that the CTA “must not consider any historical costs of operating the systems prior to the time a new party joins the Plans.” SIAC also did not attach any work papers in support of its calculations.

On November 4, 2005, Nasdaq formally requested entry into the CTA and CQ Plans. In its request, Nasdaq questioned whether SIAC had properly calculated the entry fee. It expressed concern that “production costs that are more on the order of operating expenses and should not be capitalized may have been included in the [entry fee] calculation.” It sought to meet with SIAC to ascertain the nature of the expenses included in both development costs and production costs.

In a memorandum dated January 9, 2006, SIAC’s Internal Audit Department reported on an “Agreed-Upon Procedures” engagement that it had performed for the purpose of “validat[ing] the assumptions used in the calculation of the Participation Fee.” 23/ The memorandum recited that SIAC’s auditors were asked to validate the “assumptions” that SIAC used in calculating the new entry fee for Nasdaq. However, the memorandum was silent as to what those assumptions were. Nor did the memorandum indicate the “clearly defined criteria” on which the “Agreed-Upon Procedures” engagement was based. In the memorandum, SIAC’s auditors focused solely on whether an expense could be capitalized under GAAP. SIAC’s auditors did not address the question whether an expense was an historical cost of operating the CTA’s systems. Nor did

21/ From the record, it appears that SIAC and the CTA traditionally billed participants for two categories of expenses, “development” and “production.”

22/ The calculation was performed for only a tenth CTA Plan Participant because ISE had not yet asked to have the entry fee calculated for it.

23/ According to the January 9, 2006, memorandum, an Agreed-Upon Procedures engagement was “one in which the auditor agrees to perform specific audit procedures based upon a set of clearly defined criteria. The client or customer sets forth the procedures and is solely responsible for their sufficiency.”

they identify any category of historical operating costs to be excluded from the calculation. Rather, SIAC's auditors simply identified one category of costs that should be "included" under GAAP and another that should be "excluded" under GAAP. SIAC's auditors concluded that they found the costs and assumptions used in the calculations to be "reasonable."

At the CTA's January 20, 2006, meeting, SIAC presented its January 9, 2006, audit memorandum. When NASD, Nasdaq's parent at the time, raised questions regarding SIAC's calculations, the CTA granted NASD an opportunity to have its accountants meet with SIAC's accountants to address NASD's concerns. In its brief, the CTA asserts, and Nasdaq does not dispute, that NASD availed itself of the opportunity on February 2, 2006.

On February 9, 2006, SIAC issued a second estimate of Nasdaq's new entry fee. SIAC applied the same methodology used in making the first estimate, but arrived at a slightly lower fee of \$912,918, which reflected the exclusion of certain production costs that were previously included in the calculation.

In a memorandum to the CTA dated March 6, 2006, Nasdaq objected to SIAC's inclusion of production costs in the calculation of Nasdaq's entry fee. Nasdaq stated, in pertinent part:

In the absence of instructions from the Operating Committee, however, SIAC included in its figures all expenditures that could have been capitalized for a five-year period not only for development, but also for production. Fortunately, SIAC did separate expenditures into two categories, development expenses which are permitted under the Plan and operating or production expenses which are not. As a result, impermissible operating expenses can readily be excluded by striking all production expenses in the presentation provided by SIAC.

Nasdaq also objected to SIAC's use of a CPI inflator. Based on SIAC's February 9, 2006, presentation, which identified \$2,839,747 in total development expenses without a CPI inflator, Nasdaq proposed that it pay an entry fee of \$283,975 (\$2,839,747 divided by ten, the then-current number of CTA Participants).

On March 22, 2006, SIAC issued an updated calculation of CTA costs based on the five-year period ending December 2005. The calculation also reflected the fact that the International Securities Exchange, or ISE, had requested to join the CTA Plan. This circumstance required the CTA to calculate entry fees for both a tenth and an eleventh participant. SIAC's calculation showed that a tenth entrant should pay \$873,381, and that an eleventh entrant should pay \$793,983.

At the CTA's March 23, 2006, meeting, the participants discussed costs to be included in the calculation of the new entry fee. Nasdaq moved for a vote on its proposal to pay a \$283,975 entry fee, but no participant seconded the motion. Another motion was made to admit Nasdaq

and ISE as participants for an entry fee of \$833,682 each ($\$873,381 + \$793,983 = 1,667,364$ divided by two is \$833,682). This motion was seconded and approved.

At the CTA's May 10, 2006, meeting, the participants determined that Nasdaq and ISE could each pay their \$833,682 entry fee in two equal installments, one within thirty days of that meeting and the other by the end of calendar year 2006. On June 16, 2006, Nasdaq wired payment of the first half of the entry fee. 24/ This petition for review followed. 25/

III.

Parties' Contentions

A. Nasdaq

Nasdaq contends that the CTA made three errors in calculating the entry fee. First, the CTA improperly included \$492,678 of historical operating costs in the calculation. As SIAC's documents reveal, the CTA historically has segregated all of its costs into one of two categories: development costs, *i.e.*, the costs of developing, expanding, and maintaining the CTA's facilities, and production or operating costs, *i.e.*, the costs of operating the CTA's systems. To calculate Nasdaq's fee, the CTA began with its "existing separation of Development Costs and Production Costs and then excluded costs in each category that could not be capitalized under GAAP." In Nasdaq's view, "[w]hat [the CTA] should have done – to adhere to the Commission's warning that the Participants must not consider any historical costs of operating the systems prior to the time a new party joins the Plans – was to begin with its existing Development Costs and then exclude those Development Costs that could be capitalized under GAAP." Nasdaq contends that the CTA, by including production, or operating, costs in its fee calculation, erroneously included \$492,678 of historical operating costs. 26/

Second, the CTA improperly applied a CPI inflator. Nasdaq argues that the Entry Fee Amendments do not authorize application of a CPI inflator or the practice of inflating historical costs to present day dollars. Moreover, application of a CPI inflator runs counter to accounting

24/ The record does not indicate whether Nasdaq has paid the second half of the entry fee.

25/ ISE has not petitioned for review.

26/ Nasdaq states that it arrived at this figure by taking SIAC's Production Cost Amortization Through December 2005 of \$5,419,466 and dividing it by eleven, the number of CTA Plan participants including Nasdaq and ISE.

principles of fixed assets. By applying a CPI inflator, the CTA overstated its costs by \$68,172. 27/

Third, the CTA improperly treated Nasdaq and ISE as the tenth and eleventh participants, respectively, of the CTA Plan, and averaged the entry fees. In Nasdaq's view, Nasdaq and ISE each should be treated as the eleventh participant.

B. CTA

The CTA responds that it properly excluded historical operating costs in calculating the entry fee. It deliberated over the fee calculation at no fewer than eight meetings, with three different presentations from SIAC. Commission staff members were present at each of the meetings and presentations and never suggested that the CTA had performed the calculation improperly.

The CTA acknowledges that, for recordkeeping purposes, it categorizes costs as either "development" costs or "production" costs. However, contrary to Nasdaq's claim, "production" costs are not synonymous with "operating" costs. The CTA asserts that whether it categorizes a cost as a "development" or "production" cost for recordkeeping purposes is irrelevant to the calculation of an entry fee. "What is relevant is whether a cost that CTA has placed in the 'production cost' category is a cost that CTA incurs in order to enhance or maintain the system or a cost that CTA incurred in order to operate the system." The CTA asserts that the "CTA incurs a portion of total production costs in enhancing and maintaining CTA systems, separate and apart from the production costs that [the] CTA incurs in operating the systems. The [Entry Fee Amendments] require [the] CTA to include the former in the entry-fee calculation, but prohibits [the] CTA from including the latter."

The CTA notes that, in an exhibit ("Exhibit A") to its December 3, 2004, letter transmitting the Entry Fee Amendments to the Commission for approval, the CTA included a hypothetical example of the calculation of an entry fee. The example set forth total production costs. It then carved out of total production costs those costs that were to be included in the calculation. The CTA asserts that it calculated Nasdaq's entry fee according to the methodology reflected in the hypothetical calculation. 28/ It suggests that the Commission's staff, which had

27/ Using SIAC's March 22, 2006 Presentation, Nasdaq subtracted "Development Cost Amortization – CPI Adjusted" from "Development Cost Amortization" and then divided by eleven, the number of CTA Plan participants. Nasdaq then repeated the same process for Production costs. As set forth above, Nasdaq argues that all Production Costs should be excluded from the calculation of the new entry fee.

28/ In its reply brief, Nasdaq asserts that the CTA's hypothetical calculation has no place in the record because it was not included in the Entry Fee Amendments presented to, and
(continued...)

“considerable” input into the methodology, placed its imprimatur on the CTA’s calculation of Nasdaq’s entry fee. 29/

The CTA acknowledges that it applied a CPI inflator, but asserts that it did so in compliance with the hypothetical calculation contained in Exhibit A. Exhibit A demonstrates that the CTA Plan participants, acting under the Commission’s guidance, “clearly intended” that changes in the CPI would be factored into the calculation. The CTA states, moreover, that it is “perfectly appropriate” to take into account the time value of money by adding back the inflation factor.

The CTA acknowledges that the CTA Plan is silent on the sharing of new entrant fees by multiple participants who enter the Plan in the same year. As a strict time priority, Nasdaq would be the tenth, and not the eleventh, CTA Plan participant because Nasdaq took the necessary steps to become a new participant sooner than ISE did. Having Nasdaq and ISE share the entry fees payable by the tenth and eleventh participants was considered by the participants to be a fair and reasonable way to proceed since Nasdaq and ISE were proposing to enter the CTA Plan at approximately the same time.

IV.

Analysis

As a threshold matter, we believe that Exchange Act Section 11A(b)(5) provides us with authority to review Nasdaq’s petition. Section 11A(b)(5)(A) authorizes the Commission, on its own motion or upon application by an aggrieved party, to review any prohibition or limitation of access to services provided by a registered securities information processor, in this case, the

28/ (...continued)

approved by, the CTA Plan participants, not included in the Commission’s release approving the Entry Fee Amendments, and not published in the Federal Register.

29/ The CTA relies on SIAC’s February 9, 2006, presentation as evidence that it included only those production costs that could be capitalized under GAAP. The February 9, 2006, presentation cites as included production costs “Data Processing, e.g., System Hardware (Non-Stop CPU’s, UNIX/Linux Servers),” “Communications Equipment Leases, e.g., Network Routers and Switches,” and “Afterhours Development/ Testing (Shared Data Center).” The CTA further relies on the January 9, 2006, audit report as providing verification that its calculations were proper.

In its reply brief, Nasdaq disputes the propriety of the CTA’s inclusion of the costs of Data Processing and Communications Equipment Leases. Nasdaq also takes issue with the CTA’s apparent capitalization of its direct labor costs under the labels “Product Planning” and “Communications Engineering.”

CTA. Section 11A(b)(5)(B) provides that if the Commission finds, after notice and opportunity for a hearing, that the prohibition or limitation is consistent with the provisions of the Exchange Act and the rules and regulations thereunder, and the aggrieved party has not been discriminated against unfairly, the Commission, by order, must dismiss the proceeding. Section 11A(b)(5)(B) also provides that if the Commission does not make any such finding, or if the Commission finds that the prohibition or limitation imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, the Commission, by order, must set aside the prohibition or limitation and require the securities information processor to permit the aggrieved party access to the services offered by the processor.

Section 11A(b)(5) thus vests the Commission with the substantive power to review prohibitions or limitations on access by registered securities information processors. The Commission previously has concluded that “the level of charges, or the terms at which facilities and services are offered by a registered securities information processor, can constitute a prohibition or limitation on access to those facilities and services.” ^{30/} In the March 2005 release adopting the Entry Fee Amendments, the Commission stated that any disagreement among Plan participants and a new entrant regarding the calculation of a proper fee would be subject to review by the Commission under Section 11A(b)(5). ^{31/}

Turning to the merits, we have reviewed the record assembled by the CTA. It consists primarily of minutes of CTA/CQ meetings between January 2005 and May 2006, the January 9, 2006, memorandum from SIAC’s auditors, and SIAC’s proposed calculations of the entry fee, as reflected in its presentations of October 12, 2005, February 9, 2006, and March 22, 2006. We conclude that, at this stage, we lack sufficient information to make the necessary determinations under Section 11A(b)(5). Accordingly, we direct the parties to address the following questions:

- (1) Does the CTA maintain its books and records on a GAAP basis?
 - (a) If so, what is the CTA’s policy regarding the capitalization of costs?
 - (b) Does that policy establish a capitalization threshold?
 - (c) What literature does the CTA rely on to capitalize its costs?

- (2) Did the CTA include in its calculation any development, expansion, or maintenance expenditures that are not capitalizable under GAAP?
 - (a) If so, what was the nature of those expenditures and the basis for including them in the calculation of Nasdaq’s entry fee?

^{30/} Institutional Networks Corp., Exchange Act Rel. No. 20088 (Aug. 16, 1983), 28 SEC Docket 980, 982 & n.18 (Order Instituting Proceedings and Granting Temporary Stay).

^{31/} Exchange Act Rel. No. 51391 (Mar. 17, 2005), 84 SEC Docket 4136, 4138 n.23.

- (3) How did CTA construe the phrase “could have been treated as capital expenditures” (as that phrase is used in CTA Plan Section III(c)) for purposes of calculating Nasdaq’s entry fee?
 - (a) What was the total amount of costs included in the fee calculation which were not actually capitalized in CTA’s books and records?
 - (b) What was the reason for not capitalizing the costs identified in (3)(a)?
 - (c) What portion of the costs identified in (3)(a) related to development, expansion, and maintenance expenditures?
- (4) Describe the types of costs within each category (development, expansion, and maintenance) that the CTA treated as capitalizable under GAAP for purposes of the fee calculation.
 - (a) In calculating Nasdaq’s entry fee, what was the total amount of costs for each category (development, expansion, and maintenance)?
- (5) What is meant by “CTA’s facilities” (as that term is used in CTA Plan Section III(c)) for purposes of calculating Nasdaq’s entry fee?
- (6) What software development activities were capitalized in accordance with Statement of Position 98-1 32/?
- (7) Were any assets reviewed for impairment following the guidance in FASB Statement No. 144, Accounting for Impairment or Disposal of Long-Lived Assets?
 - (a) If so, how was the impairment of those assets considered in the calculation of Nasdaq’s entry fee?
- (8) Did the CTA include any leases in its calculation of Nasdaq’s entry fee?
 - (a) If so, which leases were included in the fee calculation?
 - (b) How were those leases accounted for under GAAP?
- (9) In its amortization of capitalized expenditures, how did the CTA treat those capitalized expenditures that were incurred before the five-year period set forth in CTA Plan Section III(c), i.e., were all, some, or none of the amortized expenditures included?

32/ American Institute of Certified Public Accountants (“AICPA”) Statements of Position (“SOP”) provide guidance on financial accounting and reporting issues. Statement of Position 98-1 was cited by SIAC’s auditors in the January 9, 2006, memorandum.

- (10) What weight should be given to the hypothetical calculations contained in Exhibit A to the CTA's December 3, 2004, letter transmitting the Entry Fee Amendments to the Commission for approval?

The parties are free to address any other matters that they deem relevant. We also invite any interested persons, including the Division of Market Regulation, to address these issues. 33/

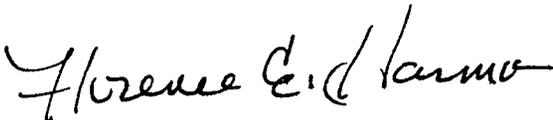
Disputes involving registered securities information processors, national market system plans, or transaction reporting plans under Exchange Act Section 11A and the rules thereunder are governed by the Rules of Practice. 34/ We have determined to appoint a law judge to preside over this proceeding. 35/

Accordingly, it is ORDERED that the petition for review of the Nasdaq Stock Market, LLC, be, and it hereby is, accepted; and it is further

ORDERED that the Chief Administrative Law Judge Brenda P. Murray shall designate an administrative law judge to preside over this proceeding in accordance with this Order; and it is further

ORDERED that submissions may be received from the parties and any interested party, as well as from our Division of Market Regulation.

By the Commission.


By: Florence E. Harmon
Deputy Secretary

Nancy M. Morris
Secretary

33/ See Rule of Practice 210(d), 17 C.F.R. § 201.210(d) (providing for amicus participation and setting forth procedure for filing amicus brief).

34/ 17 C.F.R. § 201.101(a)(9); see 17 C.F.R. § 201.100(c) (authorizing the Commission, by order, to direct an alternative procedure if it determines that doing so would serve the interests of justice and not result in prejudice to any party).

35/ See, e.g., Cincinnati Stock Exchange, 54 S.E.C. 857 (2000) (in Section 11A(b)(5) case in which record required further development, Commission appointed law judge to preside over proceeding and directed parties to address certain issues).

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-55912; File No. PCAOB-2007-02)

June 15, 2007

Public Company Accounting Oversight Board; Notice of Additional Solicitation of Comments on the Filing of Proposed Rule on Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments

On June 12, 2007, the Commission published notice, pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), that on May 25, 2007, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules relating to Auditing Standard No. 5 ("AS5"), An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements; a Related Independence Rule; and conforming amendments to the PCAOB's auditing standards.¹ The Commission published notice of these proposed rules to solicit comments on the proposed rules from interested persons. As stated in that notice, interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the Act. The Commission is publishing this additional solicitation of comment to request specific comment on the following:

- (1) Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately

¹ See Exchange Act Release No. 34-55876 (June 7, 2007), 72 FR 32340 (June 12, 2007).

incorporated into the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?

- (2) Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement regarding significant deficiencies divert auditors' attention away from material weaknesses?
- (3) Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?
- (4) Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.
- (5) Is AS5 sufficiently clear about the extent to which auditors can use the work of others?
- (6) Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?
- (7) Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2007-02 on the subject line.

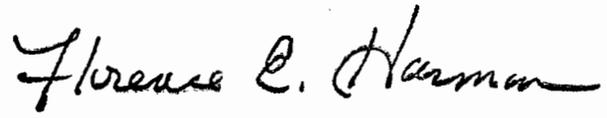
Paper comments:

- 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 No. PCAOB-2007-02. This file number should be included on the subject line if e-mail is used. To help process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Website (<http://www.sec.gov/rules/pcaob>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 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. All submissions should refer to File Number PCAOB-2007-02. Comments

should be submitted on or before July 12, 2007. The Commission intends to act on the proposed rule no later than July 27, 2007.

By the Commission.

A handwritten signature in cursive script that reads "Florence E. Harmon". The signature is written in black ink and is positioned to the right of the typed name.

Florence E. Harmon

Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

*Commissioner Casey
Not Participating*

SECURITIES EXCHANGE ACT OF 1934
Release No. 55914 / June 15, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12660

In the Matter of

STANISLAV KAMINSKY,

Respondent.

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

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 15(b) 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 that:

Summary

This matter involves unauthorized trading by Stanislav Kaminsky ("Kaminsky") while he was associated with Marquis Financial Services, Inc. ("Marquis Financial"), a broker-dealer based in Burbank, California. Between February 2005 and April 2005, Kaminsky executed unauthorized trades in the accounts of at least two of his customers which, combined with margin and/or commission charges, caused each account to lose more than 40% of its value. Previously, in January 2003, the Commission ordered Kaminsky to cease and desist from violations of the antifraud provisions of the federal securities laws and suspended him from association with any broker or dealer for twelve months for engaging in sales practice abuses, including unauthorized trading, between April 1997 and November 1997. Kaminsky has also been a respondent in several NASD arbitration actions, one of which was resolved against him.

Respondent

1. Kaminsky, age 30, is a resident of Brooklyn, New York. Kaminsky holds NASD Series 7, 24, and 63 licenses. Between July 2004 and November 2005, Kaminsky was associated with Marquis Financial.

Other Relevant Entity

2. Marquis Financial is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. The firm is currently headquartered in Burbank, California, and has two branch offices located in Spring Hill, Florida and Brooklyn, New York. It was previously headquartered in Hicksville, New York.

Kaminsky's Prior Sales Practice Abuses

3. On January 29, 2003, the Commission, in In the Matter of Stanislav Kaminsky, Admin. Proc. File No. 3-11023 (January 29, 2003), found that Kaminsky had engaged in fraudulent sales practices, including churning and unauthorized and unsuitable trading, in the accounts of five customers while he was associated with W.J. Nolan and Co., a broker-dealer registered with the Commission. The Commission ordered Kaminsky to cease and desist from committing or causing any future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10b of the Exchange Act and Rule 10b-5 thereunder, and from causing violations of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder. In addition to suspending Kaminsky from association with any broker or dealer for twelve months, the Commission ordered Kaminsky to pay disgorgement and prejudgment interest in the amount of \$30,454 and a civil penalty in the amount of \$20,509.

4. As a result of conduct that took place between 2000 and 2002, Kaminsky was charged in at least four NASD arbitration claims with executing unauthorized transactions in customers' accounts. One of the arbitration claims resulted in Kaminsky and the broker-dealer with whom he was then employed being found jointly and severally liable to the customer for \$30,381 in compensatory damages and \$10,000 in attorney fees.

Kaminsky's Current Sales Practice Abuses

5. Between February 2005 and April 2005, Kaminsky executed transactions in the accounts of at least two customers without the customers' authorization. Kaminsky also traded on margin without the customer's authorization in one of the accounts.

6. In early February 2005, Kaminsky recommended to one customer that certain investments in the customer's account be sold to purchase shares in two stocks Kaminsky recommended. The customer rejected Kaminsky's recommendation, and told him to not execute the trades. Nevertheless, in direct contravention of the customer's instructions, Kaminsky, later in February, sold more than \$9,500 of securities in the customer's account, and used the proceeds to purchase the stocks he recommended.

7. Subsequently, in March 2005 and again in April 2005, without the customer's authorization, Kaminsky purchased, on margin, 3,000 additional shares of one of the stocks Kaminsky recommended. In addition, in April 2005, Kaminsky, without the customer's authorization, sold two investments from the customer's account for \$29,481 and \$4,874.

8. Kaminsky earned more than \$1,212 in commissions from the unauthorized trades in the customer's account. As a result of the unauthorized transactions in the customer's account, and the attendant commissions and margin charges, the value of the customer's account decreased by more than 40%.

9. In early February 2005, Kaminsky sold more than \$9,000 worth of government securities from a second customer's account, and used the proceeds from the sale to purchase shares in one of the same stocks Kaminsky recommended to the first customer. The customer did not authorize either transaction.

10. When the customer discovered the unauthorized trades, he complained to Kaminsky and demanded that his account positions be restored. Kaminsky tried to convince the customer to keep the trades, but the customer refused. The customer's account was never restored to its prior positions.

11. Kaminsky earned approximately \$298 in commissions from the unauthorized trades in the customer's account. As a result of the unauthorized transactions in this customer's account, and the attendant commissions, the value of the customer's account decreased by more than 50%.

Violations

12. As a result of the conduct described above, Kaminsky willfully violated Section 17(a) of the Securities Act, 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, in that he employed devices, schemes, or artifices to defraud; obtained money or property by means of untrue statements of material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engaged in any transaction, act, practice, or courses of business which operated or would operate as a fraud or deceit upon any person, in connection with the offer, purchase or sale of any security. An unauthorized trade is fraudulent where it is accompanied by deception, misrepresentation, or non-disclosure. SEC v. Hasho, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); In the Matter of Edgar B. Alacan, 83 SEC Docket 842, 845 (July 6, 2004); In the Matter of Sandra K. Simpson and Daphne Pattee, 77 SEC Docket 1983, 2001 (May 14, 2002) (*quoting* Donald A. Roche, 53 S.E.C. 16, 24 (1997)).

Disgorgement and Civil Penalties

13. Respondent has submitted a sworn Statement of Financial Condition dated April 5, 2007 and other evidence and has asserted his inability to pay a civil penalty and the full amount of disgorgement and prejudgment interest.

IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Respondent Kaminsky be, and hereby is barred from association with any broker or dealer.

B. 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.

C. Respondent shall pay \$1,510 in disgorgement and \$167 in prejudgment interest, but payment of all but \$400 is waived based upon Respondent's sworn representations in his Statement of Financial Condition dated April 5, 2007 and other documents submitted to the Commission.

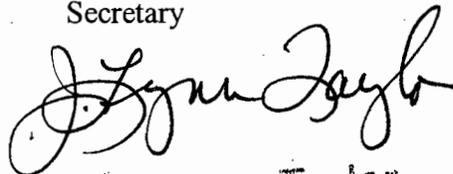
D. Based upon Respondent's sworn representations in his Statement of Financial Condition dated April 5, 2007 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent.

E. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the full amount of disgorgement plus pre-judgment interest and the maximum civil penalty allowable under the law. No other issue shall be considered in connection with the petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of the full amount of disgorgement plus prejudgment interest and a penalty should not be ordered; (3) contest the amount of disgorgement and interest to be ordered and the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

F. IT IS FURTHER ORDERED that Respondent shall, within ten days of the entry of this Order, pay disgorgement of \$400 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 Stanislav Kaminsky 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 Timothy Warren, Associate Director, Division of Enforcement, Securities and Exchange Commission, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55931 / June 20, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2618 / June 20, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12661

In the Matter of

ALLIED CAPITAL
CORPORATION,

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 Allied Capital Corporation ("Allied" 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 over 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.

III.

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

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Respondent

1. **Allied Capital Corporation**, incorporated in Maryland and headquartered in Washington, D.C., is a closed-end management investment company that has elected to be regulated as a business development company (“BDC”) pursuant to Section 54 of the Investment Company Act of 1940 (“Investment Company Act”). Allied provides privately negotiated debt and equity financing to middle market companies, with a primary focus on private finance. Allied’s securities are registered pursuant to Section 12(g) of the Exchange Act. Allied makes periodic filings with the Commission pursuant to Section 13(a) of the Exchange Act.

Summary

2. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, Allied violated recordkeeping and internal controls provisions of the federal securities laws relating to the valuation of certain securities in its private finance portfolio for which market quotations were not readily available. During the relevant period, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported or accurately and fairly reflected certain valuations it recorded on a quarterly basis for some of its securities. In addition, Allied’s internal controls failed to provide reasonable assurances that Allied would value these securities in accordance with generally accepted accounting principles. Further, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, Allied failed to provide reasonable assurances that the recorded accountability for certain securities in its private finance portfolio was compared with existing fair value of those same securities at reasonable intervals by failing to: (a) provide its board of directors (“Board”) with sufficient contemporaneous valuation documentation during Allied’s March and September quarterly valuation processes; and (b) maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy.

3. Allied has implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes.

Background

4. As a BDC, Allied is required to value its private finance security portfolio pursuant to the requirements in Section 2(a)(41) of the Investment Company Act. Because the large majority of Allied’s investments in its private finance portfolio are securities for which market quotations are not readily available, Section 2(a)(41)(B)(ii) of the Investment Company Act requires that Allied’s Board determine the fair value of its portfolio securities in good faith. The fair value of securities for which market quotations are not readily available is the price Allied would reasonably expect to receive on a current sale of the security.¹ By the end of the relevant

¹ See AICPA Audit and Accounting Guide - Investment Companies (Sect. 2.35-2.39), which incorporates Accounting Series Release No. 118 (“ASR 118”). The Commission has provided interpretative guidance related to financial reporting in the Accounting Series Releases, which is included in the Codification of Financial Reporting Policies. Thus, conformity with the ASR 118 is required by Commission rules and is consistent with GAAP. See also Articles 1-01(a) and 6.03 of Regulation S-X.

period, Allied's private finance portfolio recorded at fair value grew to over \$1.7 billion, which represented approximately 65% of Allied's total assets, and included investments in approximately 152 portfolio companies.

5. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, however, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported the valuations of certain of its securities for which market quotations are not readily available ("private finance investments"). With respect to 15 private finance investments reviewed by staff, Allied could not produce sufficient contemporaneous documentation to support, or which accurately and fairly reflected, its Board's determination of fair value. Instead, in some instances, the written valuation documentation Allied presented to its Board for these investments failed to include certain relevant indications of value available to it (as further discussed below) and sometimes introduced changes to key inputs used to calculate fair value from quarter to quarter without sufficient written explanation of the rationale for the changes (e.g., changes from EBITDA to revenue-based valuations and in some instances, changes in multiples used to derive enterprise value). The written valuation documentation retained by Allied for these private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.

6. The following are three examples of insufficient recordkeeping of Allied's private finance investments during the relevant period.

7. **Company A** - During the relevant period, Allied held a debt investment in Company A, a telecommunications company. Allied was unable to produce contemporaneous written documentation, in reasonable detail, to support its valuation of Company A during the quarters ended June 30, 2001 and September 30, 2001. Specifically, Allied's valuation of Company A for these quarters was derived, in part, by including revenues from discontinued lines of business to establish fair value. Allied maintains that it used a reduced multiple to offset any potential overstatement that would have otherwise resulted from the inclusion of those revenues, but it did not provide the Board with contemporaneous written documentation, in reasonable detail, to support this claim. In addition, Allied did not retain the valuation documentation it presented to the Board for Company A for the quarters ended December 31, 2001 and March 31, 2002. Allied valued its \$20 million subordinated debt investment in Company A at \$20 million (i.e., cost) in its Forms 10-Q for the quarters ended June 30, 2001 and September 30, 2001. In its 2001 Form 10-K and its Form 10-Q for the period ended March 31, 2002, Allied valued its \$20 million subordinated debt investment in Company A at \$10.3 million. Allied subsequently wrote down its subordinated debt investment in Company A to \$245,000 in its Form 10-Q for the quarter ended June 30, 2002.

8. **Company B** - During the relevant period, Allied held a subordinated-debt investment in Company B, a direct marketing company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company B for the quarter ended March 31, 2003. Specifically, Allied's valuation was based, in large part, on a potential future buyout event by Allied that was preliminary in nature. Allied maintains that – as a general practice – the Board would have discussed why this particular potential future buyout event was significant enough to form the basis of its valuation of Company

B, but it could not provide contemporaneous written documentation in reasonable detail to support this claim. Further, Allied's valuation documentation did not fully reflect Allied's consideration of competing buyout offers for Company B, which, if accepted, would have reduced the fair value of Allied's investment. Allied valued its \$16.5 million subordinated debt investment in Company B at \$14.3 million in its Form 10-Q for the quarter ended March 2003. Allied subsequently wrote down its subordinated debt investment in Company B from \$14.3 million to \$50,000 in its Form 10-Q for the quarter ended June 30, 2003.

9. **Company C** - During the relevant period, Allied held a subordinated debt investment in Company C, an office supply company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company C from the quarter ended September 30, 2001 through the quarter ended March 31, 2002. For example, Allied's written valuation documentation failed to include all relevant facts available to it regarding Company C's deteriorating financial condition, including the fact that Company C had lost one of its largest customers as a result of the terrorist attack on the World Trade Center. Allied valued its subordinated debt investment in Company C at \$8 million in its Forms 10-Q and Form 10-K for the quarters ended September 30, 2001 through March 31, 2002 and subsequently wrote that investment down to \$50,000 in its Form 10-Q for the quarter ended June 30, 2002.

10. Allied also failed to implement internal accounting controls relating to its private finance investment valuations that were sufficient to provide reasonable assurances that these valuations were fairly stated in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. For example, there were certain instances where Allied did not provide its Board (or its valuation committee) with sufficient written information to support the Board's determinations of fair value.² For example, in several instances, the written valuation documentation presented to the Board was incomplete or inadequate to support the fair value recorded by Allied (*e.g.*, enterprise values were listed on worksheets without any explanation; necessary inputs and/or calculations were either missing or incomplete). In other instances, Allied's valuation documentation during the relevant period contained unexplained departures from, or changes to, key inputs from quarter to quarter. During the relevant period, Allied did not provide its Board with written valuation documentation from prior periods. At least one Board member, however, maintained prior period valuation documentation during a portion of the relevant period, but Allied did not regularly provide the Board with comparative information about prior period inputs until the quarter ended September 30, 2003.

11. In addition, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, the valuation documentation presented to Allied's Board during the March and September quarterly valuation processes consisted of quantitative worksheets that failed to provide an adequate explanation of the various inputs. For example, changes in valuations from quarter to quarter were not always explained in reasonable detail in the written documentation. Moreover, Allied did not prepare a written description of the quantitative and qualitative analyses used to

² Allied's failure to provide the Board with such information is inconsistent with the guidance in ASR 118 that a fund's board must satisfy itself that "all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered . . ." *See supra n. 1.*

develop its valuations until the quarter ended June 30, 2002. During this period, Allied also failed to maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy. While Allied maintains that its Board members and employees engaged in discussions before and during the Board meetings to satisfy themselves with the recorded valuations for Allied's private finance investments, the written valuation documentation retained by Allied for certain private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.³

12. During the relevant period, Allied private finance department personnel typically recommended the initial valuations on the investment deals on which they worked. While there were some existing independent checks of Allied's valuation process, these checks, standing alone, did not provide a sufficient assessment of the objectivity of valuations of the private finance investments. For example, the valuation committee assigned to review each investment on a quarterly basis was comprised, in large part, of private finance managing directors and principals. Allied has since implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes, including, but not limited to: quarterly valuation assistance from third-parties; and the establishment of a new Chief Valuation Officer position to oversee the valuation process.

13. As a result of the conduct described above, Allied violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. See, e.g., In the Matter of Morgan Stanley, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain documentation to support its bond valuations violated Section 13(b)(2)(A)).

14. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(ii) of the Exchange Act, which requires reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. See, e.g., In the Matter of Morgan Stanley, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain internal controls sufficient to ensure that it valued its bond positions and its aircraft in accordance with GAAP violated Section 13(b)(2)(B)).

15. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(iv) of the Exchange Act, which requires reporting companies to provide reasonable

³ Commission guidance provides that "... directors should take into consideration all indications of value available to them in determining the 'fair value' assigned to a particular security. The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent accountant." See ASR 118.

assurances that the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

IV.

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

V.

Undertakings

Respondent has undertaken for a period of two years from the entry of this Order to:

1. Continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation process.
2. Continue to employ third-party valuation consultants to assist in its quarterly valuation process for private finance investments in a manner consistent with the Respondent's current practices.

VI.

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

Accordingly, the Commission HEREBY ORDERS, pursuant to Section 21C of the Exchange Act, that:

- A. Respondent Allied cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A); 13(b)(2)(B)(ii) and 13(b)(2)(B)(iv) of the Exchange Act; and
- B. Respondent shall comply with the undertakings enumerated in Section V above.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

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

Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55933 / June 20, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2620 / June 20, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12662

In the Matter of

CAMBREX CORPORATION,

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 Cambrex Corporation ("Cambrex" 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 that:

Respondent

1. Cambrex is a Delaware corporation with headquarters in East Rutherford, New Jersey. Cambrex supplies human health and bioscience products to the life sciences industry, produces feed additives and intermediates for the animal health/agriculture markets, and manufactures other specialty and fine chemicals. For the fiscal year ended December 31, 2005, Cambrex had net revenues of \$455,097,000 and a net loss of \$110,458,000. Cambrex's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange.

Summary

2. Between at least 1997 through 2001, Cambrex accrued an imbalance of approximately \$17.1 million in its intercompany accounts. Of that amount, approximately \$3.5 million was erroneously reflected as income when it in fact should have been accounted for as an operating expense, and Cambrex could not ascertain whether another \$2.6 million was similarly booked improperly, though it also treated this figure as if it had been reflected as income. As a result, Cambrex issued erroneous periodic and annual reports.

3. The erroneous filings occurred because Cambrex failed to reconcile its intercompany accounts on a monthly basis. Cambrex failed to reconcile its intercompany accounts for three principal reasons. First, Cambrex did not adequately staff its internal accounting function. Second, Cambrex lacked a functional intercompany transaction policy. Third, when Cambrex instituted projects to perform a historical reconciliation of its intercompany accounts, the projects were not completed. Cambrex failed to reconcile the intercompany accounts even though its outside auditor provided Cambrex with several management letters that warned of potential ramifications if the imbalance was not fixed.

4. Cambrex's failure to reconcile its intercompany accounts continued until the end of 2002, when Cambrex was forced to address the issue because of the certification requirements of the newly-enacted Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). A Cambrex subsidiary's controller initially refused to sign a Sarbanes-Oxley-related internal sub-certification because of his awareness of the problems reconciling the intercompany accounts. His refusal triggered a series of discussions by Cambrex's audit committee concerning the issue. In December 2002, Cambrex hired a new CFO with a strong accounting background, who finally devoted adequate resources to the task of reconciling the historical imbalances.

5. As a result, in January 2003, Cambrex announced that it would restate its financial results for the years ending December 31, 1997, through December 31, 2001 (the "Restatement

Period"). Cambrex stated that it had overstated pre-tax income by a total of \$6.1 million, or \$5.1 million after taxes, over the fiscal years 1997 through 2001. Net income was overstated by \$1.3 million, \$2.9 million, \$0.2 million and \$0.8 million in 2001, 2000, 1999, and 1998, respectively, and understated by \$0.1 million in 1997.

Background

A. Intercompany Accounts at Cambrex

6. Cambrex has approximately fourteen operating subsidiaries located throughout the world. In order to record and account for activity, such as the transfer of expenses, assets, or liabilities, conducted between these affiliated companies, Cambrex utilizes intercompany accounts.

7. Intercompany transactions are supposed to be booked through an identical corresponding charge by each side of a given transaction or expense, which, if done properly, would have no impact on Cambrex's consolidated assets, liabilities, expenses, or revenues. For example, if Cambrex corporate ("Corporate") agrees to absorb an expense incurred by a subsidiary, if recorded correctly, Corporate should record a debit to an expense account, increasing the expense on Corporate's income statement, and a credit to an intercompany account on its balance sheet. The subsidiary should record a credit to an expense account on its income statement and a debit to an intercompany account on its balance sheet. If Corporate were to initially record and pay for an expense that should be charged to a subsidiary, the above entries should be reversed. In both instances, as a result of these identical credits and debits, the accounts would net to zero and there would be no impact on Cambrex's consolidated assets, liabilities, expenses, or revenues.

8. Within Corporate, Cambrex's internal accounting group, known as the finance department ("Finance Department"), was responsible for, among other things, reviewing and reconciling the intercompany accounts. During the relevant time periods, the Corporate Finance Department was supervised by the Controller. A designated employee, usually the most junior, was supposed to review the intercompany accounts as part of a process to ensure that all intercompany accounts balanced and were properly netted-out in consolidation. To do this, the employee used computer software that alerted the employee if an imbalance existed, in which case the employee was then supposed to access separate software that essentially operated as Cambrex's general ledger, to view the detail behind the specific transactions that caused an imbalance within a particular intercompany or group loan account.

9. Once discrepancies were identified, the Finance Department was tasked with resolving the difference through discussions with relevant personnel at the subsidiary. If no agreement could be reached, the Corporate Controller was supposed to make a unilateral, final decision about how to treat the discrepancy. During the Restatement Period, this process did not occur. Instead of reconciling the difference, the designated Finance Department employee simply logged the discrepancies.

10. The intercompany accounts were incorporated into Cambrex's financial statements during the monthly consolidation process. Because of its many subsidiaries, Cambrex performed a

multi-level consolidation that generated a single, final balance sheet, incorporating Corporate as well as both the domestic and international subsidiaries. The consolidation was performed at the close of every month, in order to generate monthly financial reports, comparing the actual results reported by the sites with their forecasted and prior year's results. During the consolidation process, Cambrex would identify the sum of all intercompany imbalances (those entries where both sides to an intercompany transaction did not book the same dollar figure). Under Generally Accepted Accounting Principles, it is necessary to eliminate intercompany transactions in the consolidation process. Cambrex erroneously believed it eliminated its intercompany imbalances by entering the sum of all the imbalances in a line item, known as a "top side adjustment," on its consolidated balance sheet. The top-side adjustment was only made on the balance sheet – and not the income statement – because of a long-standing but erroneous assumption that the imbalanced intercompany accounts did not affect Cambrex's income statement.

11. In fact, under certain circumstances, Cambrex's imbalanced intercompany accounts did affect its income statement. This occurred when, for example, a subsidiary recorded an expense that it intended to transfer to Corporate where, in order to transfer the expense, it should have recorded a credit to an expense account to reduce its operating expenses on its income statement and a debit to an intercompany account on its balance sheet. When Corporate, however, did not book an offsetting entry to increase its expenses and adjust its intercompany account, this resulted in an understatement of consolidated expenses and an overstatement of consolidated income in Cambrex's consolidated financial statement. Similarly, there were instances where Corporate intended to transfer certain fringe benefit expenses to a subsidiary and Corporate recorded one amount and the subsidiary recorded a different amount resulting in a corresponding understatement or overstatement of consolidated expenses, which also affected Cambrex's consolidated income statement.

B. Cambrex Failed to Perform Monthly Reconciliations of the Intercompany Accounts.

12. During the Restatement Period, Cambrex did not reconcile its intercompany accounts on a monthly basis. This failure contributed to a growing imbalance that needed to be corrected through a historical reconciliation. Although Cambrex executives were aware of the problem – and were specifically told by its auditor in 1999 that the failure to reconcile intercompany accounts could ultimately impact earnings – they took only limited and inadequate steps to address the issue. The historical reconciliation project was started several times, only to be quickly abandoned. Throughout, Cambrex failed to provide adequate staffing to the reconciliation project.

13. The Corporate Finance Department was inadequately staffed to reconcile the intercompany accounts. In addition, Cambrex's limited accounting staff prioritized other responsibilities, such as monthly and periodic financial reporting, over the monthly intercompany reconciliation. In fact, Finance Department personnel believed that other group responsibilities took precedence over the monthly intercompany reconciliation. As a result, most personnel responsible for the internal accounting function made only a limited effort, if any, to perform a monthly reconciliation. These personnel rarely communicated with Cambrex subsidiaries concerning discrepancies in intercompany accounts, and did not ensure that such discrepancies

were remedied, but only logged the existence of these unresolved balances. Furthermore, the Finance Department experienced considerable staff turnover and new employees were not trained to handle the monthly reconciliation.

14. The individuals directly responsible for supervising these employees were aware that the intercompany imbalances were not being fully reconciled on a monthly basis and that the Finance Department was not properly staffed to do so. As a result, these individuals took insufficient steps to ensure that the intercompany accounts were regularly reconciled.

15. Although Cambrex maintained an intercompany transaction policy, it was not shown to various employees responsible for its implementation. The policy's instructions were not followed because several individuals tasked with reconciling the intercompany accounts never saw the document. In addition, this document offered conflicting guidance by simultaneously mandating that the accounts be reconciled on a monthly basis and allowing unreconciled items to be carried into the following month. It was also unclear whether the document was intended to cover all intercompany transactions or a more limited subset of transactions. Moreover, while the document required that a schedule of all intercompany balances be completed and sent to Corporate as part of the quarterly reporting process, such schedules were not always prepared.

16. A supervisor responsible for the reconciliation of the intercompany accounts was aware of an intercompany transaction policy and knew that certain steps outlined in the policy were being taken, yet he did not recall reviewing it or consulting it. Although at various times the company set out to perform a historical reconciliation – often terming the project a “high priority” – the project was never completed. Cambrex failed to complete the historical reconciliation even though Cambrex's auditor warned that Cambrex's failure to properly reconcile the unbalanced accounts could affect the reported income statement in its financial disclosures.

C. Cambrex Failed to Reconcile the Historical Imbalance in its Intercompany Accounts.

17. By failing to reconcile the intercompany accounts on a monthly basis, Cambrex generated a lengthy backlog of unreconciled entries. In order to determine the proper treatment of the entries underlying the imbalance, it became necessary to perform a historical reconciliation of the intercompany accounts.

18. However, during the Restatement Period, Cambrex did not reconcile the historical imbalance. This failure occurred because Cambrex did not employ sufficient personnel to perform the historical reconciliation and Cambrex never completed several reconciliation initiatives. These failures occurred even though Cambrex's auditor warned that Cambrex's failure to properly reconcile the unbalanced accounts could affect the reported income statement in Cambrex's financial disclosures.

19. Cambrex relied on its internal accounting personnel to reconcile the imbalanced historical entries. However, much like the monthly reconciliation process, Cambrex did not employ sufficient manpower or devote adequate resources to complete the historical reconciliations. Again, supervisors were aware that the Finance Department was not performing

the historical intercompany reconciliation and was not properly staffed to do so. In fact, there were two substantial periods of time, each lasting several months, when Corporate performed no work to reconcile the historical imbalance.

20. Each year between 1999 and 2001, Cambrex instituted projects, at the direction of Finance Department supervisors, to reconcile the historical intercompany account imbalance. None of the reconciliation projects, one of which included assistance from an employee outside the Finance Department and an accountant employed by Cambrex's outside auditor, was completed, and many steps set forth in the various plans were either not taken or left incomplete. Furthermore, Cambrex supervisors never took adequate steps to determine whether the internal accounting personnel had reconciled the intercompany account imbalances or why these tasks had not been completed.

21. Even when Cambrex identified a serious problem within the intercompany accounts, it took insufficient corrective steps. For instance, during 2001, Cambrex discovered that a subsidiary had been consistently incorrectly booking payments for fringe benefits. Upon discovering these errors, Cambrex and its personnel had direct evidence that a certain portion of the reconciliation resulted in an income effect on its P&L, which refuted a long-standing assumption about the nature of the imbalances. Yet, even after learning of this error, Cambrex did not take adequate measures to complete the historical reconciliation and determine the full extent of any adjustment needed to be made.

D. Cambrex Did Not Adequately Address Management Letters From its Auditor.

22. Cambrex failed to reconcile the historical intercompany imbalance in spite of several annual warnings by its auditor of the consequences of such a failure.

23. In early 1999, Cambrex's outside auditor issued a management letter to Cambrex for its audit for the year ended December 31, 1998 ("1998 Management Letter"). The 1998 Management Letter outlined key issues arising from that year's audit and recommended changes. Among the suggestions was a recommendation titled: "Reconciliations over Intercompany Transactions Should Be Improved." The recommendation stated the following:

The Company should improve the adequacy of intercompany balance reconciliations. This issue, if not addressed, may result in a misstatement of intercompany accounts and not allow for proper elimination of such at the consolidated level. This could result in an unfavorable impact to earnings in the period discovered.

We recommend that the Company implement procedures to identify and reconcile intercompany transactions.

24. In its response to the 1998 Management Letter, Cambrex's management stated that it agreed with its outside auditor's observation and recommendation. It also stated that, "[a] draft policy is currently issued which addresses the procedures required to confirm intercompany balances between subsidiaries on a monthly basis." The 1998 Management Letter, along with

Cambrex management's response, were provided to Cambrex's audit committee.

25. After receiving the 1998 Management Letter, neither Cambrex management, nor its audit committee, took the necessary steps to reconcile the historical imbalances or address the failures to reconcile the accounts on a monthly basis. Furthermore, no steps were taken to determine if Cambrex's accounting department was following the intercompany policy.

26. Cambrex's auditor issued another management letter to Cambrex in the beginning of 2000, which covered the 1999 audit. In this letter, the auditor stated that Cambrex did not have an intercompany policy and did not perform periodic reconciliation of balances. Cambrex's auditor warned that, if unchecked, the unreconciled accounts could result in an inability to "detect a misstatement" and "an unexpected and unfavorable impact to earnings in the period discovered." Cambrex's auditor recommended that Cambrex "implement procedures to reconcile intercompany account balances at least quarterly." In its response, Cambrex noted that it had "initiated a project to bring intercompany accounts into balance" and, once finished, they would be "reconciled formally as part of the quarterly management reporting process." Cambrex also claimed to be evaluating "the feasibility of implementing an automated balancing feature for intercompany transactions in the [computer] system." The management letter for the 1999 audit, and Cambrex management's response were provided to Cambrex's audit committee.

27. Again, Cambrex did not follow through in its response and, as a result, did not fulfill the steps needed to reconcile the intercompany and group loan accounts. The project that Cambrex initiated to reconcile the accounts was never completed. Cambrex also did not begin formally reconciling the account balances on a quarterly basis, and an automated balancing feature was not implemented.

28. During the next two years, Cambrex's auditor provided Cambrex with management letters for the 2000 and 2001 audits that were not distributed to the audit committee. In the management letters, the auditor stated that periodic reconciliations of intercompany balances were still not being performed, and reiterated their recommendation that Cambrex implement procedures to reconcile intercompany balances on a quarterly basis. It was also noted that the management letter from 2000 (for the 1999 audit) was still applicable. Cambrex management did not provide a response to these comments.

E. Effect of Sarbanes-Oxley Act on the Reconciliation Project

29. Cambrex did not adequately address its historical reconciliation problems until the end of 2002, after issues were raised concerning the certification of Cambrex's financial disclosures pursuant to Sarbanes-Oxley. In order to complete the CEO and CFO certifications required by Sarbanes-Oxley, Cambrex required sub-certifications from all of its Corporate and subsidiary Controllers concerning the accuracy of its financial reporting. When the controller for one of Cambrex's subsidiaries initially refused to sign the sub-certification because of his awareness of the problems concerning the intercompany accounts, this refusal prompted a series of discussions by the Audit Committee. In December 2002, Cambrex hired a new CFO who engaged additional accounting staff and consultants and mobilized a strong reconciliation effort. As a

result, Cambrex finally devoted sufficient resources to reconcile all of the historical imbalances.

F. Cambrex's Restatement

30. At the close of trading on January 23, 2003, Cambrex issued a press release announcing that it would restate its financial results for the years ended December 31, 1997, through December 31, 2001, after discovering "certain discrepancies" in its intercompany accounts. In its annual report for fiscal year 2002 filed on March 20, 2003, Cambrex stated that "certain administrative and other charges were not properly expensed in [] prior periods" and, as a result, Cambrex had overstated pre-tax income by \$6.1 million, or \$5.1 million after taxes, for the fiscal years 1997 through 2001. Net income was overstated by \$1.3 million, \$2.9 million, \$0.2 million and \$0.8 million in 2001, 2000, 1999, and 1998, respectively, and understated by \$0.1 million in 1997.

31. As a result of its 2003 restatement, Cambrex's pre-tax earnings and net income were affected as follows:

	Increase (Decrease) in Reported Amounts <u>(\$Millions except EPS)</u>		
<u>Year</u>	<u>Pre-tax Earnings</u>	<u>Net Income</u>	<u>EPS</u>
1997-1999	(\$0.9)	(\$.9)	(\$.03)
2000	(\$3.5)	(\$2.9)	(\$.11)
2001	(\$1.7)	(\$1.3)	(\$.05)

The change in pre-tax earnings as a result of the restatement represented a downward revision of .60%, 5.29% and 4.79% for the years 1997-1999, 2000, and 2001, respectively. Pre-tax earnings for these years, following the restatement, were \$152.2, \$66.4, and \$34.7 (millions) for 1997-1999, 2000, and 2001, respectively. Similarly, the restatement reflected a decrease in net income of .95%, 6.20% and 4.95% for 1997-1999, 2000, and 2001, respectively, corresponding to restated net income for those periods, of \$94.2, \$46.8, and \$25.5 (millions), respectively.

32. Cambrex's \$6.1 million overstatement consisted of approximately \$3.5 million that Cambrex identified as having been erroneously booked as a reduction of operating expenses, which resulted in an increase in the income reported on Cambrex's income statement, and another \$2.6 million that it was unable to determine whether to treat as having impacted its income or balance statement. To be conservative, Cambrex treated the \$2.6 million as impacting income.

G. Legal Standards

33. Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and asset dispositions, and Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in accordance with generally accepted accounting principles.

34. Section 21C of the Exchange Act provides that the Commission may order any person who is or was a cause of a violation of any provision of the Exchange Act, due to an act or omission the person knew or should have known would contribute to the violation, to cease and desist from committing or causing such violation.

H. Conclusions

35. Cambrex failed, over at least a five-year period, to correct long standing deficiencies in the handling of its intercompany accounts, and failed to reconcile its intercompany accounts on a monthly or periodic basis. As a result, Cambrex's books, records and accounts did not, in reasonable detail, accurately and fairly reflect its intercompany accounts or income statement.

36. By its failure to implement a system of internal controls sufficient to prevent the intercompany and group loan accounts from becoming imbalanced, and its failure, on several occasions, to rectify the intercompany and group loan imbalance problem after becoming aware of it, Cambrex failed to implement internal accounting controls relating to its intercompany and group loan accounts which were sufficient to provide reasonable assurances that these accounts were accurately stated in accordance with generally accepted accounting principles.

37. As a result of the conduct described above, Cambrex violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

38. Cambrex, as a result of the conduct described above, also violated Section 13(b)(2)(B) which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles.

Cambrex's Remedial Efforts

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

Undertakings

Cambrex has undertaken to:

40. Reconcile account balances between and among Cambrex and any of its related entities (hereinafter, the "intercompany accounts") on a monthly, quarterly and annual basis;

41. Institute formal, written policies and procedures for reconciling the intercompany accounts on a monthly, quarterly and annual basis, including, but not limited to, the implementation of internal controls adopted to ensure that such reconciliation takes place;

42. For at least two (2) years from the date of the Order, Cambrex shall designate an experienced accountant within its Finance Department to function as the Intercompany and Group Loan Review Accountant. This individual will be responsible for ensuring compliance with paragraphs 40-41 above;

43. For at least two (2) years from the date of the Order, the Cambrex Controller (or individual with equivalent authority) will certify, at the end of each quarterly reporting period, that: (i) he or she has supervised the Intercompany and Group Loan Accountant; and (ii) Cambrex has complied with paragraphs 40-42 above;

44. For at least two (2) years from the date of the Order, Cambrex will employ its outside auditor to conduct an annual review of its intercompany accounts, the reconciliation of these accounts and the compliance with the undertakings in this settlement. The company shall cooperate fully with its outside auditor and shall provide the auditor with access to its files, books, records, and personnel as reasonably requested for the review. The results of the review will be presented, both in writing and orally, to both the Chief Financial Officer and the Chief Executive Officer no more than 30 days after the conclusion of the annual audit and in writing to the Commission's staff no more than 30 days after the conclusion of the annual audit;

45. Maintain and preserve the certifications, pursuant to paragraph 43, for a period of ten (10) years from the date of the Order;

46. Provide a written report, within one hundred twenty (120) calendar days of the date of the Order to the Commission's staff that details Cambrex's implementation of the undertakings articulated in paragraphs 40-45; and

47. Cambrex shall send all reports, notices and other written communications with the Commission's staff in connection with this Order to David Rosenfeld, Associate Regional Director, United States Securities and Exchange Commission, 3 World Financial Center, Room 4300, New York, New York 10281.

IV.

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

Accordingly, it is hereby ORDERED that:

- A. Respondent Cambrex cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act.
- B. Respondent shall comply with the undertakings in Section III above.

By the Commission.

Nancy M. Morris
Secretary


By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 239

[RELEASE NO. 33-8812; FILE NO. S7-10-07]

RIN 3235-AJ89

**REVISIONS TO THE ELIGIBILITY REQUIREMENTS FOR PRIMARY
SECURITIES OFFERINGS ON FORMS S-3 AND F-3**

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing to amend the eligibility requirements of Form S-3 and Form F-3 to allow domestic and foreign private issuers to conduct primary securities offerings on these forms without regard to the size of their public float or the rating of debt they are offering, so long as they satisfy the other eligibility conditions of the respective form and do not sell more than the equivalent of 20% of their public float in primary offerings pursuant to the new instructions on these forms over any period of 12 calendar months. The amendments are intended to allow more companies to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Form S-3 and Form F-3 without compromising investor protection. The proposal would not extend to shell companies, however, which would be prohibited from using Form S-3 and Form F-3 for primary offerings until 12 calendar months after they cease being shell companies.

DATES: Comments should be received on or before [insert date 60 days after date of publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-10-07 on the subject line; or
- Use the Federal Rulemaking 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 S7-10-07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, 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: Daniel Greenspan, at (202) 551-3430, in the Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3010.

SUPPLEMENTARY INFORMATION: We are proposing to amend Form S-3¹ and Form F-3² under the Securities Act of 1933.³

¹ 17 CFR 239.13.

² 17 CFR 239.33.

³ 15 U.S.C. 77a et seq.

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I. Discussion

A. Background

1. Form S-3

Form S-3 is the “short form” used by eligible domestic companies to register securities offerings under the Securities Act of 1933. The form also allows these companies to rely on their reports filed under the Securities Exchange Act of 1934⁴ to satisfy the form’s disclosure requirements. Although there have been amendments to Form S-3 since it was first adopted in 1982,⁵ the basic framework still remains. To use Form S-3, a company must meet the form’s registrant requirements,⁶ which generally pertain to reporting history under the Exchange Act,⁷ as well as at least one of the form’s transaction requirements.⁸ These transaction requirements provide that companies may register primary offerings (that is, securities offered by or on behalf of the registrant for its own account) on Form S-3 only if their non-affiliate equity market capitalization, or “public float,” is a certain size.⁹ Transactions involving primary offerings of non-convertible investment grade securities; certain rights offerings, dividend reinvestment plans and conversions; and offerings by selling shareholders of securities registered on a

⁴ 15 U.S.C. 78a et seq.

⁵ Most notably, the Commission adopted a set of comprehensive amendments in 2005 known as “Securities Offering Reform.” See Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005) (70 FR 44722). See also Simplification of Registration Procedures for Primary Securities Offerings, Release No. 33-6964 (Oct. 22, 1992) [57 FR 48970], which is discussed further at n. 12.

⁶ See General Instruction I.A. of Form S-3.

⁷ For example, the form is available only to issuers that have complied with the reporting requirements of the Exchange Act for at least one year. However, issuers of investment grade asset-backed securities do not need to have a reporting history. See General Instruction I.A.4. of Form S-3.

⁸ See General Instruction I.B. of Form S-3.

⁹ General Instruction I.B.1. of Form S-3.

national securities exchange do not require that the company has a minimum public float.¹⁰

2. 1992 Amendments to Form S-3

As originally adopted, the “public float” requirement for companies eligible to use Form S-3 to register primary offerings was \$150 million.¹¹ In 1992, the Commission reduced the minimum float threshold to the current \$75 million, based on its analysis of the trading markets and market following of registrants in various capitalization ranges.¹² When it reduced the required public float to \$75 million, the Commission stated that a large majority of the companies that would become eligible to use Form S-3 for primary offerings as a result of the reduction in required float had securities traded on either a national securities exchange or authorized for inclusion on the NASDAQ National Market System¹³ and that approximately two-thirds of the companies were followed by at least three research analysts.¹⁴ This, combined with the success of the 10-year-old integrated disclosure system and shelf registration process, persuaded the Commission

¹⁰ See General Instructions I.B.2. through I.B.4. of Form S-3.

¹¹ Adoption of Integrated Disclosure System, Release No. 33-6383 (Mar. 3, 1982) [47 FR 11380].

¹² Release No. 33-6964. In that release, the Commission estimated that, as a result of the reduction in required float, 450 additional companies with an aggregate float of \$88 billion would be eligible to register primary offerings of their securities on Form S-3. This is compared to the Commission’s estimate, in Release No. 33-6943, of 370 companies that registered approximately \$200 billion of securities on Form S-3 for delayed primary shelf offerings during calendar year 1991.

As part of this rulemaking, the Commission also reduced the reporting history necessary to register on Form S-3 from 36 to 12 months for most issuers and eliminated the alternative eligibility test for primary offerings requiring registrants to have a public float of at least \$100 million and an annual trading volume of at least 3 million shares.

¹³ There is no longer a distinction between Nasdaq and national securities exchanges. On January 13, 2006, the Commission approved Nasdaq’s application for conversion from a national securities association to a national securities exchange. The NASDAQ Stock Market commenced operations on August 1, 2006.

¹⁴ Simplification of Registration Procedures for Primary Securities Offerings, Release No. 33-6943 (July 16, 1992) [57 FR 32461], at p. 6. In this discussion, the Commission stated that “one indicia of market interest and following of a company is the number of research analysts covering the company.”

that it could extend the benefits of Form S-3 for primary offerings to a larger class of issuers without compromising the investing public's access to sufficient and timely information about such issuers.¹⁵

3. Advisory Committee on Smaller Public Companies

Recently, the issue of Form S-3 eligibility for primary offerings was addressed by the Commission's Advisory Committee on Smaller Public Companies (the "Advisory Committee"), an advisory committee chartered by the Commission in 2005 to assess the current regulatory system for smaller companies under U.S. securities laws.¹⁶ In its April 23, 2006 Final Report to the Commission, the Advisory Committee recommended that we allow all reporting companies listed on a national securities exchange, NASDAQ or trading on the Over-the-Counter Bulletin Board electronic quotation service to be eligible to use Form S-3 if they have been reporting under the Exchange Act for at least one year and are current in their reporting at the time of filing.¹⁷ The Advisory Committee noted that many smaller public companies currently are not eligible to use Form S-3 to register primary offerings because they do not meet the minimum public float requirement and are, therefore, not able to take advantage of the efficiencies associated with the use of the form. As a consequence, the Advisory Committee argued that this restriction placed limits on the ability of such companies to raise capital. The Advisory Committee also expressed its view that the reporting obligations of smaller public companies, combined

¹⁵ Id.

¹⁶ More information about the Advisory Committee is available at <http://www.sec.gov/info/smallbus/acspc.shtml>.

¹⁷ Recommendation IV.P.3. of the Final Report of the Advisory Committee on Smaller Public Companies (Apr. 23, 2006) (the "Final Report"), at 68-72. The Final Report is available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. In addition to elimination of the public float requirement, Recommendation IV.P.3. also called for (1) elimination of General Instruction I.A.3.(b) to Form S-3 requiring that the issuer has timely filed all required reports in the last year and

with the widespread accessibility over the Internet of documents filed with the Commission, have lessened the need to retain the public float standard in Form S-3. In the Advisory Committee's view, the Exchange Act reporting obligations of smaller public companies are comparable today to even the largest reporting companies and, therefore, compliance with these disclosure requirements "should be sufficient to protect investors and inform the marketplace about developments in these companies."¹⁸

4. Reasons for Proposal

The ability to conduct primary offerings on Form S-3 confers significant advantages on eligible companies. Form S-3 permits the incorporation of required information by reference to a company's disclosure in its Exchange Act filings, including Exchange Act reports that were previously filed as well as those that will be filed in the future.¹⁹ The ability of Form S-3 registrants to incorporate their subsequently filed Exchange Act reports, often called "forward incorporation," allows for automatic updating of the registration statement. By contrast, a registrant without the ability to forward incorporate²⁰ must file a new registration statement or post-effective amendment to its registration statement to prevent information in the registration statement from

(2) extending Form S-3 eligibility for secondary transactions to issuers quoted on the Over-the-Counter Bulletin Board.

¹⁸ The Final Report, at 69. The Advisory Committee also noted:

The Sarbanes-Oxley Act has required more frequent SEC review of periodic reports as well as enhanced processes, such as disclosure controls and procedures and certifications by the chief executive and chief financial officers, which further enhance investor protection.

Id. at 70.

¹⁹ See Item 12 of Form S-3: "Incorporation of Certain Information by Reference."

²⁰ For example, Forms S-1 and SB-2 do not allow registrants to forward incorporate their Exchange Act filings.

becoming outdated and to update for fundamental changes to the information set forth in the registration statement.²¹

Form S-3 eligibility for primary offerings also enables companies to conduct primary offerings “off the shelf” under Rule 415 of the Securities Act.²² Rule 415 provides considerable flexibility in accessing the public securities markets from time to time in response to changes in the market and other factors. Companies that are eligible to register these primary “shelf” offerings under Rule 415 are permitted to register securities offerings prior to planning any specific offering and, once the registration statement is effective, offer securities in one or more tranches without waiting for further Commission action. In general, post-effective amendments and new registration statements may be subject to selective review by the Commission staff and must be declared effective by the Commission or our staff through delegated authority before the registration statement may be used again to offer and sell securities.²³ The shelf eligibility resulting from Form S-3 eligibility and the ability to forward incorporate on

²¹ See Section 10(a)(3) of the Securities Act (requiring that the information contained in a prospectus used more than nine months after the effective date be as of a date not more than sixteen months prior to the effective date) and Item 512(a)(1)(i) and (ii) of Regulation S-K (requiring the inclusion by the company of an undertaking to file a post-effective amendment to comply with Section 10(a)(3) of the Securities Act and to reflect the occurrence of facts or events arising after the effective date that, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement).

²² Rule 415 [17 CFR 230.415] provides that:

(a) Securities may be registered for an offering to be made on a continuous or delayed basis in the future, Provided, That:

(1) the registration statement pertains only to:

...

(x) Securities registered (or qualified to be registered) on Form S-3 or Form F-3 which are to be offered and sold on an immediate, continuous or delayed basis by or on behalf of the registrant, a majority owned subsidiary of the registrant or a person of which the registrant is a majority-owned subsidiary.

²³ See Section 8(c) of the Securities Act.

Form S-3, therefore, allow companies to avoid additional delays and interruptions in the offering process and can reduce or even eliminate the costs associated with preparing and filing post-effective amendments to the registration statement.

By having more control over the timing of their offerings, these companies can take advantage of desirable market conditions, thus allowing them to raise capital on more favorable terms (such as pricing) or to obtain lower interest rates on debt. As a result, the ability to take securities off the shelf as needed gives issuers a significant financing alternative to other widely available methods, such as private placements with shares usually priced at discounted values based in part on their relative illiquidity.²⁴

Registration of an offering on Form S-1, the form available to many companies ineligible to use Form S-3, permits certain issuers²⁵ to incorporate by reference previously filed Exchange Act reports, but it does not permit registrants to automatically update information in the prospectus by forward incorporation of their Exchange Act filings. Further, issuers filing registration statements on Form S-1 because they are not eligible to file on Form S-3 are not permitted to register primary shelf offerings under Rule 415. Thus, it is harder for Form S-1 registrants to take advantage of favorable market opportunities. Consequently, we believe that extending Form S-3 short-form registration to additional issuers should enhance their ability to access the public securities markets.

²⁴ See, for example, Susan Chaplinsky and David Haushalter, Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity (May 2006), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=907676 (discussing the typical contractual terms of PIPEs (Private Investments in Public Equities) financings, where the average purchase discount is between 18.5% to 19.7%, depending on the types of contractual rights embedded in the securities).

²⁵ See General Instruction VII. to Form S-1, "Eligibility to Use Incorporation by Reference," for the criteria that registrants on Form S-1 must meet in order to incorporate information by reference.

Given the great advances in the electronic dissemination and accessibility of company disclosure transmitted over the Internet over the last several years,²⁶ we believe that expanding the class of companies that are permitted to use Form S-3 for primary securities offerings is once again warranted. In contrast to 1992, when the Commission last adjusted the issuer eligibility requirements for Form S-3,²⁷ all filings on Form S-3 now are filed on the Commission's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") and, therefore, are available at little or no cost to anyone interested in obtaining the information. While we believe that retaining some restrictions on Form S-3 eligibility is still advisable, we nevertheless agree with the Advisory Committee that more companies should benefit from the greater flexibility and efficiency in accessing the capital markets afforded by Form S-3. Accordingly, we are proposing to amend the Form S-3 eligibility requirements to permit registrants other than shell companies to use Form S-3 for primary offerings, whether or not they satisfy the minimum \$75 million float threshold, so long as they stay within certain offering size limitations and otherwise satisfy the eligibility requirements of the form, such as timely Exchange Act reporting for at least the prior year.

²⁶ See, for example, Internet Availability of Proxy Materials, Release No. 34-52926 (Dec. 8, 2005) [70 FR 74597] and the Final Report of the Advisory Committee, at 69:

The Commission has recently taken several steps acknowledging the widespread accessibility over the Internet of documents filed with the Commission. In its recent release concerning Internet delivery of proxy materials, the Commission notes that recent data indicates that up to 75% of Americans have access to the Internet in their homes, and that this percentage is increasing steadily among all age groups. As a result we believe that investor protection would not be materially diminished if all reporting companies on a national securities exchange, NASDAQ or the Over-the-Counter Bulletin Board were permitted to utilize Form S-3 and the associated benefits of incorporation by reference.

²⁷ See Release No. 33-6964.

B. Proposed Revisions to Form S-3

Specifically, we are proposing new General Instruction I.B.6. to Form S-3 to allow companies with less than \$75 million in public float to register primary offerings of their securities on Form S-3,²⁸ provided:

- they meet the other registrant eligibility conditions for the use of Form S-3;²⁹
- they are not shell companies³⁰ and have not been shell companies for at least 12 calendar months before filing the registration statement; and
- they do not sell more than the equivalent of 20% of their public float in primary offerings under General Instruction I.B.6. of Form S-3 over any period of 12 calendar months.³¹

²⁸ As mentioned in n. 17 above, as part of Recommendation IV.P.3 of the Final Report, the Advisory Committee also recommended that the Commission extend S-3 eligibility for secondary transactions to issuers quoted on the Over-the-Counter Bulletin Board. General Instruction I.B.3. to Form S-3 limits the use of the form for secondary offerings to securities “listed and registered on a national securities exchange or . . . quoted on the automated quotation system of a national securities association,” a restriction that excludes the securities of Over-the-Counter Bulletin Board and Pink Sheet issuers. Notwithstanding the Advisory Committee’s recommendation, we are not at this time proposing to amend the Form S-3 eligibility rules for secondary offerings because of the potential for abusive primary offerings disguised as secondary offerings. As such, this rulemaking proposal pertains only to Form S-3 eligibility for primary securities offerings and is not intended to encompass or otherwise impact existing requirements for secondary offerings on Form S-3. In this regard, we also are not revising the interpretive positions on secondary offering eligibility under General Instruction I.B.3.

²⁹ See General Instruction I.A. of Form S-3. Among other things, General Instruction I.A. requires that the registrant:

- has a class of securities registered pursuant to Section 12(b) or 12(g) of the Exchange Act or is required to file reports pursuant to Section 15(d) of the Exchange Act; and
- has been subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed in a timely manner all the material required to be filed pursuant to Section 13, 14 or 15(d) for a period of at least twelve calendar months immediately preceding the filing of the Form S-3 registration statement.

³⁰ The term “shell company” is defined in Rule 405 of the Securities Act [17 CFR 230.405]. See also Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Release No. 33-8587 (July 15, 2005) [70 FR 42233] (adopting definition of shell company).

³¹ The meaning of the phrase “period of 12 calendar months” is intended to be consistent with the way in which the phrase “12 calendar months” is used for purposes of the registrant eligibility requirements in Form S-3. A “calendar month” is a month beginning on the first day of the month and ending on the last day of that month. For example, for purposes of Form S-3 registrant eligibility, if a registrant were not timely on a Form 10-Q due on September 15, 2006, but was timely thereafter, it would first be eligible to use Form S-3 on October 1, 2007. Similarly, for purposes of proposed General Instruction I.B.6. of Form S-3, if a registrant relies on this Instruction to conduct a shelf takedown equivalent to 20% of its public float on September 15, 2007, it will next be eligible to do another takedown (assuming no change in its float) on October 1, 2008.

As a result, even companies not traded on a national securities exchange could potentially avail themselves of this new eligibility rule so long as they were able to satisfy the registrant eligibility requirements provided in General Instruction I.A.³² This would include companies quoted on the Over-the-Counter-Bulletin Board and Pink Sheets quotation services. We note that the Over-the-Counter-Bulletin Board requires quoted issuers to be registered under Section 12 of the Exchange Act³³ and filing Exchange Act reports or otherwise filing periodic reports with the appropriate regulatory agency. Moreover, we have built into our proposed rule the condition that an eligible company must be required to file Exchange Act reports and has timely filed all such reports for the 12 calendar months and any portion of a month preceding the filing of the registration statement.

To ascertain the amount of securities that may be sold pursuant to Form S-3 by registrants with a public float below \$75 million, the proposal contemplates a two-step process:

- determination of the registrant's public float immediately prior to the intended sale; and
- aggregation of all sales of the registrant's securities pursuant to primary offerings under General Instruction I.B.6. of Form S-3 in the previous 12-month period (including the intended sale) to determine whether the 20% limitation would be exceeded.

³² Form S-3 eligibility under proposed General Instruction I.B.6 and Form F-3 eligibility under proposed General Instruction I.B.5. is not intended to have broader implications under our rules beyond an issuer's ability to conduct a primary offering on Form S-3 or Form F-3, as applicable. That is, an issuer's eligibility to use Form S-3 or Form F-3 under those proposed additional form instructions does not mean that the issuer meets the requirements of Form S-3 or Form F-3 for purposes of any other rule or regulation of the Commission (apart from Rule 415(a)(1)(x), which pertains to shelf registration). See Instruction 6 to proposed General Instruction I.B.6. of Form S-3 and Instruction 6 to proposed General Instruction I.B.5. of Form F-3.

³³ 15 U.S.C. 78j.

The proposal would require registrants to compute their public float by reference to the price at which their common equity was last sold, or the average of the bid and asked prices of their common equity, in the principal market for the common equity as of a date within 60 days prior to the date of sale.³⁴ Then, for purposes of calculating the aggregate market value of securities sold during the preceding period of 12 calendar months, the proposal would require that registrants add together the gross sales price for all primary offerings pursuant to proposed Instruction I.B.6. to Form S-3 during the preceding period of 12 calendar months. Based on that calculation, registrants would be permitted to sell securities with a value up to, but not greater than, the difference between 20% of their public float and the value of securities sold in primary offerings on Form S-3 under proposed Instruction I.B.6. in the prior period of 12 calendar months.³⁵ We have placed the cap of 20% in order to allow an offering that is large enough to help an issuer meet its financing needs when market opportunities arise but small enough to take into account the effect such new issuance may have on the market for a thinly traded security.

³⁴ The determination of public float is based on a public trading market for the registrant's common equity. This is the same requirement in General Instruction I.B.1. of Form S-3 and Form F-3 that a registrant have a \$75 million market value and in the definition of accelerated filer in Exchange Act Rule 12b-2 [17 CFR 240.12b2]. Therefore, an entity with common equity securities outstanding but not trading in any public trading market would not be entitled to sell securities in a primary offering on Form S-3 under this proposal. Note that the determination of public float for purposes of form eligibility in current General Instruction I.B.1 of Form S-3 is based on the price of the registrant's common equity within 60 days prior to the date of filing the registration statement. The determination of "aggregate market value" for purposes of determining an issuer's status as an accelerated filer under Rule 12b-2 is based on the market price of the issuer's equity as of the last business day of the issuer's most recently completed second fiscal quarter.

³⁵ As proposed, the method of calculating the 20% limit on sales is the same whether the registrant is selling equity or debt securities, or a combination of both. If the proposed 20% limitation excluded debt, there is some concern that we would be inadvertently encouraging issuances of debt securities over equity. Because we do not intend for the rule to dictate or otherwise influence the overall form of security that companies offer, we have drafted the 20% limit on sales to include both equity and debt.

This aggregate gross sales price includes the sales of equity as well as debt offerings. Therefore, these registrants would now be eligible to offer non-investment grade debt on Form S-3.³⁶ In the case of securities that are convertible into or exercisable for equity shares, such as convertible debt or warrants, however, we are proposing that registrants calculate the amount of securities they may sell in any period of 12 calendar months by reference to the aggregate market value of the underlying equity shares in lieu of the market value of the convertible securities. The aggregate market value of the underlying equity would be based on the maximum number of shares into which the securities sold in the prior period of 12 calendar months are convertible as of a date within 60 days prior to the date of sale, multiplied by the same per share market price of the registrant's equity used for purposes of calculating its public float pursuant to Instruction 1 to proposed General Instruction I.B.6. of Form S-3. We believe calculating the 20% cap based on the market value of the underlying securities makes it less likely that convertible securities would be structured and offered in a manner designed to avoid the effectiveness of the cap.

It is important to note that the proposed 20% limit on sales is not intended to impact a holder's ability to convert or exercise derivative securities purchased from the company. For example, the 20% limit would apply to the amount of common stock warrants that a company could sell under Form S-3, and the number of common shares into which the warrants are exercisable would be relevant for determining the company's compliance with the 20% rule at the time the warrants were sold, but would not impede the purchaser's later exercise of the warrants.

³⁶ Currently, registrants may offer non-convertible investment grade debt securities on Form S-3 regardless of the size of their public float. See General Instruction I.B.2. to Form S-3.

Consistent with our desire to ensure that the expansion of Form S-3 eligibility does not diminish the protection of investors, the proposal specifically excludes shell companies, which will be prohibited from registering securities in primary offerings on Form S-3 unless they meet the minimum \$75 million float threshold of General Instruction I.B.1.³⁷ While we are not passing on the relative merits of shell companies and we recognize that these entities are used for many legitimate business purposes, we have repeatedly stated our belief that these entities may give rise to disclosure abuses.³⁸ Under the proposal, a former shell company that cannot meet the \$75 million float criterion but otherwise satisfies the registrant requirements of Form S-3 will become eligible to use Form S-3 to register primary offerings of its securities:

- 12 calendar months after it ceases being a shell company;
- has filed information that would be required in a registration statement on Form 10, Form 10-SB or Form 20-F, as applicable, to register a class of securities under Section 12 of the Exchange Act; and
- has been timely reporting for 12 calendar months.³⁹

³⁷ This prohibition is intended to apply equally to “blank check companies,” as such entities are defined in Rule 419 of the Securities Act. However, because we believe that the definition of “shell company” under Rule 405 is expansive enough to encompass blank check companies for purposes of excluding them from S-3 eligibility under proposed General Instruction I.B.6., we do not exclude them separately. See Use of Form S-8 and Form 8-K by Shell Companies, Release No. 33-8407 (Apr. 15, 2004) [69 FR 21650], at n. 20:

We believe that under today’s proposals all blank check companies as defined in Rule 419 would be considered shell companies until they acquire an operating business or more than nominal assets. Not all shell companies, however, would be classified as blank check companies under Rule 419.

³⁸ See, for example, Release No. 33-8591; Release No. 33-8587; Delayed Pricing for Certain Registrants, Release No. 33-7393 (Feb. 20, 1997) [62 FR 9276]; and Penny Stock Definition for Purposes of Blank Check Rule, Release No. 33-7024 (Oct. 25, 1993) [58 FR 58099].

³⁹ Similarly, Form S-8 is not available to shell companies or to former shell companies until 60 days after they have ceased being shell companies and have filed information that would be required in a registration statement on Form 10, Form 10-SB or Form 20-F, as applicable, to register a class of securities under Section 12 of the Exchange Act. See Release No. 33-8587. Unlike the eligibility rules of Form S-8, however, a company must be reporting for at least 12 calendar months before it is eligible under any criteria to use Form S-3. Therefore, instead of the 60-day delay required by Form S-8, it is more appropriate for a shell company to be prohibited from using the proposed new provisions of S-3 and F-3 until at least 12 calendar months after it ceases being a shell company.

Ordinarily, this information would be filed in a current report on Form 8-K reporting completion of the transaction that causes it to cease being a shell company.⁴⁰ In other cases, the information may be filed in a Form 10, Form 10-SB or Form 20-F. Consistent with the current registrant eligibility rules of Form S-3 and Form F-3 that require at least 12 calendar months of timely reporting, the proposed 12 calendar-month delay is intended to provide investors in the former shell company with the benefit of 12 full months of disclosure in the newly structured entity prior to its use of Form S-3 or Form F-3 for primary securities offerings.

As proposed, the 20% limitation is designed to allow issuers flexibility. Because the restriction on the amount of securities that can be sold over a period of 12 calendar months is calculated by reference to a registrant's public float immediately prior to a contemplated sale, as opposed to the time of the initial filing of the registration statement, the amount of securities that an issuer is permitted to sell can continue to grow over time as the issuer's public float increases. Therefore, the value of 20% of a registrant's float during the period that a shelf registration statement is effective may, at any given time, be much greater than at the time the registration statement was initially filed. Registrants may therefore benefit from increases in the size of their public float during the time the registration statement is effective. Conversely, the amount of securities that an issuer is permitted to sell at any given time may also decrease if the issuer's public float contracts. It is important to note, however, that a contraction in a registrant's float, such that the value of 20% of the float decreases from the time the registration statement was initially

⁴⁰ Items 2.01(f) and 5.01(a)(8) of Form 8-K require a company in a transaction where the company ceases being a shell company to file a current report on Form 8-K containing the information (or identifying the previous filing in which the information is included) that would be required in a registration statement on Form 10 or Form 10-SB to register a class of securities under Section 12 of the Exchange Act.

filed, would not necessarily run afoul of the 20% limitation because the relevant point in time for determining whether a registrant has exceeded the threshold would be the time of sale. If the sale of securities, together with all securities sold in the preceding period of 12 calendar months, does not exceed 20% of the registrant's float calculated within 60 days of the sale, then the transaction would not violate proposed Instruction I.B.6. to Form S-3 even if the registrant's public float later drops to a level such that the prior sale now accounts for over 20% of the new lower float.⁴¹

Because Form S-3 registrants who meet the \$75 million float threshold of General Instruction I.B.1. at the time their registration statement is filed are not subject to restrictions on the amount of securities they may sell under the registration statement even if their float falls below \$75 million subsequent to the effective date of the Form S-3, we believe it is appropriate to provide issuers registering on Form S-3 pursuant to proposed General Instruction I.B.6. the same flexibility if their float increases to a level that equals or exceeds \$75 million subsequent to the effective date of their Form S-3 without the additional burden of filing a new Form S-3 registration statement. Therefore, we are proposing an instruction to I.B.6. that lifts the 20% restriction on additional sales in the event that the registrant's float increases to \$75 million or more subsequent to the effective date. Of course, pursuant to Rule 401, registrants would also be required to recompute their public float each time an amendment to the Form S-3 is filed for the purpose of updating the registration statement in accordance with Section 10(a)(3) of the

⁴¹ Along these lines, under the proposal registrants would be able to sell up to the equivalent of the full 20% of their public float immediately following the effective date of their registration statement, provided that there were no prior sales pursuant to proposed General Instruction I.B.6. of Form S-3. This is consistent with Rule 415(a)(1)(x), which was amended in 2005 to allow primary offerings on Form S-3 or Form F-3 to occur immediately after effectiveness of a shelf in registration statement. See Release No. 33-8591. Assuming that the sale of the entire 20% allotted under the proposal complied

Securities Act—typically when an annual report on Form 10-K is filed. In the event that the registrant’s public float as of the date of the filing of the annual report is less than \$75 million, the 20% restriction would be reimposed for all subsequent sales made pursuant to General Instruction I.B.6. and would remain in place until the registrant’s float equaled or exceeded \$75 million.

The following examples illustrate how the proposed Instruction would operate.⁴² For purposes of these examples, we are assuming that the hypothetical registrants satisfy the registrant eligibility requirements in General Instruction I.A. of Form S-3 and are not shell companies.

Example A

On January 1, 2008, a registrant with a public float of \$50 million files a shelf registration statement on Form S-3 pursuant to proposed General Instruction I.B.6. intending to register the registrant’s offer and sale of up to \$20 million of debt and equity securities over the next three years from time to time as market opportunities arise.⁴³ The registration statement is subsequently declared effective. In March 2008, the registrant decides to sell common stock off the registration statement. To determine the amount of securities that it may sell in connection with the intended takedown, the registrant calculates its public float as of a date within 60 days prior to the anticipated date of sale, pursuant to Instruction 1 to proposed General Instruction I.B.6. Calculating that its public float is now \$55 million, the registrant determines that the total market value of all

with the rule at the time of the takedown, the subsequent contraction in the registrant’s public float would not invalidate this prior sale.

⁴² The examples that follow are for illustrative purposes only and are not intended to be indicative of market activity.

⁴³ Although only 20% of the public float may be sold in any year, a company may register a larger amount.

sales effected pursuant to Instruction I.B.6. over the past year, including the intended sale, may not exceed \$11 million, or 20% of the registrant's float. Since the registrant has not previously filed on Form S-3 and has made no prior sales off the subject Form S-3, it is able to sell the entire \$11 million off the subject Form S-3.

Assuming that it sold the entire \$11 million of securities in March 2008, the registrant in September 2008 once again contemplates a takedown off the shelf. It determines that its public float (as calculated pursuant to Instruction 1 to proposed General Instruction I.B.6.) has risen to \$60 million. Because 20% of \$60 million is \$12 million, the registrant is now able to sell additional securities in accordance with proposed General Instruction I.B.6(a), even though in March 2008 it took down the equivalent of what was then the entire 20% of its float. However, because the registrant has already sold \$11 million worth of its securities within the 12 calendar months prior to the contemplated sale, the registrant may sell no more than \$1 million of additional securities at this time.

In December 2008, the registrant determines that its public float has risen to \$85 million. To this point, assuming it has only sold an aggregate of \$12 million of its securities pursuant to the subject Form S-3 as described above, it has \$8 million of securities remaining on the registration statement and potentially available for takedown (the total amount registered of \$20 million, less the \$12 million previously sold). Because 20% of \$85 million is \$17 million, and the registrant has already sold \$12 million within the previous year, Instruction I.B.6.(a) would, in most circumstances, prohibit the registrant from selling more than an additional \$5 million of securities in the latest offering. However, under Instruction 3 to proposed General Instruction I.B.6., the registrant is no longer subject to the 20% limitation on annual sales because its float has

exceeded \$75 million. If it chooses, the registrant may sell the entire remaining \$8 million of securities all at once or in separate tranches at any time until the company updates the registration statement pursuant to Section 10(a)(3) by filing a Form 10-K. This will be the case even if the registrant's float subsequently falls below \$75 million until it files that Form 10-K.

Example B

A registrant has 12 million shares of voting common equity outstanding held by nonaffiliates. The market price of this stock is \$5, so the registrant has a public float of \$60 million. The registrant has an effective Form S-3 shelf registration statement filed in reliance on proposed General Instruction I.B.6. of Form S-3 pursuant to which the registrant wants to issue \$10 million of convertible debt securities which will be convertible into common stock at a 10% discount to the market price of the common stock. Pursuant to Instruction 2 to proposed General Instruction I.B.6., the amount of securities issued is measured by reference to the value of the underlying common stock rather than the amount for which the debt securities will be sold. At the 10% discount, the conversion price is at \$4.50 and, as a result, 2,222,222 shares currently underlie the \$10 million of convertible debt. Because the current market price of those underlying shares is \$5, the value of the securities being offered for purposes of General Instruction I.B.6. is \$11,111,110 (2,222,222 shares at \$5 per share), which is less than the \$12 million allowed by the 20% cap (20% of \$60 million).

After the convertible debt securities are sold and are outstanding, the registrant contemplates an additional takedown. To determine the amount of securities that the registrant may sell under General Instruction I.B.6. in the anticipated offering, the registrant must know its current public float and must calculate the aggregate market

value of all securities sold in the last year on Form S-3 pursuant to General Instruction I.B.6. Instruction 2 to proposed General Instruction I.B.6. requires that the registrant compute the market value of convertible debt securities sold under I.B.6. by reference to the value of the underlying common stock rather than the amount for which the debt securities were sold. With respect to the notes that were sold and have been converted, the aggregate market value of the underlying common stock is calculated by multiplying the number of common shares into which the outstanding convertible securities were converted times the market price on the day of conversion. With respect to the notes that were sold but have not yet been converted, the aggregate market value of the underlying common stock is calculated by multiplying the maximum number of common shares into which the notes are convertible as of a date within 60 days⁴⁴ prior to the anticipated sale by the per share market price of the registrant's equity used for purposes of determining its current float.

In this example, assume that the registrant has a current per share stock price of \$5.55. If half of the notes converted into common stock while the per share market price was \$5.00 (\$4.50 discount), then, for purposes of Instruction 2 to proposed General Instruction I.B.6., the value of that prior issuance is \$5,555,555 (half of the notes divided by the discounted conversion price of \$4.50 and then multiplied by \$5, the market price on the day of conversion).

As for the notes that have not yet been converted, the aggregate market value of the underlying common stock is determined by calculating the number of shares that may

⁴⁴ Note that the date chosen by the registrant for determination of the maximum number of shares underlying the convertible notes must be the same date that the registrant chooses for determining its market price in connection with the calculation of public float pursuant to proposed General Instruction I.B.6. See Instruction 5 to proposed General Instruction I.B.6.

be received upon conversion and multiplying that by the current market value of \$5.55. Therefore, the outstanding note amount (\$5 million) is divided by the discount conversion price (\$5), resulting in 1,000,000 shares and this is then multiplied by the current market value of \$5.55. Thus, for purposes of Instruction 2 to proposed General Instruction I.B.6., \$5,550,000 is the value of the outstanding notes that have not yet been converted. Adding this to the value of the notes that have already been converted results in a total value of \$11,105,555 having been issued under this Form S-3.

To determine the amount of additional securities that the registrant may sell under General Instruction I.B.6, the registrant would add the value of the notes issued (\$11,105,555) plus the value of all other securities sold by the registrant pursuant to Instruction I.B.6. during the preceding year. If this amount is less than 20% of the registrant's current public float, it may sell additional securities with a value up to, but not greater than, the difference between 20% of its current public float and the value of all securities sold by it pursuant to Instruction I.B.6. during the preceding year.

Example C

A registrant has an effective registration statement on Form S-3 through which it intends to conduct shelf offerings of its securities. The Form S-3 was filed pursuant to proposed General Instruction I.B.6. At the time of its first shelf takedown, the registrant's public float is equal to \$20 million (which means that the maximum amount available to be sold under the 20% cap would be \$4 million). Based on proposed General Instruction I.B.6(a), the registrant sells \$3 million available of its debt securities. Six months later, the registrant's public float has decreased to \$10 million. The registrant wishes to conduct an additional takedown off the shelf but, because of the reduction in its float, it is prohibited from doing so. This is because with a public float of \$10 million,

General Instruction I.B.6(a) would only allow the registrant to sell a maximum of \$2 million worth of securities (20% of \$10 million) pursuant to the registration statement during the prior period of 12 calendar months that ends on the date of the contemplated sale. However, the registrant has already sold securities valued (for purposes of proposed General Instruction I.B.6.) at \$3 million in the 6 months prior to the contemplated sale and so must wait until at least full year has passed since the \$3 million sale of debt securities to undertake another offering off the Form S-3 unless its float increases. Note that although the registrant's float would not allow additional sales, the \$3 million takedown of securities 6 months prior does not violate the 20% restriction because, at the time of that prior sale, the registrant's float was \$20 million.

...

Because allowing smaller public companies to take advantage of shelf primary offerings on Form S-3 would permit such companies to avail themselves of periodic takedowns without further Commission action or prior staff review, some concerns have been raised.⁴⁵ Although the Commission staff may review registration statements before

⁴⁵ For example, see Report of the Task Force on Disclosure Simplification (Mar. 5, 1996) (the "Task Force"), available at <http://www.sec.gov/news/studies/smpl.htm>. Among other things, the Task Force made several recommendations to amend the shelf registration procedure "so as to provide increased flexibility to a wider array of companies with respect to their capital-raising activities." These recommendations included a "modified form of shelf registration" that would have allowed smaller companies to price their securities on a delayed basis for up to one year in order to time securities offerings more effectively with opportunities in the marketplace. The Task Force stated:

While this recommendation will afford small companies time and cost savings, the Task Force appreciates concerns raised about possible adverse effects shelf registration may have on the adequacy and accuracy of disclosures provided to investors, on Commission oversight of the disclosures and on the role of underwriters in the registration process. These concerns are similar to those raised when the shelf registration rule was first being considered on a temporary basis and was made available to any offering including an initial public offering.

See also, Delayed Pricing for Certain Registrants, Release No. 33-7393 (Feb. 20, 1997) [62 FR 9276]. Following on the Task Force's recommendations, the Commission proposed to permit certain smaller companies to price registered securities offerings on a delayed basis for up to one year after effectiveness. The Commission noted, however:

they are declared effective, individual takedowns are not subject to prior selective staff review. Under the current rules, if these issuers were instead using Form S-1 or Form SB-2, they would be required to file separate registration statements for each new offering, which would be subject to pre-offering selective staff review before going effective.

While we recognize that extending the benefits of shelf registration to an expanded group of companies will, by necessity, limit the staff's direct prior involvement in takedowns of securities off the shelf, we believe that the risks will be justified by the benefits that will accrue by facilitating the capital formation efforts of smaller public companies. As we have discussed elsewhere in this release, the risks to investor protection by expanding the base of companies eligible for primary offerings on Form S-3 have been significantly mitigated by technological advances affecting the manner in which companies communicate with investors, allowing widespread, direct, and contemporaneous accessibility to company disclosure at little or no cost. Moreover, the scope of disclosure obligations and liability of smaller public companies under the federal securities laws are sufficiently comparable for these purposes to the largest reporting companies such that the proposed expansion of Form S-3 primary offering eligibility should not adversely impact investors.⁴⁶

Concerns have been raised that the expedited access to the markets that would be provided by these proposals could make it difficult for gatekeepers, particularly underwriters, to perform adequate due diligence for the smaller companies that would be eligible to use expanded Rule 430A.

⁴⁶ We acknowledge that the companies implicated in this rulemaking are not yet subject to Section 404 of Sarbanes-Oxley. See Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Release No. 33-8760 (Dec. 15, 2006) [71 FR 76580]. We have taken steps to implement a plan to improve the efficiency and effectiveness of Section 404 implementation, including its scalability to smaller companies. See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Release No. 34-55929 (June 20, 2007).

Although we believe that the public securities markets have benefited from advances in both technology and corporate disclosure requirements, we are nevertheless mindful that companies with a smaller market capitalization as a group have a comparatively smaller market following than larger, well-seasoned issuers and are more thinly traded. Securities in thinly traded markets may be more vulnerable to potential manipulative practices. In this regard, to ensure that shelf eligibility is expanded with appropriate moderation and attention to the continued protection of investors, we have proposed to exclude shell companies from eligibility and to impose a 20% restriction on the amount of securities that can be sold into the market on Form S-3 in any period of 12 calendar months by issuers with a public float below \$75 million.⁴⁷ By placing such restrictions on the expansion of Form S-3 eligibility, we believe we are mitigating the potential for abuse that could result as a function of the increase in the volume of smaller public company securities sold in primary offerings on Form S-3. At the same time, we believe that the 20% limit will be sufficient to accommodate the capital raising needs of the large majority of smaller public companies.⁴⁸

We note that the Advisory Committee, in its May 2006 Final Report to the Commission, expressed support for a more expansive rule change, with no suggestion of a limitation on Form S-3 eligibility other than current required Exchange Act reporting and listed on a national securities exchange or the Over-the-Counter Bulletin Board.

⁴⁷ Under the proposal, offerings above the 20% limitation would violate the form requirements, and may have implications under Section 5.

⁴⁸ In connection with this rulemaking, the Division of Corporation Finance undertook a review of shelf registration takedowns in 2006 by companies with a public float of moderate size. Specifically, the Division looked at all prospectus supplements filed pursuant to shelf registration statements in calendar year 2006 by companies with a public float between \$75 million and \$140 million. While we observed a wide range of variously sized shelf takedowns (from less than 1% of float to greater than 80% of float), the data suggests that limiting smaller public companies to 20% of their public float in

However, we are not at this time proposing such a less restrictive eligibility requirement. We believe that by restricting the applicability of the revised eligibility rule to companies that are not shell companies and by imposing the 20% limitation on the amount of securities that smaller public companies may sell pursuant to primary offerings on Form S-3, as described, the proposal strikes the appropriate balance between helping to facilitate capital formation through the securities markets and our objective of investor protection. If the amendment is adopted as proposed, this would not foreclose the possibility that we may revisit the appropriateness of this 20% restriction at a later time. However, we believe that limiting the expanded use of S-3 as proposed will allow us to consider the impacts of the expansion in an environment where there are limitations so that investor protection concerns are addressed.

C. Proposed Revisions to Form F-3

Form F-3, which was designed to parallel Form S-3,⁴⁹ is the equivalent short-form registration form available for use by “foreign private issuers”⁵⁰ to register securities offerings under the Securities Act. Similar to Form S-3, Form F-3 is available to foreign

any 12-month period strikes the appropriate balance between the capital needs of these companies and investor protection concerns.

⁴⁹ See Integrated Disclosure System for Foreign Private Issuers, Release No. 33-6360 (Nov. 20, 1981) [46 FR 58511], at 7:

The three forms proposed under the Securities Act roughly parallel proposed Forms S-1, S-2 and S-3 in the domestic integration system, but the foreign system is based on the Form 20-F instead of the Form 10-K and annual report to shareholders as the uniform disclosure package.

⁵⁰ The term “foreign private issuer” is defined in Rule 405 of the Securities Act to mean any foreign issuer other than a foreign government except an issuer meeting the following conditions:

- (1) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and
- (2) Any of the following:
 - (i) The majority of the executive officers or directors are United States citizens or residents;
 - (ii) More than 50 percent of the assets of the issuer are located in the United States; or
 - (iii) The business of the issuer is administered principally in the United States.

private issuers that satisfy the form's registrant requirements and at least one of the form's transaction requirements.⁵¹ The Form F-3 registrant requirements are similar to Form S-3 and generally relate to a registrant's reporting history under the Exchange Act.⁵² In addition, like the Form S-3 registration statement, Form F-3 limits the ability of registrants to conduct primary offerings on the form unless their public float equals or exceeds a particular threshold.⁵³

As with Form S-3, the Commission has attempted to limit the availability of Form F-3 for primary offerings to a class of companies believed to provide a steady stream of corporate disclosure that is broadly digested and disseminated to the marketplace. When the Commission adopted Form F-3 in 1982,⁵⁴ it set the public float test for foreign issuers at \$300 million in response to public comment recommending that the numerical test for foreign issuers be much greater than for domestic registrants.⁵⁵ In 1994, however, the Commission reduced this threshold to \$75 million in order to extend to foreign issuers the

⁵¹ See General Instruction I. of Form F-3: "Eligibility Requirements for Use of Form F-3."

⁵² One difference is that, unlike Form S-3, General Instruction I.A.1. of Form F-3 requires that registrants have previously filed at least one annual report on Form 20-F, Form 10-K or, in certain cases, Form 40-F under the Exchange Act. For an explanation of this difference, see Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Release No. 33-7029 (Nov. 3, 1993) at 3; and Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Release No. 33-7053 (Apr. 19, 1994), at 2 (explaining that the requirement was adopted "in order to ensure that information regarding the issuer is available to the market").

⁵³ See General Instruction I.B.1. of Form F-3. Note that, unlike Form S-3, the Instruction makes reference to the registrant's "worldwide" public float.

⁵⁴ Adoption of Foreign Issuer Integrated Disclosure System, Release No. 33-6437 (Nov. 19, 1982) [47 FR 54764].

⁵⁵ See Release No. 33-7029, at 2.

benefits of short-form registration “to the same extent available to domestic companies.”⁵⁶ In explaining its rationale, the Commission stated:

[Our] experience with foreign issuers, as well as the internationalization of securities markets, indicates that foreign issuers with a public float of \$75 million or more have a degree of analyst following in their world-wide markets comparable to similarly-sized domestic companies.⁵⁷

As a result, the Commission believed that expanding Form F-3 eligibility by lowering the float standard to \$75 million would give foreign issuers the same capital raising advantages enjoyed by domestic issuers on Form S-3 without compromising investor protection.⁵⁸

In order to maintain the rough equivalency between Form S-3 and Form F-3, which have had the same public float criteria for primary offering eligibility since 1994,⁵⁹ we are proposing amendments to Form F-3 that are comparable to our proposed changes to Form S-3. Specifically, proposed General Instruction I.B.5. to Form F-3 would allow foreign private issuers with less than \$75 million in worldwide public float to register primary offerings of their securities on Form F-3, provided:

⁵⁶ Release No. 33-7053, at 2. In the same rulemaking, the Commission also reduced the reporting history requirement in Form F-3 from 36 to 12 months to match the eligibility criteria applicable to domestic companies using Form S-3.

⁵⁷ Release No. 33-7029, at 2.

⁵⁸ In the release adopting this change to the Form F-3 eligibility requirements, the Commission stated:

These provisions are part of the ongoing efforts of the Commission to ease the transition of foreign companies into the U.S. disclosure system, enhance the efficiencies of the registration and reporting processes and lower costs of compliance, where consistent with investor protection.

Release No. 33-7053, at 2.

⁵⁹ The Commission’s adoption of the “Securities Offering Reform” amendments in July 2005 is a recent instance where parallel changes were made to Form S-3 and Form F-3. See Release No. 33-8591. For example, the 2005 amendments provided that the ability to conduct an automatic shelf offering under both Form S-3 and Form F-3 is limited to registrants that qualify as “well-known seasoned issuers” under Rule 405 of the Securities Act. We note the minimum public float threshold required to be a well-known seasoned issuer is the same for both Form S-3 and Form F-3.

- they meet the other registrant eligibility conditions for the use of Form F-3;
- they are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement; and
- they do not sell more than the equivalent of 20% of their public float in primary offerings under General Instruction I.B.5. on Form F-3 over any period of 12 calendar months.

D. Request for Comment

We request and encourage any interested person to submit comments on the proposal and any other matters that might have an impact on the proposal. With respect to any comments, we note that such comments are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments. In addition to general comment, we encourage commenters to address the following specific questions:

- Is the proposed change in the public float eligibility criteria for Forms S-3 and F-3 appropriate? Is our assumption correct that it is appropriate to lift the public float restrictions in a limited manner given advances in the electronic dissemination and accessibility of company disclosure transmitted over the Internet?
- In this regard, in what way is market following an important criteria in light of these technological changes?⁶⁰
- The Form S-3 eligibility requirement for primary offerings which requires minimum public float was last set in 1992 at \$75 million. Based on the Personal Consumption Expenditures Price Index (PCEPI) and the Consumer Price Index (CPI), if this threshold were adjusted for inflation, it would equal between \$100-110 million, respectively, in today's dollars. Does this suggest that we should not adopt this proposal and leave the form eligibility requirements unchanged, since by retaining \$75 million as the minimum and not raising it to at least \$100 million to account for inflation, we are in effect allowing a lower threshold than was established in 1992?
- Should the Commission retain the float test in all cases for primary offerings,

⁶⁰ See Release No. 33-6383, at 8 (discussing the objective of relating short-form registration to the existence of widespread following in the marketplace).

but set it below \$75 million? Should the float test be higher than \$75 million?

- Should we make parallel changes to Forms S-3 and F-3, as proposed? If not, in what way should they be different? For example, are there special conditions relating to foreign issuers that would make any of the proposed amendments not appropriate or should they be tailored in any way?
- Is there a more appropriate criteria to determine eligibility for primary offerings on Forms S-3 and F-3 than public float? Given the more limited liquidity of companies with a public float less than \$75 million, would a more appropriate criteria for eligibility relate to Average Daily Trading Volume for the prior year? If so, is 25% of Average Daily Traded Volume an appropriate cap (for ADTV) per year? Should the cap be based on dollar volume traded per day? If not, how would the criteria be evaluated for purposes of determining issuances other than common stock? If Average Daily Trading Volume is used as the criteria instead of public float, over what period should the average be calculated?
- Is the proposed 20% limitation on the amount of securities that can be sold over any period of 12 calendar months appropriate? Should this restriction be broader or more narrow? For example should 20% be higher or lower or should the one-year period be longer or shorter? Is this the right amount to provide smaller public companies with a realistic financing alternative? If the restriction is not appropriate as proposed, what alternatives are preferable and why?
- Proposed General Instruction I.B.6. of Form S-3 would restrict the amount of securities that can be sold by a registrant over a period of “12 calendar months.” This parallels the way in which the phrase “12 calendar months” is used for purposes of the registrant eligibility requirements in Form S-3. Therefore, if a registrant relies on General Instruction I.B.6. to conduct a shelf takedown equivalent to 20% of its public float on September 15, 2007, it will next be eligible to do another takedown (assuming no change in its float) on October 1, 2008. Instead of “12 calendar months,” would it be preferable if the relevant measurement period was “one year,” so that a registrant who conducted a shelf takedown equal to 20% of its float on September 15, 2007 would next be eligible to do another takedown (assuming no change in its float) under General Instruction I.B.6. on September 15, 2008?
- Should we allow non-investment grade debt to be offered under this provision? Should we have a cap for the amount of non-investment grade debt that may be sold? If so, is it appropriate to tie the cap to public float? If not, what would be a more appropriate criteria?
- In the case of securities that are convertible into or exercisable for equity shares, such as convertible debt securities, we are proposing that the registrant

calculate the amount sold by reference to the aggregate market value of the underlying equity shares in lieu of the market value of the convertible securities. Should we also include in the amount the value of the overlying securities? Should derivative securities be calculated in a different manner?

- Under Rule 430B, except for an effective date resulting from the filing of a form of prospectus for purposes of updating the registration statement pursuant to Section 10(a)(3) or reflecting fundamental changes in the information in the registration statement pursuant to the issuer's undertakings, the prospectus filing will not create a new effective date for directors or signing officers of the issuer, whereas the filing of a registration statement on Form S-1, which issuers with a market capitalization of less than \$75 million would otherwise need to use for these offerings, would. Likewise, the filing of the prospectus will not be a new effective date for auditors who provided consent in an existing registration statement for their report on previously issued financial statements as the filing of a new Form S-1 would. Is this potential "gap" in liability appropriate in the situations allowed under the proposed revisions?
- Should the 20% limitation be calculated only with respect to securities sold pursuant to the proposed amendment or should it include all securities sold pursuant to registered public offerings on Form S-3, S-1, SB-2, etc? Should the 20% also include securities sold pursuant to private offerings? Should it include securities sold pursuant to registered public offerings on any form by selling shareholders?
- Should the calculation of 20% of the registrant's public float reflect increases and decreases in the registrant's public float during the period that its shelf registration statement is effective, as is currently proposed? Do concerns relating to investor protection and potential market manipulation weigh in favor of a different method of calculating the 20% limitation, such as determining the 20% limit at the time the registration statement is filed rather than at the time of each sale under the registration statement? Would an annual limitation on the number of offerings on Forms S-3 and F-3 that a registrant may conduct under proposed General Instruction I.B.6. strike the appropriate balance between investor protection and capital formation facilitation?
- Should the calculation of a registrant's public float for purposes of the amendment be based on an average, such as the average weekly float during the four calendar weeks preceding the sale in question?
- As proposed, General Instruction I.B.6. of Form S-3 and General Instruction I.B.5. of Form F-3 provide that the 20% restriction on sales will be lifted in the event that the registrant's public float equals or exceeds \$75 million subsequent to the effective date. However, registrants would be required to

recompute their public float each time they filed an amendment to update the registration statement pursuant to Rule 401 and, if the float measured less than \$75 million, the 20% restriction on sales could be reimposed until the float equaled or exceeded \$75 million. If the 20% restriction is lifted because the registrant's public float surpasses \$75 million, but is subsequently reimposed because the float falls below \$75 million, should the calculation of 20% take into consideration the value of all securities sold pursuant to Form S-3 (or Form F-3, as applicable) in primary offerings in the preceding year; only securities sold pursuant to General Instruction I.B.6. of Form S-3 (or General Instruction I.B.5. of Form F-3, as applicable), in the preceding year; or, should the calculation ignore the value of securities sold prior to the date of the update when the float was last measured?

- In the event that a registrant's public float equals or exceeds \$75 million, is it appropriate for the transformation of the filing from a primary shelf filing under General Instruction I.B.6. of Form S-3 (or General Instruction I.B.5. of Form F-3, as applicable) to a primary shelf filing under General Instruction I.B.1. of Form S-3 (or General Instruction I.B.1. of Form F-3, as applicable) to be made without there being a new effective date for the registration statement? If we should have a new effective date for the registration statement, how would that date be set and should there be any filing made with the Commission?
- Should the calculation of a registrant's public float for purposes of the amendments be made by reference to the price of the registrant's common equity within 60 days prior to the date of sale, or should the reference period for the price of the registrant's common equity be as of a date closer to the date of sale?
- What should be the consequence of an issuer exceeding the 20% restriction on sales? If the consequences of violating the 20% are significant, would the risks of doing so adversely affect the willingness of issuers to use the proposal? If so, what, if anything, should be done to ameliorate those risks?
- Should the issuer's intent be a factor in determining the consequences of a violation of the 20% restriction?
- Should we amend Rule 401(g)⁶¹ of the Securities Act to provide that violations of the 20% restriction would also violate the requirements as to proper form under Rule 401 even though the registration statement has been declared effective previously?
- The proposal does not exclude any type of offerings, such as at-the-market offerings. Should we impose restrictions on the manner of sale under

⁶¹ 17 CFR 230.401(g).

proposed General Instruction I.B.6. to Form S-3 (and, on Form F-3, proposed General Instruction I.B.5.), so that only certain kinds of distributions, such as firm commitment underwritten offerings, are permitted?

- We recently eliminated restrictions on primary “at-the-market” offerings of equity securities for primary shelf eligible issuers because we felt they were not necessary to provide protection to markets or investors for seasoned issuers.⁶² Given that the proposal allows smaller companies to do primary offerings, should registrants utilizing proposed General Instruction I.B.6. to Form S-3 (and, on Form F-3, proposed General Instruction I.B.5.) be prohibited from conducting at-the-market offerings under Rule 415(a)(4)?⁶³ If at-the-market offerings are allowed, should we nevertheless require that such offers and sales be made only through registered broker-dealers and require such broker-dealers to be named as underwriters in the prospectus?
- Should all companies with a public trading market, including companies traded on the Pink Sheets, be allowed to use the amended form as proposed or should we limit it to just interdealer quotations systems with some level of oversight and operated by a self-regulatory organization?
- Is the proposal not to extend expanded Form S-3 and F-3 eligibility to shell companies appropriate? If not, why?
- Are there other restraints on the proposed expansion of Form S-3 and F-3 eligibility that should be considered, such as restricting the classes of issuers that may utilize this expansion or the types and amounts of securities that may be registered on Forms S-3 and F-3 pursuant to this expansion?
- If the eligibility standards for Form S-3 and Form F-3 are expanded as

⁶² See Release No. 33-8591.

⁶³ Prior to the adoption of Securities Offering Reform in July 2005, Rule 415 prohibited registrants from making at-the-market offerings on Form S-3 or Form F-3 unless certain conditions were met. The conditions were that: the amount of securities could not exceed ten percent of the registrant’s public float; the securities had to be sold through an underwriter or underwriters acting as principal(s) or agent(s) for the registrant; and the underwriter(s) must be named in the prospectus. Among other things, the 2005 amendments eliminated these restrictions for primary shelf eligible issuers. In the Securities Offering Reform adopting release, the Commission stated:

The restrictions on primary “at-the-market” offerings of equity securities currently set forth in Rule 415(a)(4) were adopted initially to address concerns about the integrity of trading markets. As discussed in the Proposing Release, we are eliminating these restrictions for primary shelf eligible issuers because they are not necessary to provide protection to markets or investors. The market today has greater information about seasoned issuers than it did at the adoption of the “at-the-market” limitations, due to enhanced Exchange Act reporting. Further, trading markets for these issuers’ securities have grown significantly since that time. Requiring the involvement of underwriters and limiting the amount of securities that can be sold imposes artificial limitations on this avenue for these issuers to access capital.

proposed, will allowing this larger class of companies to conduct limited primary offerings of their securities on these forms provide them with a meaningful source of financing? How might this proposal impact the private markets for these companies' securities?

- If the proposal is adopted, what types of financings are issuers likely to make on the expanded eligibility on Form S-3 and F-3?
- If the proposal is adopted, it is foreseeable that some companies with a public trading market but with securities not listed or authorized for listing on a national securities exchange may be eligible to offer such securities in primary offerings on Form S-3 or Form F-3. Since the proposal is not intended to alter the exemption from state regulation of securities offerings under Section 18 of the Securities Act, will the effect of state blue sky law make it prohibitively difficult for companies without "covered" securities (as defined by Section 18(b)) to register such securities in primary offerings on Form S-3 and F-3 pursuant to the proposal? If the answer is yes, what steps can we take to make the amendments more useful to companies?
- Are there any market practices that may arise as a result of this proposal that we should be concerned about?
- Is there any investor protection loss the proposal does not address? If so, how can we address it? Are there any additional disclosures that are appropriate? For instance, are there any disclosures required in Forms S-1 or F-1 that should be included in Forms S-3 or F-3 filed under General Instruction I.B.6. of Form S-3 or General Instruction I.B.5. of Form F-3, respectively? Should issuers have to disclose in the prospectus their calculation of the amount of securities being offered, the amount offered pursuant to these Instructions for the last 12 calendar months and of the amount of securities that may be offered under the filing during the year?

II. Paperwork Reduction Act

A. Background

The proposed amendments to Forms S-3 and F-3 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.⁶⁴ We are submitting these to the Office of Management and Budget for review and

⁶⁴ 44 U.S.C. 3501 et seq.

approval in accordance with the Paperwork Reduction Act.⁶⁵ The titles for this information are:

“Form S-3” (OMB Control No. 3235-0073);

“Form S-1”⁶⁶ (OMB Control No. 3235-0065);

“Form SB-2”⁶⁷ (OMB Control No. 3235-0418);

“Form F-3” (OMB Control No. 3235-0256); and

“Form F-1”⁶⁸ (OMB Control No. 3235-0258)

We adopted existing Forms S-3, S-1, SB-2, F-3 and F-1 pursuant to the Securities Act. These forms set forth the disclosure requirements for registration statements that are prepared by eligible issuers to provide investors with the information they need to make informed investment decisions in registered offerings.

Our proposed amendments to Forms S-3 and F-3 are intended to allow issuers that are currently ineligible to use Forms S-3 and F-3 for primary offerings because they do not meet the forms’ public float requirements to nevertheless register a limited amount of securities in primary offerings on Form S-3 or Form F-3, as applicable, so long as they are not shell companies and meet the other eligibility requirements of the forms.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to

⁶⁵ 44 U.S.C. 3507(d) and 5 CFR 1320.11.

⁶⁶ Because our amendments to Form S-3 and Form F-3 are anticipated to affect the annual number of Forms S-1, Forms SB-2 and Forms F-1 filed, we are required to include them in the titles of information collections even though we are not proposing to amend them in this release.

⁶⁷ See n. 66 above.

⁶⁸ Id.

respond to, a collection of information unless it displays a currently valid control number.

The information collection requirements related to registration statements on Forms S-3, S-1, SB-2, F-3 and F-1 are mandatory. There is no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

B. Summary of Information Collections

Because the amendments that we are proposing in this release pertain only to Forms S-3 and F-3 eligibility and not to the disclosure required by these forms, we do not believe that the amendments will impose any new recordkeeping or information collection requirements. On a per-response basis, this proposal would not increase or decrease existing disclosure burdens for Form S-3 or Form F-3. However, because we expect that many companies newly eligible for primary offerings on Forms S-3 and F-3 as a result of these amendments will choose to file short-form Form S-3 and Form F-3 registration statements in lieu of Forms S-1, SB-2 or F-1, as applicable, we believe there will be an aggregate decrease in the disclosure burdens associated with Forms S-1, SB-2 and F-1 and an increase in the disclosure burdens associated with Forms S-3 and F-3. The shift in aggregate disclosure burden among these forms will be due entirely to the change in the number of annual responses expected with respect to each form as companies previously ineligible to use Form S-3 and Form F-3 switch to these forms for their public offerings and away from Forms S-1, SB-2 and F-1. In addition, because of the anticipated benefits to issuers associated with Forms S-3 and F-3, in particular the lower costs of preparing and filing the registration statements and the ability to make delayed and continuous offerings in response to changing market conditions, we think that this will increase the demand for and lead to more company filings on Forms S-3 and

F-3 than would otherwise have been made on Forms S-1, SB-2 and F-1. That is, we think that the opportunity for capital raising will be more robust for many companies because of the availability of shelf registration on Form S-3. We also anticipate that many companies will choose to offer their securities directly to the public through registration on Forms S-3 and F-3 instead of through private placements and therefore, if the proposal is adopted, we expect comparatively more Form S-3 and F-3 registration statements to be filed as companies forego private offerings in favor of the public markets. In order to provide an estimate of the change in the collection of information burden for purposes of the Paperwork Reduction Act, our assumption is that the proposed amendments to Forms S-3 and F-3 will result in an overall increase in the number of such forms filed annually and an overall decrease in the number of Forms S-1, Forms SB-2 and Forms F-1 filed annually. As discussed, however, we do not expect that the incremental increase in the number of all Forms S-3 and F-3 filed will be roughly equal to the incremental decrease in the number of Forms S-1, Forms SB-2 and Forms F-1 filed, because our assumption is that the advantages of shelf registration on Form S-3 and Form F-3 will encourage financings on these forms that would otherwise have been carried out through exempt offerings or perhaps not at all. Therefore, we believe the proposal would result in a net increase in the annual aggregate number of filings on all Forms S-3, S-1, SB-2, F-3 and F-1 taken together, since the increased number of Form S-3 and F-3 filings should exceed the decreased number of Form S-1, SB-2 and F-1 filings. Accordingly, we believe the overall net decrease in disclosure burden that should result from companies changing to the more streamlined Forms S-3 and F-3 will be offset to some extent by newly eligible companies filing Forms S-3 and F-3 more frequently than they did Forms S-1, SB-2 or F-1. However, this offset could be lessened in part by the proposed 20% limitation on the

amount of securities that companies may sell on Form S-3 and Form F-3 in any period of 12 calendar months. Companies that require more capital but are prohibited by this 20% restriction from using Form S-3 and Form F-3 for primary offerings may, as a result, continue to conduct some offerings on Forms S-1, SB-2 or F-1 or through the private markets even though Form S-3 and F-3 are preferable.

C. Paperwork Reduction Act Burden Estimates

For purposes of the Paperwork Reduction Act, we estimate the annual decrease in the paperwork burden for companies to comply with our proposed collection of information requirements to be approximately 39,952 hours of in-house company personnel time and to be approximately \$47,942,000 for the services of outside professionals.⁶⁹ These estimates include the time and the cost of preparing and reviewing disclosure, filing documents and retaining records. Our methodologies for deriving the above estimates are discussed below.

Our estimates represent the burden for all issuers, both large and small. As mentioned, however, the estimated decreases are wholly attributable to our assumptions, discussed in Section B. above, about how the amendments will influence the behavior of certain issuers who were formerly ineligible to conduct primary offerings on Forms S-3 and F-3. These issuers are non-shell companies who satisfy the registrant eligibility requirements of Form S-3⁷⁰ or Form F-3,⁷¹ as applicable, but had a public float of less than \$75 million at the end of their last fiscal year. In all, we estimate that there were

⁶⁹ For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest thousand.

⁷⁰ See n. 29 above.

⁷¹ See n. 51 above.

4,901 such companies at the end of calendar year 2006 and that they filed a total of 815 registration statements on Forms S-1, SB-2 and F-1 during the twelve months ending December 31, 2006.⁷² To determine the effect of our proposal on the overall paperwork burden, we have assumed that these filings on Forms S-1, SB-2 and F-1 would have been made instead on Form S-3 or Form F-3, as applicable, to the extent that the issuers would not be limited by the proposed 20% restriction on the amount of securities they may offer in any period of 12 calendar months. Therefore, we assume that the Forms S-1, SB-2 and F-1 filed by the subject companies will decrease from the number filed in 2006, but because of the proposed 20% restriction on sales, will not decrease to 0. Instead, we believe that some Forms S-1, SB-2 and F-1 will continue to be filed annually by these companies. To reflect this, we have taken the number of Forms S-1, SB-2 and F-1 that were filed by these companies in calendar year 2006 and decreased this number by 85% for each form, for a total decrease of 694 filings.⁷³ Therefore, we assume that approximately 694 fewer Forms S-1, SB-2 and F-1 will be filed by all issuers in calendar year 2006. The actual number could be more or less depending on various factors, including future market conditions.

Furthermore, we believe that the 4,901 companies that we estimate will be affected by the rule change would have conducted more registered securities offerings had they been able to use Forms S-3 and F-3 because of the benefits of forward incorporation and the ability to utilize shelf registration to maximize market opportunities. We assume that the inability of these companies to utilize Forms S-3 and

⁷² The total of 815 filings is comprised of 138 Forms S-1; 674 Forms SB-2; and 3 Forms F-1.

⁷³ This number deducts 85% from the totals for each of the three registration forms, as follows: Form S-1 (85% of 138, rounded up, equals 118); Form SB-2 (85% of 674, rounded up, equals 573); and

F-3 limited their capacity to access the public securities markets and, because of the cost and lack of flexibility associated with Forms S-1, SB-2 and F-1, either did not file registration statements on Forms S-1 SB-2 or F-1, or were limited in the number that they filed. We therefore believe that the annual number of responses on Forms S-3 and F-3 for purposes of the Paperwork Reduction Act will increase by an increment greater than simply the total of 694 fewer registration statements on Forms S-1, SB-2 and F-1 that we estimate will be filed going forward by the 4,901 companies who would qualify for primary offerings on Forms S-3 and F-3 as a result of our proposal. We further assume that this increase in Forms S-3 and F-3 will be mitigated to some degree by the proposed 20% restriction on securities sold in any period of 12 calendar months, which may limit the frequency and volume of additional securities offerings on Form S-3 and Form F-3. To reflect this, we have taken the 694 Forms S-1, SB-2 and F-1 that were filed by these companies in calendar year 2006 and increased this number by 10% for each form, for a total increase of 765 filings.⁷⁴ Therefore, we assume that approximately 765 additional Forms S-3 and F-3 will be filed over and above the number of total Forms S-3 and F-3 filed by all issuers, large and small, in calendar year 2006. The actual number could be more or less depending on various factors, including future market conditions.

To calculate the total effect of the proposed amendments on the overall compliance burden for all issuers, large and small, we subtracted the burden associated with the 694 fewer Forms S-1, SB-2 and F-1 registration statements that we expect will

Form F-1 (85% of 3, rounded up, equals 3). Adding these together, the combined reduction totals 694 filings.

⁷⁴ This number adds a 10% premium to the individual totals for each of the three registration forms, as follows: Form S-1 (10% of 118, rounded up, equals 12); Form SB-2 (10% of 573, rounded up, equals 58); and Form F-1 (10% of 3, rounded up, equals 1). The sum of these increases, which is equal to 71, is then added to the total of 694 Forms S-1, SB-2 and F-1 filed by the subject companies in 2006.

be filed annually in the future and added the burden associated with our estimate of 765 additional Forms S-3 and F-3 filed annually as a result of the proposal. We used current Office of Management and Budget estimates in our calculation of the hours and cost burden associated with preparing, reviewing and filing each of these forms.

Consistent with current Office of Management and Budget estimates and recent Commission rulemaking,⁷⁵ we estimate that 25% of the burden of preparation of Forms S-3, S-1, SB-2, F-3 and F-1 is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of \$400 per hour.⁷⁶ The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours.

The table below illustrates our estimates concerning the incremental annual compliance burden in the collection of information in hours and cost for Forms S-3, S-1, SB-2, F-3 and F-1 as a result of this proposal.

Form	Estimated Change in Annual Responses	Hours/Form ⁷⁷	Incremental Burden	25% Issuer	75% Professional	\$400/hr Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*\$400
S-3	761	459	349,299	87,324.75	261,974.25	\$104,789,000
S-1	(118)	1,176	(138,768)	(34,692)	(104,076)	(\$41,630,400)
SB-2	(573)	638	(365,574)	(91,393.5)	(274,180.5)	(\$109,672,200)
F-3	4	166	664	166	498	\$199,200
F-1	(3)	1,809	(5,427)	(1,356.75)	(4,070.25)	(\$1,628,100)
Total			(159,806)	(39,951.5)	(119,854.5)	(\$47,941,800)

⁷⁵ For discussions of the relative burden of preparation of registration statements under the Securities Act allocated between issuers internally and their outside advisers, see Executive Compensation and Related Person Disclosure, Release No. 33-8732A (Aug. 29, 2006) [71 FR 56225] and Release No. 33-8591.

⁷⁶ In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of \$400 as the average cost of outside professionals that assist issuers in preparing disclosures and conducting registered offerings.

⁷⁷ This reflects current Office of Management and Budget estimates.

D. Request for Comment

We request comment in order to evaluate the accuracy of our estimate of the burden of the collections of information.⁷⁸ Any member of the public may direct to us any comments concerning the accuracy of these burden estimates. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington DC 20503, and should send a copy of the comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-10-07. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-10-07, and be submitted to the Securities and Exchange Commission, Office of Filings and Information Services, Branch of Records Management, 6432 General Green Way, Alexandria, VA 22312. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

III. Cost-Benefit Analysis

A. Summary of Proposals

We are proposing revisions to the transaction eligibility requirements of Forms S-3 and F-3 that would allow companies to take advantage of these forms for primary offerings regardless of the size of their public float. Whereas secondary offerings may be registered on Forms S-3 and F-3 irrespective of float, the current instructions to Forms

⁷⁸ Comments are requested pursuant to 44 U.S.C. 3506(c)(2)(B).

S-3 and F-3 restrict the use of these forms for primary securities offerings to companies that have a minimum of \$75 million in public float calculated within 60 days prior to the date the registration statement is filed. To expand the availability of Forms S-3 and F-3 for primary offerings to more companies, we propose to allow companies with less than \$75 million in public float to register primary offerings of their securities on Forms S-3 and F-3, provided:

- they meet the other registrant eligibility conditions for the use of Form S-3 or Form F-3, as applicable;
- they are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement; and
- they do not sell more than the equivalent of 20% of their public float in primary offerings under General Instruction I.B.6. of Form S-3 or under General Instruction I.B.5. of Form F-3 over any period of 12 calendar months.

B. Benefits

The ability to conduct primary offerings on Forms S-3 and F-3 confers significant advantages on eligible companies in terms of cost savings and capital formation. The time required to prepare Form S-3 or Form F-3 is significantly lower than that required for Forms S-1, F-1 and SB-2.⁷⁹ This difference is magnified by the fact that Form S-3 and Form F-3, unlike Forms S-1, SB-2 and F-1, permit registrants to forward incorporate required information by reference to disclosure in their Exchange Act filings. Therefore, Form S-3 and Form F-3 registration statements can be automatically updated. This allows such companies to avoid additional delays and interruptions in the offering process and can reduce the costs associated with preparing and filing post-effective amendments to the registration statement.

Overall, we anticipate that the proposed expansion of Form S-3 and Form F-3 eligibility will decrease the aggregate costs of complying with the Commission's rules by allowing companies previously eligible to use only Form S-1, Form SB-2 or Form F-1 the use of short-form registration on Form S-3 or Form F-3, as applicable. Using our estimates prepared for purposes of the Paperwork Reduction Act, we estimate that under the proposal the annual decrease in the compliance burden for companies to comply with our proposed collection of information requirements to be approximately 39,952 hours of in-house company personnel time (valued at \$6,992,000⁸⁰) and to be approximately \$47,942,000 for the services of outside professionals. If our assumptions regarding these costs and current practices are not correct or complete, then the decreased costs we anticipate may prove to be either higher or lower than our current estimate.

In addition to the benefits associated with the estimated reduction in the time required to prepare Forms S-3 and F-3 in lieu of Forms S-1, SB-2 and F-1, and a company's ability to forward incorporate prospectus disclosure by reference, Forms S-3 and F-3 provide substantial flexibility to companies raising money in the capital markets, which ultimately may reduce the cost of capital for such companies and facilitate their access to additional sources of investment. Companies that are eligible to use Form S-3 or Form F-3 for primary offerings are able to conduct delayed and continuous registered offerings under Rule 415 of the Securities Act, which provides considerable flexibility in accessing the public securities markets from time to time in response to changes in the

⁷⁹ The Office of Management and Budget currently estimates the time required to prepare Form S-3 and Form F-3 as 459 hours and 166 hours, respectively. This is contrasted with current estimates for Form S-1, F-1 and SB-2 as 1,176 hours, 1,809 hours and 638 hours, respectively.

⁸⁰ Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of \$175 per hour.

market and other factors. Eligible companies are permitted to register securities prior to planning any offering and, once the registration statement is effective, offer these securities in one or more tranches without waiting for further Commission action. By having more control over the timing of their offerings, these companies can take advantage of desired market conditions, thus allowing them to raise capital on more favorable terms (such as pricing) or to obtain lower interest rates on debt. In addition, they can vary certain terms of the securities being offered upon short notice, enabling them to more efficiently meet the competitive requirements of the public securities markets. We believe that extending shelf registration benefits to more companies, as we have proposed, will facilitate the capital-raising efforts of smaller public companies who currently have fewer financing options than their larger counterparts.⁸¹ Consequently, we anticipate that the proposal, if adopted, would result in smaller issuers raising more capital through the public markets rather than through exempt offerings conducted in the domestic and offshore markets. Investors in these companies will benefit by such companies' improved access to capital on more favorable terms. In particular, investors in smaller public companies may be less subject to the risk of dilution in the value of their shares if the companies in which they invest are able to meet more of their capital needs in the public markets. By selling into the public markets, these companies may be able to avoid the substantial pricing discounts that private investors often demand to compensate them for the relative illiquidity of the restricted shares they are purchasing.⁸²

⁸¹ See generally, Chaplinsky and Haushalter, Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity.

⁸² Id.

The public registration of securities also provides additional benefits to investors over alternative forms of capital raising. To the extent that the amendments, if adopted, lead to an increase in the use of Form S-3 and Form F-3 as a source of financing and a decrease in private market alternatives, investors in those offerings will benefit from the additional investor protections associated with public registration.

Notwithstanding our belief regarding the beneficial effects of the proposed amendments, however, any resulting benefits that accrue to companies and their investors as a result of these amendments will depend on future market conditions and circumstances unique to each company.

C. Costs

As discussed in Section B. above, we do not expect that the proposed amendments to Forms S-3 and F-3 will materially increase companies' overall compliance costs associated with preparing, reviewing and filing these registration statements, although there may be some additional costs incurred by companies to monitor their ongoing compliance with the 20% sales restriction imposed by the amendments. At the same time, the amendments could result in certain additional market costs that are difficult to quantify. For example, it has been suggested that there are risks inherent in allowing smaller public companies to take advantage of shelf primary offerings on Forms S-3 and F-3: because this would permit such companies to avail themselves of periodic takedowns without further Commission action or prior staff review, concerns have been raised about the increased potential for fraud and market manipulation.⁸³ Although the Commission would retain the authority to review

⁸³ See n. 45 above.

registration statements before declaring them effective, individual takedowns are not subject to prior staff review. Under the current rules, if issuers are instead using Forms S-1, SB-2 or F-1, they would be required to file separate registration statements for each new offering, which would be subject to selective staff review before going effective. If these issuers can instead conduct shelf offerings on Form S-3 and Form F-3, there may be some loss of the deterrent effect on the companies' disclosures in connection with each takedown off the shelf because of the lack of prior staff review. In addition, the short time horizon of shelf offerings may also reduce the time that participating underwriters have to apply their independent scrutiny and judgment to an issuer's prospectus disclosure. We have also considered the effect the amendments may have on market demand in the securities of smaller public companies offered on Form S-3 and Form F-3. If there is a perception that smaller public company securities offered through shelf registration statements are more prone to abuse because of the lack of involvement by the Commission staff, this may erode investor confidence in these offerings generally. This could, in turn, make it more difficult for these companies to raise capital and significantly negate the benefits of the rule.

While we recognize that extending the benefits of shelf registration to an expanded group of companies will, by necessity, limit the staff's direct involvement in takedowns of securities off the shelf and could therefore pose some risk to investors, we believe that the costs will be justified by the benefits that will accrue by facilitating the capital formation efforts of smaller public companies. As we have discussed elsewhere in this release, the risks to investor protection by expanding the base of companies eligible for primary offerings on Forms S-3 and F-3 have been significantly mitigated by technological advances affecting the manner in which companies communicate with

investors, allowing widespread, direct, and contemporaneous accessibility of company disclosure at little or no cost. Moreover, the scope of heightened disclosure obligations and liability of smaller public companies under the federal securities laws are sufficiently comparable for these purposes to the largest reporting companies such that the proposed expansion of Form S-3 and Form F-3 primary offering eligibility should not adversely impact investors. In this regard, to ensure that the expansion of eligibility is carried out with appropriate moderation and attention to the continued protection of investors, we have proposed to exclude shell companies from eligibility and to impose a 20% restriction on the amount of securities that can be sold into the market in any period of 12 calendar months by eligible issuers on Forms S-3 and F-3. We note, however, that monitoring compliance with this 20% limitation may be more difficult given the lack of prior staff review before a shelf offering.

D. Request for Comment

We solicit comments, including quantitative data, to assist our assessment of the costs and benefits of the proposal that we have identified, or any other costs or benefits that we have not addressed but ought to consider. Commenters are encouraged to address any potentially material costs and benefits, whether direct or indirect.

IV. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Securities Act Section 2(b)⁸⁴ requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

⁸⁴ 15 U.S.C. 77b(b).

We expect the proposed amendments, if adopted, to increase efficiency and enhance capital formation, and thereby benefit investors, by facilitating the ability of smaller public companies to access the capital markets consistent with investor protection. Currently, many companies are ineligible to use Forms S-3 and F-3 to register primary offerings of their securities because the size of their public float does not satisfy the \$75 million threshold required by these forms. Consequently, they are unable to take advantage of the important benefits enjoyed by eligible companies, the most significant of which is the ability to conduct primary offerings on a delayed and continuous basis. The ability to register securities that may be taken off the shelf as needed, without prior staff review, provides a powerful tool for capital formation because it allows companies the flexibility to take advantage of desired market conditions efficiently and upon short notice. Companies may be able to raise capital more cheaply, quickly, and on more favorable terms than would otherwise be the case. We believe that investors in these companies will benefit by such companies' improved access to capital on more favorable terms. In particular, investors in smaller public companies may be less subject to the risk of dilution in the value of their shares if the companies in which they invest are able to meet more of their capital needs in the public markets. By selling into the public markets, these companies may be able to avoid the substantial pricing discounts that private investors often demand to compensate them, in part, for the relative illiquidity of the restricted shares they are purchasing.⁸⁵

We therefore believe that extending shelf registration benefits to more companies as we have proposed will facilitate the capital-raising efforts of smaller public companies

⁸⁵ See n. 82.

who currently have fewer financing options than their larger counterparts.⁸⁶

Consequently, we anticipate that the proposal, if adopted, would lead to efficiencies in capital formation, as smaller issuers would be able to raise more capital through the public markets rather than through exempt offerings conducted in the domestic and offshore markets.

At the same time, we have also considered the potential that the amendments might result in certain additional market costs that could limit any efficiencies realized. For example, it has been suggested that extending the benefits of shelf registration to an expanded group of companies will limit the staff's direct involvement in takedowns of securities off the shelf and could therefore pose some risk to investors. In addition, the short time horizon of shelf offerings also may reduce the time that participating underwriters have to apply their independent scrutiny and judgment to an issuer's prospectus disclosure. By reducing this staff and underwriter oversight, there is a risk that these securities offerings may be more vulnerable to abuses. Moreover, because companies with a smaller market capitalization, as a group, have a comparatively smaller market following than larger, well-seasoned issuers and are more thinly traded, smaller companies' securities may be more vulnerable to potential manipulative practices. We also have considered the effect the amendments may have on market demand in the securities of smaller public companies offered on Form S-3 and Form F-3. If there is a perception that smaller public company securities offered through shelf registration statements are more prone to abuse because of the lack of prior involvement by the Commission staff, this may erode investor confidence in these offerings generally. This

⁸⁶ See n. 81.

could, in turn, make it more difficult for these companies to raise capital and significantly negate the benefits of the rule.

We do not believe that the potential efficiencies and benefits to capital formation resulting from the amendments will be substantially lessened by these potential costs.

We believe that the risks to investor protection by expanding the base of companies eligible for primary offerings on Forms S-3 and F-3 have been significantly mitigated by technological advances affecting the manner by which companies communicate with investors, allowing widespread, direct, and contemporaneous accessibility of company disclosure at little or no cost. Moreover, the scope of heightened disclosure obligations and the liability of smaller public companies under the federal securities laws are sufficiently comparable for these purposes to the largest reporting companies, such that the proposed expansion of Form S-3 and Form F-3 primary offering eligibility should not adversely impact investors. In this regard, to provide that the expansion of eligibility is carried out with appropriate moderation and attention to the continued protection of investors, we have proposed to exclude shell companies from eligibility and to impose a 20% restriction on the amount of securities that can be sold into the market in any period of 12 calendar months by eligible issuers on Forms S-3 and F-3.

In addition to the salutary effects that we anticipate with respect to capital formation, companies may also realize cost efficiencies stemming from the enhanced ability to incorporate by reference disclosure information from their Exchange Act filings. Because Forms S-3 and F-3 allow a company maximum reliance on its Exchange Act filings to satisfy required prospectus disclosure, these registration statements can be more abbreviated than alternative registration forms and are updated automatically by the company's future Exchange Act filings. This translates into a reduction in the time and

the cost of preparing and reviewing disclosure, filing documents, and retaining records. We estimate that under the proposal the annual decrease in the compliance burden for companies who previously were ineligible to use Forms S-3 and F-3 for primary offerings to be approximately 39,952 hours of in-house company personnel time (valued at \$6,992,000⁸⁷) and to be approximately \$47,942,000 for the services of outside professionals.

The effects of the proposed amendments on competition are difficult to predict, but it is possible that making it easier for smaller public issuers to access the domestic public securities markets will lead to a reallocation of capital, as companies that previously had little choice but to offer their securities in private offerings or in offshore markets because of their S-3 and F-3 ineligibility will now find it cost-effective to offer their securities domestically in primary offerings on Form S-3 and Form F-3. If such a reallocation occurs, it may also impact securities market professionals, such as finders, brokers and agents, who specialize in facilitating private securities offerings. The demand for these services may shift to the public markets, where other professionals, such as investment banks that underwrite public offerings, have a comparative advantage.

We request comment on whether the proposals, if adopted, would promote efficiency, competition, and capital formation or have an impact or burden on competition. Commenters are requested to provide empirical data and other factual support for their views, if possible.

⁸⁷ See n. 80 above.

V. Initial Regulatory Flexibility Act Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed revisions to the eligibility requirements for the use of registration statements on Forms S-3 and F-3 to register primary offerings of securities.

A. Reasons for the Proposed Action

Currently, many smaller public companies are ineligible to use Forms S-3 and F-3 to register primary offerings of their securities because the size of their public float does not satisfy the \$75 million threshold required by these forms. Consequently, they are unable to take advantage of the important benefits enjoyed by eligible companies, the most significant of which is the ability to conduct primary offerings on a delayed and continuous basis. The ability to register securities that may be taken off the shelf as needed, without prior staff review, provides a powerful tool for capital formation because it allows companies the flexibility to take advantage of desired market conditions efficiently and on short notice. As such, eligible companies may be able to raise capital more cheaply, quickly, and on more favorable terms than would otherwise be the case. Without this source of financing, smaller public companies that are not eligible to register primary offerings on Form S-3 or Form F-3 currently have fewer, and less favorable, financing options than their larger Form S-3 and F-3-eligible counterparts.

B. Objectives

The proposed amendments aim to amend Forms S-3 and F-3 to extend the benefits of incorporation by reference and shelf registration to more companies, which in turn will facilitate the ability of smaller public companies to access the capital markets.

C. Legal Basis

We are proposing these amendments pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act, as amended.

D. Small Entities Subject to the Proposed Amendments

The Regulatory Flexibility Act defines “small entity” to mean “small business,” “small organization,” or “small governmental jurisdiction.”⁸⁸ The Commission’s rules define “small business” and “small organization” for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission.⁸⁹ Roughly speaking, a “small business” and “small organization,” when used with reference to an issuer other than an investment company, means an issuer with total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,100 issuers, other than investment companies, that may be considered reporting small entities.⁹⁰

The proposal would affect small entities that are not shell companies and satisfy the registrant eligibility requirements for the use of Form S-3 or Form F-3, which

⁸⁸ 5 U.S.C. §601(6).

⁸⁹ Rules 157 under the Securities Act [17 CFR 230.157], 0-10 under the Exchange Act [17 CFR 240.0-10] and 0-10 under the Investment Company Act [17 CFR 270.0-10] contain the applicable definitions.

⁹⁰ The estimated number of reporting small entities is based on 2007 data, including the Commission’s EDGAR database and Thomson Financial’s Worldscope database. This represents an update from the number of reporting small entities estimated in prior rulemakings. See, for example, Executive Compensation and Related Disclosure, Release No. 33-8732A (Aug. 29, 2006) [71 FR 53158] (in which the Commission’s estimated a total of 2,500 small entities, other than investment companies).

generally pertain to a company's reporting history under the Exchange Act.⁹¹ Based on these registrant eligibility requirements, we estimate that there are approximately 990 small entities that would be affected by the proposal and would therefore become eligible to use Form S-3 or Form F-3 for primary securities offerings.

E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments to the transaction eligibility requirements of Forms S-3 and F-3 would affect only small entities that meet the registrant eligibility requirements of Form S-3 or Form F-3, as applicable, are not shell companies and choose voluntarily to register one or more primary securities offerings on Form S-3 or Form F-3. Because Forms S-3 and F-3 are abbreviated registration forms that can be updated automatically through incorporation by reference of a registrant's Exchange Act filings, we believe use of the forms by eligible small entities would decrease their existing compliance burden. Because the proposal does not affect the information disclosure requirements of Form S-3 or Form F-3, we do not believe that the costs of complying with the amendments for small entities will be disproportionate to that of large entities.⁹² We recognize, however, that there will be some additional costs associated with an issuer's need to continually monitor its compliance with the proposed 20% limitation on sales in any period of 12 calendar months, but we believe that any such costs will be insignificant.

⁹¹ See n. 29 and n. 51 above.

⁹² It should be noted, however, that General Instruction II.C. of Form S-3 currently requires "small business issuers" (as defined in Rule 405 of the Securities Act [17 CFR 230.405]) to refer to the disclosure items in Regulation S-B [17 CFR 228.10 *et seq.*] and not Regulation S-K. Since Regulation S-B disclosure requirements generally are less extensive than Regulation S-K, small business issuers that file on Form S-3 may have a comparatively lesser compliance burden than larger issuers. However, because the Office of Management and Budget does not provide average compliance estimates for Form S-3 that distinguish between filers subject to Regulation S-K and filers subject to Regulation S-B, we have not made such a distinction in this Initial Regulatory Flexibility Analysis.

For purposes of the Paperwork Reduction Act, we estimate the annual decrease in the paperwork burden for small entities to comply with our proposed collection of information requirements to be approximately 7,854 hours of in-house company personnel time (valued at \$1,375,000⁹³) and to be approximately \$9,425,000 for the services of outside professionals. To arrive at these estimates, we applied the same methodology to small entities that we described in Section II.C. above for large and small companies combined. Assuming that 990 small entities would be eligible for primary offerings on Forms S-3 and F-3 if the proposal is adopted, we estimated that these entities filed a total of 193 registration statements on Forms S-1, SB-2 and F-1 during the twelve months ending December 31, 2006.⁹⁴ We then assumed that these filings on Forms S-1, SB-2 and F-1 would have been made instead on Forms S-3 or Form F-1, as applicable, to the extent that the issuers would not be limited by the proposed 20% restriction on the amount of securities they may offer in any period of 12 calendar months. Therefore, we assume that the Forms S-1, SB-2 and F-1 filed by the subject small entities will decrease from the number filed in 2006 but, because of the proposed 20% restriction on sales, this number will not decrease to 0. Instead, we believe that some Forms S-1, SB-2 and F-1 will continue to be filed annually by these small entities. As such, we have taken the number of Forms S-1, SB-2 and F-1 that were filed by these small entities in calendar year 2006 and decreased this number by 85% for each form, for a total decrease of 165 filings.⁹⁵ Therefore, we assume that approximately 165 fewer Forms S-1, SB-2 and F-1

⁹³ See n. 80 above.

⁹⁴ The total of 193 filings is comprised of 21 Forms S-1; 172 Forms SB-2; and 0 Forms F-1.

⁹⁵ This number deducts 85% from the totals for each of the three registration forms, as follows: Form S-1 (85% of 21, rounded up, equals 18); Form SB-2 (85% of 172, rounded up, equals 147); and Form F-1 (85% of 0 equals 0). Adding these together, the combined reduction is equal to 165 filings.

will be filed by all small entities in calendar year 2006. The actual number could be more or less depending on various factors, including future market conditions.

Furthermore, we believe that the 990 small entities that we estimate will be affected by the rule change would have conducted more registered securities offerings had they been able to use Forms S-3 and F-3 because of the benefits of forward incorporation and the ability to utilize shelf registration to maximize market opportunities. We assume that the inability of these small entities to utilize Forms S-3 and F-3 limited their capacity to access the public securities markets and, because of the cost and lack of flexibility associated with Forms S-1, SB-2 and F-1, either did not file registration statements on Forms S-1, SB-2 or F-1, or were limited in the number that they filed. We therefore believe that the annual number of responses on Forms S-3 and F-3 for purposes of the Paperwork Reduction Act will increase by an increment greater than simply the total of 165 fewer registration statements on Forms S-1, SB-2 and F-1 that we estimate will be filed going forward by the 990 small entities who would qualify for primary offerings on Forms S-3 and F-3 as a result of our proposal. We further assume that this increase in Forms S-3 and F-3 will be mitigated to some degree by the proposed 20% restriction on securities sold in any period of 12 calendar months, which may limit the frequency and volume of additional securities offerings on Form S-3 and Form F-3. To reflect this, we have taken the 165 Forms S-1, SB-2 and F-1 that were filed by these small entities in calendar year 2006 and increased this number by 10% for each form, for a total increase of 182 filings.⁹⁶ Therefore, we assume that approximately 182

⁹⁶ This number adds a 10% premium to the individual totals for each of the three registration forms, as follows: Form S-1 (10% of 18, rounded up, equals 2); Form SB-2 (10% of 147, rounded up, equals 15); and Form F-1 (10% of 0 equals 0). The sum of these increases, which is equal to 17, is then added to the total of 165 Forms S-1, SB-2 and F-1 filed by the subject companies in 2006.

additional Forms S-3 and F-3 will be filed over and above the number of total Forms S-3 and F-3 filed by small entities in calendar year 2006. The actual number could be more or less depending on various factors, including future market conditions.

To calculate the total effect of the proposed amendments on the overall compliance burden for small entities, we subtracted the burden associated with the 165 fewer Forms S-1, SB-2 and F-1 registration statements that we expect will be filed annually by small entities in the future and added the burden associated with our estimate of 182 additional Forms S-3 and F-3 filed annually by small entities as a result of the proposal. We used current Office of Management and Budget estimates in our calculation of the hours and cost burden associated with preparing, reviewing and filing each of these forms.

We estimate that 25% of the burden of preparation of Forms S-3, S-1, SB-2, F-3 and F-1 is carried by the small entity internally and that 75% of the burden is carried by outside professionals retained by the small entity at an average cost of \$400 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the small entity internally is reflected in hours.

The table below illustrates our estimates concerning the incremental annual compliance burden in hours and cost for Forms S-3, S-1, SB-2, F-3 and F-1 for small entities as a result of this proposal.

Form	Estimated Change in Annual Responses	Hours/Form ⁹⁷	Incremental Burden	25% Issuer	75% Professional	\$400/hr Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*\$400
S-3	182	459	83,538	20,884.5	62,653.5	\$25,061,400
S-1	(18)	1,176	(21,168)	(5,292)	(15,876)	(\$6,350,400)
SB-2	(147)	638	(93,786)	(23,446.5)	(70,339.5)	(\$28,135,800)
F-3	0	166	0	0	0	\$0
F-1	0	1,809	0	0	0	\$0
Total			(31,416)	(7,854)	(23,562)	(\$9,424,800)

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed amendments could have an effect that we have not considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

F. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no federal rules that conflict with or completely duplicate the proposed amendments.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposal, the Regulatory Flexibility Act requires that we consider the following alternatives:

1. establishing different compliance or reporting requirements which take into account the resources available to smaller entities;
2. the clarification, consolidation or simplification of disclosure for small entities;
3. use of performance standards rather than design standards; and
4. exempting smaller entities from coverage of the disclosure requirements, or any part thereof.

⁹⁷ This reflects current Office of Management and Budget estimates.

Of these alternatives, only the last appears germane to this proposal. Alternative 3 is not applicable, as the distinction between performance standards and design standards has no bearing on the proposed amendments. Alternatives 1 and 2, because they pertain to establishing different or simplified reporting requirements for smaller entities, also would not seem helpful in this instance because our proposal, if adopted, would reduce the compliance burden on eligible smaller entities. Regarding Alternative 4, we considered relaxing the transaction eligibility requirements for Forms S-3 and F-3 to a greater degree than we are proposing. As discussed above in this release, some have advocated in favor of allowing primary offerings on Form S-3 by all companies that have been reporting under the Exchange Act for at least one year and are current in their Exchange Act reporting at the time of filing. As we stated, however, we decline at this time to propose a less restrictive eligibility requirement. We believe that imposing the 20% limitation on the amount of securities that smaller public companies may sell pursuant to primary offerings on Forms S-3 and F-3, as described, strikes the appropriate balance between helping to facilitate capital formation through the securities markets and our primary objective of investor protection.

H. Solicitation of Comment

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- the number of small entity issuers that may be affected by the proposed revisions to Forms S-3 and F-3;
- the existence or nature of the potential impact of the proposed revisions on small entity issuers discussed in the analysis; and
- how to quantify the impact of the proposed revisions.

Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed revisions are adopted, and will be placed in the same public file as comments on the proposed amendments.

VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,⁹⁸ a rule is “major” if it has resulted, or is likely to result in:

- an annual effect on the U.S. economy of \$100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment or innovation.

We request comment on whether our proposal would be a “major rule” for purposes of the Small Business Regulatory Enforcement Fairness Act. We solicit comment and empirical data on:

- the potential effect on the U.S. economy on an annual basis;
- any potential increase in costs or prices for consumers or individual industries; and
- any potential effect on competition, investment, or innovation.

VII. Statutory Authority and Text of the Amendments

The amendments described in this release are being proposed under the authority set forth in §§ 6, 7, 8, 10 and 19(a) of the Securities Act, as amended.

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

⁹⁸ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II, of the Code of Federal Regulations as follows:

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for part 239 is revised to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 77mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Amend Form S-3 (referenced in §239.13) by adding General Instruction I.B.6. to read as follows:

Note -The text of Form S-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form S-3 * * *

B. Transaction Requirements. * * *

6. Limited Primary Offerings by Certain Other Registrants. Securities to be offered for cash by or on behalf of a registrant; provided that:

(a) the aggregate market value of securities sold by or on behalf of the registrant pursuant to this Instruction I.B.6. during the period of 12 calendar months immediately prior to, and including, the sale is no more than 20% of the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant; and

(b) the registrant is not a shell company (as defined in §230.405 of this chapter) and has not been a shell company for at least 12 calendar months previously and if it has been a shell company at any time previously, has filed current Form 10 information with the Commission at least 12 calendar months previously reflecting its status as an entity that is not a shell company.

Instructions.

1. “Common equity” is as defined in Securities Act Rule 405 (§230.405 of this chapter). For purposes of computing the aggregate market value of the registrant’s outstanding voting and non-voting common equity pursuant to General Instruction I.B.6., registrants shall use 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 sale. See the definition of “affiliate” in Securities Act Rule 405 (§230.405 of this chapter).

2. For purposes of computing the aggregate market value of all securities sold by or on behalf of the registrant in offerings pursuant to General Instruction I.B.6. during any period of 12 calendar months, registrants shall aggregate the gross proceeds of such sales; provided, that, in the case of derivative securities convertible into or exercisable for shares of the registrant’s common equity, registrants shall calculate the aggregate market value of any underlying equity shares in lieu of the market value of the derivative securities. The aggregate market value of the underlying equity shall be calculated by multiplying the maximum number of common equity shares into which the derivative securities are convertible or for which they are exercisable as of a date within 60 days prior to the date of sale, by the same per share market price of the registrant’s equity used for purposes of calculating the aggregate market value of the registrant’s outstanding

voting and non-voting common equity pursuant to Instruction 1 to General Instruction I.B.6. If the derivative securities have been converted or exercised, the aggregate market value of the underlying equity shall be calculated by multiplying the actual number of shares into which the securities were converted or received upon exercise, by the market price of such shares on the date of conversion or exercise.

3. If the aggregate market value of the registrant's outstanding voting and non-voting common equity computed pursuant to General Instruction I.B.6. equals or exceeds \$75 million subsequent to the effective date of this registration statement, then the 20% limitation on sales specified in General Instruction I.B.6(a) shall not apply to additional sales made pursuant to this registration statement on or subsequent to such date and instead the registration statement shall be considered filed pursuant to General Instruction I.B.1.

4. The term "Form 10 information" means the information that is required by Form 10, Form 10-SB, or Form 20-F (§249.210, §249.210b, or §249.220f of this chapter), as applicable to the registrant, to register under the Securities Exchange Act of 1934 each class of securities being registered using this form. A registrant may provide the Form 10 information in another Commission filing with respect to the registrant.

5. The date used in Instruction 2 to General Instruction I.B.6. shall be the same date used in Instruction 1 to General Instruction I.B.6.

6. A registrant's eligibility to register a primary offering on Form S-3 pursuant to General Instruction I.B.6. does not mean that the registrant meets the requirements of Form S-3 for purposes of any other rule or regulation of the Commission apart from Rule 415(a)(1)(x) (§230.415(a)(1)(x)) of this chapter).

* * * * *

3. Amend Form F-3 (referenced in §239.33) by adding General Instruction I.B.5. to read as follows:

Note -The text of Form F-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM F-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form F-3 * * *

B. Transaction Requirements. * * *

5. Limited Primary Offerings by Certain Other Registrants. Securities to be offered for cash by or on behalf of a registrant; provided that:

(a) the aggregate market value of securities sold by or on behalf of the registrant pursuant to this Instruction I.B.5. during the period of 12 calendar months immediately prior to, and including, the sale is no more than 20% of the aggregate market value worldwide of the voting and non-voting common equity held by non-affiliates of the registrant; and

(b) the registrant is not a shell company (as defined in §230.405 of this chapter) and has not been a shell company for at least 12 calendar months previously and if it has been a shell company at any time previously, has filed current Form 10 information with the Commission at least 12 calendar months previously reflecting its status as an entity that is not a shell company.

Instructions.

1. “Common equity” is as defined in Securities Act Rule 405 (§230.405 of this chapter). For purposes of computing the aggregate market value of the registrant’s outstanding voting and non-voting common equity pursuant to General Instruction I.B.5., registrants shall use 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 sale. See the definition of “affiliate” in Securities Act Rule 405 (§230.405 of this chapter).

2. For purposes of computing the aggregate market value of all securities sold by or on behalf of the registrant in offerings pursuant to General Instruction I.B.5. during any period of 12 calendar months, registrants shall aggregate the gross proceeds of such sales; provided, that, in the case of derivative securities convertible into or exercisable for shares of the registrant’s common equity, registrants shall calculate the aggregate market value of any underlying equity shares in lieu of the market value of the derivative securities. The aggregate market value of the underlying equity shall be calculated by multiplying the maximum number of common equity shares into which the derivative securities are convertible or for which they are exercisable as of a date within 60 days prior to the date of sale, by the same per share market price of the registrant’s equity used for purposes of calculating the aggregate market value of the registrant’s outstanding voting and non-voting common equity pursuant to Instruction 1 to General Instruction I.B.5. If the derivative securities have been converted or exercised, the aggregate market value of the underlying equity shall be calculated by multiplying the actual number of shares into which the securities were converted or received upon exercise, by the market price of such shares on the date of conversion or exercise.

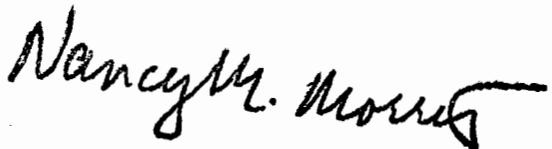
3. If the aggregate market value of the registrant's outstanding voting and non-voting common equity computed pursuant to General Instruction I.B.5. equals or exceeds \$75 million subsequent to the effective date of this registration statement, then the 20% limitation on sales specified in General Instruction I.B.5(a) shall not apply to additional sales made pursuant to this registration statement on or subsequent to such date and instead the registration statement shall be considered filed pursuant to General Instruction I.B.1.

4. The term "Form 10 information" means the information that is required by Form 10, Form 10-SB, or Form 20-F (§249.210, §249.210b, or §249.220f of this chapter), as applicable to the registrant, to register under the Securities Exchange Act of 1934 each class of securities being registered using this form. A registrant may provide the Form 10 information in another Commission filing with respect to the registrant.

5. The date used in Instruction 2 to General Instruction I.B.5. shall be the same date used in Instruction 1 to General Instruction I.B.5.

6. A registrant's eligibility to register a primary offering on Form F-3 pursuant to General Instruction I.B.5. does not mean that the registrant meets the requirements of Form F-3 for purposes of any other rule or regulation of the Commission apart from Rule 415(a)(1)(x) (§230.415(a)(1)(x)) of this chapter).

By the Commission.



Nancy M. Morris
Secretary

Dated: June 20, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210 and 240

[RELEASE NOS. 33-8811; 34-55930; File No. S7-24-06]

RIN 3235-AJ58

Definition of a Significant Deficiency

AGENCY: Securities and Exchange Commission.

ACTION: Request for additional comment.

SUMMARY: We are requesting additional comment on the definition of the term “significant deficiency.” Because this term is used in the Commission’s rules implementing Section 302 and Section 404 of the Sarbanes-Oxley Act, we believe that a definition of this term should also be in the Commission’s rules, in addition to being in the auditing standards.

DATES: Comment Date: Comments should be received on or before [insert date 24 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.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-24-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

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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 S7-24-06. 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 at (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, 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: N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551-3430, or Josh K. Jones, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551-5300, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are soliciting additional comment on Rule 12b-2¹ under the Securities Exchange Act of 1934 (the "Exchange Act")² and Rule 1-02³ of Regulation S-X.⁴

¹ 17 CFR 240.12b-2.

² 15 U.S.C. 78a et seq.

³ 17 CFR 210.1-02.

⁴ 17 CFR 210.1-01 et seq.

I. Background

The Commission's rules implementing the requirements of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")⁵ require management to disclose to both the audit committee and the external auditor all "material weaknesses" and "significant deficiencies" identified based upon management's evaluation.⁶ In adopting rules to implement these sections of Sarbanes-Oxley, the Commission indicated that these terms had the same meaning for purposes of the Commission's rules as they had under generally accepted auditing standards and therefore, did not specifically define them. Subsequent to the Commission's adoption of rules implementing Sections 302 and 404 of Sarbanes-Oxley, the Public Company Accounting Oversight Board ("PCAOB") adopted Auditing Standard No. 2,⁷ which revised these definitions. Since the Commission's intention in the Adopting Release was to refer to the definition used by auditors of public companies, the Commission staff issued an interpretation indicating that the PCAOB's definition of these terms would apply to the Section 404 rules issued by the Commission.⁸

More recently, as part of the Commission's project providing more guidance to management on completing its evaluation and assessment of internal control over financial reporting ("ICFR") in accordance with Section 404 of Sarbanes-Oxley, the

⁵ 15 U.S.C. 7262.

⁶ Release No. 33-8238 (Jun. 5, 2003) [68 FR 36636, Jun. 18, 2003], referred to herein as the "Adopting Release."

⁷ An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.

⁸ See, for example, question 13 of Office of the Chief Accountant and Division of Corporation Finance: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised Oct. 6, 2004), available at <http://www.sec.gov/info/accountants/controlfaq1004.htm>.

Commission initially sought comment on the both the terms “significant deficiency” and “material weakness” in its concept release on ICFR requirements,⁹ and then proposed and adopted a definition for only the term “material weakness.”¹⁰ As part of that rulemaking process, commenters pointed out that while the December proposing release¹¹ referenced significant deficiencies, the Commission did not include a definition of significant deficiency within the proposal.¹² Certain commenters indicated that the Commission should include a definition of significant deficiency in the Interpretive Guidance.¹³

II. Discussion

As part of the Interpretive Guidance rulemaking process, the Commission determined that it was appropriate for the Commission to include in its rules definitions for certain integral terms associated with the Commission’s rules implementing Sarbanes-Oxley. Further, in light of the comments received in response to the proposed Interpretive Guidance, and because Commission rules implementing Section 302(a) of Sarbanes-Oxley require that management communicate significant deficiencies to the audit committee and the external auditors, the Commission has decided to solicit additional comment on a definition for “significant deficiency.” As a result, we are soliciting additional comment on amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term.

⁹ Release No. 34-54122 (Jul. 11, 2006) [71 FR 40866, Jul. 18, 2006] available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>.

¹⁰ Release No. 34-55929 (Jun. 20, 2007), and referred to herein as the “Interpretive Guidance.”

¹¹ Release Nos. 33-8762; 34-54976 (Dec. 20, 2006) [71 FR 77635, Dec. 27, 2006].

¹² See, for example, letters from Cardinal Health, Inc. (Cardinal), Edison Electric Institute, and Protiviti.

¹³ See, for example, letters from Cardinal and Protiviti.

The purpose of management's obligations with respect to significant deficiencies within the Commission's rules is to disclose those matters relating to ICFR that are of sufficient importance that they should be reported to the external auditor and to the audit committee so that these parties can more effectively carry out their respective responsibilities with regard to the company's financial reporting, but which do not require disclosure to investors. Including a definition of significant deficiency in Commission rules, in combination with the definition of material weakness, will provide a useful complement to the Commission's Interpretive Guidance by enabling management to refer to Commission rules and guidance for information on the meaning of these terms rather than the referring to the auditing standards.

In developing the definition, we considered comments received in response to the PCAOB's proposed auditing standard for audits of internal control over financial reporting. In its proposed auditing standard, the PCAOB proposed to define significant deficiency as "a control deficiency, or combination of control deficiencies such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected."¹⁴ Further, a significant misstatement was defined as "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting." In response to the comments received on their proposal, the PCAOB decided to modify their proposed definition in order to focus the auditor on the communication requirement surrounding the term "significant deficiency" and to provide clarity that

¹⁴ See PCAOB Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (Release Number 2006-007, Dec. 19, 2006).

auditors are not required to scope their audits to search for deficiencies that are less severe than a material weakness. We believe that the focus of the term “significant deficiency” should be the underlying communication requirement that results between management, audit committees and independent auditors. As such, we are soliciting comment on a definition that focuses squarely on matters that are important enough to merit attention by those responsible for oversight of the company’s financial reporting. Significant deficiency would be defined as “a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a registrant’s financial reporting.”¹⁵

The framework for the definition of significant deficiency varies from that recently adopted for “material weakness.” Unlike the term “material weakness,” we do not believe it is necessary for the definition of significant deficiency to explicitly include a likelihood component (that is, reasonable possibility) and that focusing on matters that are important enough to merit attention will allow for sufficient and appropriate judgment for management to determine the deficiencies that should be reported to the auditor and the audit committee.

III. Request for Comment

We request additional comment on defining the term “significant deficiency.” In addition to general comment, we encourage comments to address the following specific questions:

¹⁵ This definition of “significant deficiency” is also used in Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, which was approved by the PCAOB on May 24, 2007.

- Would the definition of a “significant deficiency” facilitate more effective and efficient certification of quarterly and annual reports if it were defined as discussed above?
- Conversely, should the definition of “significant deficiency” include a likelihood component or other specific criteria? If so, should we align such a definition with the PCAOB’s auditing standard, and how?
- We do not anticipate that the definition will impact the amount of time it takes for management to evaluate whether identified deficiencies are significant deficiencies, nor do we anticipate that this definition will affect any existing collection of information. However, are there any additional costs or burdens involved in evaluating whether identified deficiencies meet the definition of significant deficiency? If so, what are the types of costs, and the anticipated amounts? In what way can the definition be further modified to mitigate such costs while still appropriately describing deficiencies that should be disclosed to audit committees and auditors?
- We believe one of the benefits of the definition is that it focuses on the desired result of identifying matters that are important enough to merit attention, which will allow management to use sufficient and appropriate judgment to determine the deficiencies that should be reported to the auditor and the audit committee while allowing management to use its judgment to determine what those matters are. Are there additional potential benefits we have not considered? Additionally, a potential consequence of the definition is that, due to the flexibility provided in the definition, there may be less

comparability among companies in terms of what management determines is a significant deficiency. Is this accurate? Are there other potential costs or burdens? How should we mitigate such costs or burdens?

- Is there any special impact of the definition of significant deficiency on smaller public companies? If so, what is that impact and how should we address it?

* * * * *

By the Commission.



Nancy M. Morris
Secretary

June 20, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229 and 240

[RELEASE NOS. 33-8809; 34-55928; FR-76; File No. S7-24-06]

RIN 3235-AJ58

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting an amendment to our rules to clarify that an evaluation which complies with the Commission's interpretive guidance published in this issue of the Federal Register in Release No. 34-55929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting. We are also amending our rules to define the term material weakness and to revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting. The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors.

EFFECTIVE DATE: [insert date 60 days after publication in the Federal Register], except the amendment to §210.2-02T, is effective until June 30, 2009.

FOR FURTHER INFORMATION CONTACT: N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551-3430, or Josh K. Jones, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551-5300, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

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SUPPLEMENTARY INFORMATION: We are adopting amendments to Rules 13a-15(c),¹ 15d-15(c),² and 12b-2³ under the Securities Exchange Act of 1934 (the “Exchange Act”),⁴ Rules 1-02,⁵ 2-02⁶ and 2-02T⁷ of Regulation S-X,⁸ and Item 308 of Regulations S-B and S-K.⁹

In a companion release issued in today’s Federal Register, we are issuing interpretive guidance to assist companies of all sizes in completing top-down, risk-based evaluations of internal control over financial reporting.¹⁰ In addition, we are issuing a release to request additional comment on the definition of the term “significant deficiency.”¹¹

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¹ 17 CFR 240.13a-15(c).

² 17 CFR 240.15d-15(c).

³ 17 CFR 240.12b-2.

⁴ 15 U.S.C. 78a *et seq.*

⁵ 17 CFR 210.1-02.

⁶ 17 CFR 210.2-02.

⁷ 17 CFR 210.2-02T.

⁸ 17 CFR 210.1-01 *et seq.*

⁹ 17 CFR 228.308 and 229.308.

¹⁰ Release No. 34-55929 (Jun. 20, 2007) (hereinafter “Interpretive Guidance”).

¹¹ Release No. 34-55930 (Jun. 20, 2007).

B. Rules 1-02 and 2-02 of Regulation S-X and Item 308 of Regulations S-B and S-K

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IX. Statutory Authority and Text of Rule Amendments

I. BACKGROUND

In implementing Section 404(a) of the Sarbanes-Oxley Act of 2002¹² (“Sarbanes-Oxley”), the Commission adopted amendments to Exchange Act Rules 13a-15 and 15d-15 to require companies, other than registered investment companies, to include in their annual reports filed pursuant to Section 13(a) or 15(d)¹³ of the Exchange Act a report by management on the company’s internal control over financial reporting (“ICFR”) and a

¹² 15 U.S.C. 7262.

¹³ 15 U.S.C. 78m(a) or 78o(d).

registered public accounting firm's attestation report on ICFR. Rules 13a-15 and 15d-15 also require management of each company to evaluate the effectiveness, as of the end of each fiscal year, of the company's ICFR.¹⁴

On December 20, 2006, the Commission issued a proposing release that contained interpretive guidance for management ("Proposed Interpretive Guidance") regarding its required evaluation of ICFR and amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) to make it clear that an evaluation conducted in accordance with the Proposed Interpretive Guidance was one way to satisfy the annual management evaluation required by those rules. In addition, we proposed amendments to Rule 2-02(f) of Regulation S-X to require that the registered public accounting firm's attestation report on ICFR express a single opinion directly on the effectiveness of ICFR, and to clarify the circumstances in which we would expect that the accountant cannot express an opinion on ICFR. We also proposed amendments to Rule 1-02(a)(2) of Regulation S-X to revise the definition of attestation report to conform it to the proposed changes to Rule 2-02(f).¹⁵

We received over 200 comment letters in response to our Proposing Release.¹⁶ These letters came from corporations, professional associations, large and small accounting firms, law firms, consultants, academics, investors and other interested parties. Of these, approximately 70 respondents commented on the proposed rule

¹⁴ Release No. 33-8238 (June 5, 2003) [68 FR 36636] (hereinafter "Adopting Release"). See Release No. 33-8392 (Feb. 24, 2004) [69 FR 9722] for compliance dates applicable to accelerated filers. See Release No. 33-8760 (Dec. 15, 2006) [71 FR 76580] for compliance dates applicable to non-accelerated filers.

¹⁵ Release Nos. 33-8762; 34-54976 (Dec. 20, 2006) [71 FR 77635] (hereinafter "Proposing Release").

¹⁶ The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549 in File No. S7-24-06, or may be viewed at <http://www.sec.gov/comments/s7-24-06/s72406.shtml>.

amendments. We have reviewed and considered all of the comments that we received on the proposed rule amendments. The adopted rules reflect changes made in response to many of these comments. We discuss our conclusions with respect to each proposed rule amendment and the related comments in more detail throughout this release.

II. DISCUSSION OF AMENDMENTS

A. Exchange Act Rules 13a-15(c) and 15d-15(c)

1. Proposal

Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer subject to the Exchange Act reporting requirements, other than a registered investment company, to evaluate the effectiveness of the issuer's ICFR as of the end of each fiscal year. We proposed to amend these rules to state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR, an evaluation conducted in accordance with the Proposed Interpretive Guidance would satisfy the evaluation requirement in those rules.

2. Comments on the Proposal

While many commenters supported the proposed amendments to Rules 13a-15 and 15d-15,¹⁷ some expressed the view that although the guidance is appropriately principles-based, the nature of the requirements set forth in the Proposed Interpretive Guidance is not well-suited to the type of safe-harbor protection intended by the

¹⁷ See, for example, letters from America's Community Bankers (ACB), BP p.l.c. (BP), Business Roundtable, Enbridge Inc., European Association of Listed Companies, Hudson Financial Solutions (Hudson), ING Groep N.V. (ING), PPL Corporation (PPL), Silicon Valley Leadership Group (SVLG), The Hundred Group of Finance Directors (100 Group), and UnumProvident Corporation (UnumProvident).

amendments.¹⁸ For instance, three commenters suggested that the Proposed Interpretive Guidance does not contain specific, objective criteria that a company's management could use to demonstrate that its evaluation complies with the requirements of the Proposed Interpretive Guidance.¹⁹ Consequently, two of these commenters went on to conclude that the amendments may eventually lead to the Interpretive Guidance being viewed as an exclusive evaluation approach. In light of these and similar concerns, one commenter suggested broadening the amended rule language to explicitly indicate that an evaluation provides a reasonable basis for management's ICFR assessment if it includes: (1) an identification of the risks that are reasonably likely to result in a material misstatement of the company's financial statements; (2) an evaluation of whether the company has placed controls in operation that are designed to address those risks; and (3) a risk-based process for gathering and evaluating evidence regarding the effective operation of those controls.²⁰

One commenter opposed both the Proposed Interpretive Guidance and the proposed rule amendments and expressed the view that management will, as a result of the nature of the Proposed Interpretive Guidance, claim the protection afforded by the amendments for deficient evaluations.²¹ Another commenter expressed the view that the

¹⁸ See, for example, letters from American Electronics Association (AeA), James J. Angel, Cleary Gottlieb Steen & Hamilton LLP (Cleary), Financial Reporting Committee of the Association of the Bar of the City of New York (NYC Bar), and U.S. Chamber of Commerce (Chamber).

¹⁹ See, for example, letters from Cleary, NYC Bar, and Reznick Group, P.C.

²⁰ See letter from Cleary.

²¹ See joint letter from Consumer Federation of America, Consumer Action, and U.S. Public Interest Research Group.

proposed rule amendments could result in a “minimalist” attitude towards the internal control evaluation on the part of management.²²

3. Final Rule

After consideration of the comments that we received, we have determined to adopt the amendments to Rules 13a-15(c) and 15d-15(c) as proposed. The amended rules state that there are many different ways to conduct an evaluation that will satisfy the evaluation requirement in the rules, and the Interpretive Guidance clearly states that compliance with the guidance is voluntary. Therefore, concerns that the amendments may cause confusion as to whether compliance with the Interpretive Guidance is mandatory or may result in an exclusive standard are unfounded. We understand that many companies already complying with the Section 404 requirements have established an ICFR evaluation process that may differ from the approach described in the Interpretive Guidance. There is no requirement for these companies to alter their procedures to align them with the Interpretive Guidance.

We have decided not to broaden the amended rule language to include factors to consider in determining whether alternative methods satisfy the standard primarily because we think this type of “broadening” may actually limit the potential universe of acceptable evaluation methods. For example, while we believe the Interpretive Guidance’s top-down, risk-based approach will result in both effective and efficient evaluations of the effectiveness of ICFR, management may choose to establish an alternative evaluation approach. An alternative approach may be deemed preferable if it complements a company’s existing quality improvement processes or enterprise risk

²² See letter from Tatum LLC.

management methodologies and still provides management with a reasonable basis for its assessment of ICFR effectiveness. Therefore, we do not think it is appropriate or necessary to mandate the approach set forth in the Interpretive Guidance.

Regarding the comments expressing concern that the principles-based nature of the Proposed Interpretive Guidance may not easily lend itself to the safe-harbor type provisions, we acknowledge that the amendments to Rules 13a-15 and 15d-15 are of a somewhat different nature from other safe-harbor provisions, which typically prescribe very specific conditions that must be met before a company or person may claim protection under the safe-harbor. Nonetheless, we believe establishing the Interpretive Guidance as one way to satisfactorily evaluate ICFR will serve the important purpose of communicating the objectives and requirements of the ICFR evaluation. Moreover, most commenters preferred that the guidance for conducting an evaluation of ICFR be issued on an interpretive basis rather than codified as a rule.²³ Accordingly, a direct reference in the rules to the Interpretive Guidance will help ensure that companies are aware of the guidance.

We are issuing the Interpretive Guidance, and taking a series of other steps, to improve and strengthen implementation of the ICFR requirements. Regardless of whether management uses the Interpretive Guidance, we remain committed to a strong implementation of the ICFR requirements and to ensuring that issuers perform a sufficient evaluation. As is currently the case, the sufficiency of an evaluation will be determined based on each issuer's particular facts and circumstances.

²³ Approximately thirty-three commenters directly responded to the question about whether the guidance should be issued as an interpretation or codified as a Commission rule. Approximately 70% of such respondents indicated that the guidance should be issued as an interpretation.

B. Rules 1-02 and 2-02 of Regulation S-X and Item 308 of Regulations S-B and S-K

1. Proposal

Rule 2-02(f) of Regulation S-X requires the registered public accounting firm's attestation report on management's assessment of ICFR to clearly state the "opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's ICFR is fairly stated in all material respects." The term "assessment" as used in Rule 2-02(f) refers to management's disclosure of its conclusion about the effectiveness of the company's ICFR, not the efficacy of the process followed by management to arrive at its conclusion. To more effectively communicate the auditor's responsibility in relation to management's assessment, we proposed to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. We believe this opinion necessarily conveys whether the disclosure of management's assessment is fairly stated. In addition, we proposed revisions to Rule 2-02(f) to clarify the rare circumstances in which the accountant would be unable to express an opinion.

We also proposed conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. The PCAOB proposed a conforming revision to its auditing standard to reflect this revision as well.²⁴

2. Comments on the Proposal

We received comments on the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the effectiveness of ICFR by the auditor in the attestation report on ICFR. Those who

²⁴ PCAOB Release No. 2006-007: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements. See http://www.pcaobus.org/Rules/Docket_021/index.aspx (hereinafter "Proposed Auditing Standard").

commented on this proposed amendment were equally divided, with approximately one-half supporting the Commission's proposal to eliminate the auditor's opinion on management's assessment of the effectiveness of ICFR,²⁵ and the other half expressing the view that, although the reduction to one opinion by the auditor was preferable, the opinion retained would limit improvements in the efficiency of the 404 process.²⁶

Commenters who supported the Commission's proposal believe that an auditor's opinion directly on the effectiveness of a company's ICFR provides investors with a higher level of assurance than the opinion only on management's assessment. These commenters also suggested that an audit opinion directly on the effectiveness of ICFR was a clearer expression of the scope of the auditor's work. However, those who opposed the Commission's proposal argued that an audit opinion directly on the effectiveness of ICFR would require duplicative, unnecessary and excessive testing by auditors and would therefore lead to higher audit costs.²⁷ These commenters suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. They acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and

²⁵ See, for example, letters from Banco Itaú Holding Financeira SA, BP, Cisco Systems, Inc. (Cisco), Computer Sciences Corporation (CSC), Eli Lilly and Company (Eli Lilly), Frank Consulting, PLLP, Grant Thornton LLP, Kimball International (Kimball), Lubrizol Corporation (Lubrizol), MetLife, Inc. (MetLife), NYC Bar, PPG Industries, Inc. (PPG), The Procter & Gamble Company (P&G), and RAM Energy Resources, Inc.

²⁶ See, for example, letters from 100 Group, Alamo Group, Association of Chartered Certified Accountants (ACCA), BHP Billiton Limited (BHP), European Federation of Accountants (FEE), The Financial Services Roundtable (FSR), Hess Corporation (Hess), Hutchinson Technology Inc. (Hutchinson), Institute of Internal Auditors (IIA), Institute of Management Accountants (IMA), Institut Der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW), Ian D. Lamdin (I. Lamdin), Matthew Leitch, Nasdaq Stock Market, Inc. (Nasdaq), National Venture Capital Association (NVCA), Nike, Inc. (Nike), Robert F. Richter (R. Richter), Rod Scott, Southern Company (Southern), and SVLG.

²⁷ See, for example, letters from 100 Group, ACCA, Hess, Nasdaq, Nike, and Southern.

testing management's assessment process; however, they expected that the auditor's own testing could be significantly reduced from the scope required to render an opinion directly on the effectiveness of ICFR.²⁸ Additionally, commenters were concerned that the proposed rule change was in direct conflict with Section 404(b) of Sarbanes-Oxley, which explicitly calls for the auditor to issue an attestation report on management's assessment of the effectiveness of ICFR.²⁹

In view of the proposal to require only one opinion by the auditor in its report on the effectiveness of a company's ICFR, commenters thought that continued references in Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to an "attestation report on management's assessment of internal control over financial reporting" would be confusing.³⁰ These commenters suggested that we eliminate these references and refer to the auditor's report only as an "attestation report on internal control over financial reporting."

3. Final Rule

After consideration of the comments, we have decided to adopt the proposed amendments to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the effectiveness of ICFR by the auditor in its attestation report on ICFR because it more effectively communicates the auditor's responsibility in relation to management's process and necessarily conveys whether management's assessment is fairly stated. In view of this decision, we agree with commenters that Rules 1-02(a)(2) and 2-02(f) of Regulation S-X will be clearer if they refer to the

²⁸ See, for example, letters from BHP and NVCA.

²⁹ See, for example, letters from FEE, FSR, Hutchinson, IDW, IIA, IMA, I. Lamdin, and R. Richter.

³⁰ See, for example, letters from 100 Group, BDO Seidman LLP, Cleary, Financial Executives International Committee on Corporate Reporting (FEI CCR), Manulife Financial (Manulife), Microsoft Corporation (MSFT), Neenah Paper, Inc (Neenah), and NYC Bar.

auditor's report as an "attestation report on internal control over financial reporting" rather than an "attestation report on management's assessment of internal control over financial reporting." We, therefore, have made this change. We also have made conforming changes to Rule 2-02T of Regulation S-X and Item 308 of Regulations S-B and S-K.³¹

Despite the fact that the revised rules no longer require the auditor to separately express an opinion concerning management's assessment of the effectiveness of the company's ICFR, auditors currently are required under Auditing Standard No. 2 ("AS No. 2"),³² and would continue to be required under the Proposed Auditing Standard, to evaluate whether management has included in its annual ICFR assessment report all of the disclosures required by Item 308 of Regulations S-B and S-K. Both AS No. 2 and the Proposed Auditing Standard would require the auditor to modify its audit report on the effectiveness of ICFR if the auditor determines that management's assessment of ICFR is not fairly stated. Consequently, the revisions are fully consistent with, and will continue to achieve, the objectives of Section 404(b) of Sarbanes-Oxley.

In considering the concerns raised by commenters about the scope of auditor testing that is required to render an opinion directly on the effectiveness of ICFR, the Commission believes that an auditing process that is restricted to evaluating what management has done would not necessarily provide the auditor with a sufficient level of assurance to render an independent opinion as to whether management's assessment (that is, conclusion) about the effectiveness of ICFR is correct. Moreover, the PCAOB's

³¹ Item 308 sets forth the ICFR disclosure that must be included in a company's annual and quarterly reports.

³² An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.

auditing standards with respect to a company's ICFR derive from both Section 103(a)(2)(A)(iii) and Section 404(b) of Sarbanes-Oxley. Section 404(b) of Sarbanes-Oxley requires the auditor to "attest to, and report on, the assessment made by the management of the issuer." Section 103(a)(2)(A)(iii) of Sarbanes-Oxley requires that each audit report describe the scope of the auditor's testing of the internal control structure and procedures and present, among other information: (1) the findings of the auditor from such testing; (2) an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles; and (3) a description of material weaknesses in such internal controls.³³

The Commission believes that an audit opinion directly on the effectiveness of ICFR is consistent with both Section 404 and Section 103 of Sarbanes-Oxley. Further, the Commission believes that the expression of a single opinion directly on the

³³ Section 103(a)(2)(A)(iii) states that "each registered public accounting firm shall -- describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) --

- (I.) the findings of the auditor from such testing;
- (II.) an evaluation of whether such internal control structure and procedures --
 - (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- (III.) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing."

effectiveness of ICFR clarifies that an auditor is not responsible for issuing an opinion on management's process for evaluating ICFR.

C. Definition of Material Weakness

1. Proposal

The Proposed Interpretive Guidance defined a material weakness as a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR. Further, we indicated that the definition formulated in the proposal was intended to be consistent with its use in existing auditing literature and practice.³⁴

2. Comments on the Proposal

Commenters expressed concern about differences between our proposed definition of material weakness and that proposed by the PCAOB in its Proposed Auditing Standard and requested that the two definitions be aligned.³⁵ Commenters also suggested that a single definition of material weakness be established for use by both auditors and management. They further thought that we should codify the definition in our rules.³⁶

In addition, commenters pointed out that while the Proposed Interpretive Guidance referred to significant deficiencies, the Commission did not include a definition

³⁴ The PCAOB's Proposed Auditing Standard provided the following definition of material weakness: "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected."

³⁵ See, for example, letters from Edison Electric Institute (EEI), FEI CCR, Financial Executives International Small Public Company Task Force (FEI SPCTF), The Institute of Chartered Accountants in England and Wales (ICAEW), Nina Stofberg, and SVLG.

³⁶ See, for example, letters from FEE and ICAEW.

of significant deficiency within the Proposed Interpretive Guidance.³⁷ Despite the fact that the Proposed Interpretive Guidance did not include a definition of significant deficiency, commenters on this topic provided feedback about both the Commission's proposed definition of material weakness and the definition of significant deficiency as proposed by the PCAOB.³⁸ Certain commenters indicated that the Commission should include a definition of significant deficiency in the Interpretive Guidance.³⁹

Commenters also provided feedback on the probability language in the definition of material weakness. Commenters expressing support for the "reasonable possibility" standard in the proposed definition⁴⁰ noted that this language improves the clarity of the existing definition and will reduce time spent evaluating deficiencies.⁴¹ In contrast, other commenters felt that the probability standard should be changed.⁴² These commenters noted that the meaning of "reasonably possible" was the same as "more than remote" and therefore would not reduce the effort devoted to identifying and analyzing deficiencies. Two of these commenters suggested the Commission use a "reasonable likelihood"

³⁷ See, for example, letters from Cardinal Health, Inc. (Cardinal), EEI, and Protiviti.

³⁸ The PCAOB's Proposed Auditing Standard provided the following definition of significant deficiency: "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." A significant misstatement was defined as "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

³⁹ See, for example, letters from Cardinal and Protiviti.

⁴⁰ See, for example, letters from Cisco, FEI CCR, Hudson, MetLife, MSFT, and P&G.

⁴¹ See, for example, letters from Cisco, Committee on Capital Markets Regulation (CCMR), FEI SPCTF, Hudson, MetLife, MSFT, Nike, P&G, and TechNet.

⁴² See, for example, letters from the American Bar Association's Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law (ABA), ACCA, Cardinal Health, Inc., Chamber, CSC, IIA, Kimball, and NYC Bar.

standard,⁴³ and another suggested the Commission change to a “greater than fifty-percent” standard.⁴⁴ Commenters also requested additional guidance about how the concept of “materiality” impacted the definition.⁴⁵

Most of the commenters who addressed the reference to interim financial statements in the definition of material weakness indicated that the word “interim” should be removed from the definition,⁴⁶ with only one commenter expressing the view that the reference to interim financial statements should remain in the definition.⁴⁷ Some commenters who suggested removal of “interim” expressed the view that because Section 404 of Sarbanes-Oxley mandates an annual assessment of ICFR, the deficiency evaluation should also be based on the impact to the annual financial statements. Others stated that the removal of “interim” would allow management and auditors to better focus on the annual financial statements when evaluating the materiality of control deficiencies.

3. Final Rule

After consideration of the comments received, we have determined that it is appropriate for the Commission’s rules to include the definition of material weakness since it is an integral term associated with Sarbanes-Oxley and the Commission’s implementing rules. Management’s disclosure requirements with respect to ICFR are predicated upon the existence of a material weakness; therefore, we agree with the commenters’ suggestion that our rules should define this term, rather than refer to

⁴³ See letters from NYC Bar and Cleary.

⁴⁴ See letter from ABA.

⁴⁵ See, for example, letters from ABA, CCMR, CSC, Independent Community Bankers of America, ISACA and IT Governance Institute, P&G, and Rockwood Holdings, Inc.

⁴⁶ See, for example, letters from ABA, Cisco, Deloitte & Touche LLP, EEI, Eli Lilly, FEI CCR, FEI SPCTF, Ford Motor Company, MSFT, P&G, and PPL.

⁴⁷ See letter from MetLife.

auditing literature. As a result, we are amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term material weakness.

We have decided to adopt the material weakness definition substantially as proposed. The Commission has determined that the proposed material weakness definition appropriately describes those conditions in ICFR that, if they exist, should be disclosed to investors and should preclude a conclusion that ICFR is effective.

Therefore, our final rules define a material weakness as a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.⁴⁸ We anticipate that the PCAOB's auditing standards will also include this definition of material weakness.

After consideration of the proposed alternatives to the "reasonable possibility" standard in the proposed definition of material weakness, we decided not to change the proposed standard. Revisions that have the effect of increasing the likelihood (that is, risk) of a material misstatement in a company's financial reports that can exist before being disclosed could give rise to questions about the meaning of a disclosure that ICFR is effective and whether the threshold for "reasonable assurance" is being lowered. Moreover, we do not believe improvements in efficiency arising from revisions to the likelihood element would be significant to the overall ICFR evaluation effort, due, in part, to our view that the effort evaluating deficiencies would be similar under the alternative standards (for example, "reasonable possibility" as compared to "reasonable likelihood"). Lastly, we do not believe the volume of material weakness disclosures,

⁴⁸ Exchange Act Rule 12b-2 and Rule 1-02(p) of Regulation S-X.

which has declined each year since the initial implementation of Section 404 of Sarbanes-Oxley, is too high such that investors would benefit from a reduction in disclosures that would result from a higher likelihood threshold.

Regarding the reference to interim financial statements in the definition of material weakness, while we believe annual materiality considerations are appropriate when making judgments about the nature and extent of evaluation procedures, we believe that the judgments about whether a control is adequately designed or operating effectively should consider the requirement to provide investors reliable annual and quarterly financial reports. Moreover, if management's annual evaluation identifies a deficiency that poses a reasonable possibility of a material misstatement in the company's quarterly reports, we believe management should disclose the deficiency to investors and not assess ICFR as effective. As such, we have not removed the reference to interim financial statements from the definition of material weakness.

In response to the comments regarding the need for the Commission to define the term "significant deficiency," we are seeking additional comment on a definition of that term as part of a separate release issued in the Federal Register.

III. TRANSITION ISSUES

Although the amendments to Rules 1-02 and 2-02 of Regulation S-X will no longer require the auditor to separately express an opinion concerning management's assessment of the effectiveness of the company's ICFR, audits conducted under AS No. 2 will continue to result in a separate opinion on management's assessment until the PCAOB's expected new auditing standard replacing AS No. 2 becomes effective and is required for all audits. Until such time, companies may file whichever report they

receive from their independent auditor (that is, either one that contains both opinions under AS No. 2 or the single opinion under the expected new auditing standard).

IV. BACKGROUND TO REGULATORY ANALYSES

Congress enacted the Sarbanes-Oxley Act in July 2002. Section 404 of the Act directed the Commission to prescribe rules requiring each issuer required to file an annual report under Section 13(a) or 15(d) of the Exchange Act⁴⁹ to prepare an internal control report. The only Exchange Act reporting companies that Congress exempted from the Section 404 requirements were investment companies registered under Section 8 of the Investment Company Act.⁵⁰

To fulfill its statutory mandate, the Commission adopted rules in June 2003 to require all Exchange Act reporting companies other than registered investment companies, regardless of their size, to include in their annual reports a report of management, and an accompanying auditor's report, on the effectiveness of the company's internal control over financial reporting ("ICFR").⁵¹

Although the Commission adopted rules in 2003 creating the obligation for all reporting companies to include ICFR reports in their annual reports, it provided a lengthy compliance period for non-accelerated filers, which are smaller public companies with a public float below \$75 million.⁵² Under the compliance dates that the Commission

⁴⁹ 15 U.S.C. 78m or 78o(d).

⁵⁰ 15 U.S.C. 80a-8.

⁵¹ Release No. 33-8238 (June 5, 2003) [68 FR 36636].

⁵² Although the term "non-accelerated filer" is not defined in Commission rules, we use it to refer to an Exchange Act reporting company that does not meet the Exchange Act Rule 12b-2 definition of either an "accelerated filer" or a "large accelerated filer."

originally established, non-accelerated filers would not have become subject to the ICFR requirements until they filed an annual report for a fiscal year ending on or after April 15, 2005. In contrast, accelerated filers and large accelerated filers – companies with a public float of \$75 million or more – became subject to the Section 404 requirements with respect to annual reports that they filed for fiscal years ending on or after November 15, 2004.

The Commission provided this lengthy compliance period for non-accelerated filers in light of both the substantial time and resources needed by accelerated filers to properly implement the rules. In addition, it believed that a corresponding benefit to investors would result from an extended transition period that allowed companies to carefully implement the new requirements. After each of the first two years accelerated-filers implemented the Section 404 requirements, the Commission held a roundtable discussion, and solicited comment on issues that arose during implementation.⁵³

Since the initial extension period, the Commission has further extended the compliance dates for non-accelerated filers. The Commission adopted the most recent compliance date extension for non-accelerated filers in December 2006.⁵⁴ This extension was based, in part, on a recommendation from the Commission's Advisory Committee on Smaller Public Companies ("Advisory Committee"). In its Final Report, issued on April 23, 2006, the Advisory Committee raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of Section 404. The

⁵³ As a result of which, the Commission and its staff issued guidance to assist companies in implementing these requirements.

⁵⁴ Release No. 33-8760 (Dec. 15, 2006) [71 FR 77635].

Advisory Committee identified as an overarching concern the difference in how smaller and larger public companies operate.

It focused in particular on three characteristics: (1) the limited number of personnel in smaller companies, which constrains the companies' ability to segregate conflicting duties; (2) top management's wider span of control and more direct channels of communication, which increase the risk of management override; and (3) the dynamic and evolving nature of smaller companies, which limits their ability to have static processes that are well-documented.⁵⁵

The Advisory Committee suggested that these characteristics create unique differences in how smaller companies achieve effective ICFR that may not be adequately accommodated in Auditing Standard No. 2 or other implementation guidance as currently applied in practice. In addition, the Advisory Committee noted serious ramifications for smaller public companies stemming from the cost of frequent documentation changes and sustained review and testing of controls perceived to be necessary to comply with the Section 404 requirements.

The Commission also granted the December 2006 extension in view of a series of actions that the Commission and the PCAOB each announced on May 17, 2006 that they intended to take to improve the implementation of the Section 404 requirements. These actions included:

⁵⁵ Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006) ("Advisory Committee Report") available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

- Issuance of a Concept Release soliciting comment on a variety of issues that might be included in future Commission guidance for management to assist in its performance of a top-down, risk-based assessment of ICFR;
- Consideration of additional guidance from COSO on understanding and applying the COSO framework;⁵⁶
- Revisions to Auditing Standard No. 2;
- Reinforcement of auditor efficiency through PCAOB inspections and Commission oversight of the PCAOB's audit firm inspection program;
- Development, or facilitation of development, of implementation guidance for auditors of smaller public companies; and
- Continuation of PCAOB forums on auditing in the small business environment.

Pursuant to the most recent extension of the compliance dates, non-accelerated filers are scheduled to begin including a management report on ICFR in their annual reports filed for a fiscal year ending on or after December 15, 2007, and an auditor's report on ICFR for a fiscal year ending on or after December 15, 2008. It was our intention that non-accelerated filers would be able to complete their assessment of internal control without engaging an independent auditor during the first year. In addition, to eliminate second-guessing of management that might result from separating the management and auditor reports, the rules provide that the management report

⁵⁶ On July 11, 2006, COSO issued guidance entitled "Internal Control Over Financial Reporting - Guidance for Smaller Public Companies" that was designed primarily to help management of smaller public companies with establishing and maintaining effective ICFR.

included in a non-accelerated filer's annual report during the first year of compliance is deemed to be "furnished" rather than "filed."⁵⁷

The December 2006 extension of the management report requirement was intended to provide the non-accelerated filers with the benefit of both the Commission's management guidance and the COSO guidance for smaller companies before planning and conducting their initial ICFR assessments. The extension of the auditor report requirement was intended to:

- Afford non-accelerated filers and their auditors the benefit of anticipated changes to the PCAOB's Auditing Standard No. 2, and any implementation guidance issued by the PCAOB for auditors of non-accelerated filers;
- Save non-accelerated filers the costs of the auditor attestation to, and report on, management's initial assessment of ICFR;
- Enable management of non-accelerated filers to more gradually prepare for full compliance with the Section 404 requirements and to gain some efficiencies in the process of reviewing and evaluating the effectiveness of ICFR before becoming subject to the requirement that the auditor report on ICFR (and to permit investors to see and evaluate the results of management's first compliance efforts); and
- Provide the Commission with the flexibility to consider any comments it received on the Concept Release and the proposed guidance for

⁵⁷ Management's report is not deemed to be filed for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r] or otherwise subject to the liabilities of that section, unless the issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

management in response to questions related to the appropriate role of the auditor in evaluating management's internal control assessment process.

On July 11, 2006, we issued a Concept Release to seek public comment on the issues to be addressed in our guidance for management on how to assess ICFR.⁵⁸ The Commission received approximately 167 comment letters in response to the Concept Release, a majority of which supported additional Commission guidance to management that is applicable to companies of all sizes and complexities. The Commission considered the feedback received in those comment letters in drafting its Interpretive Guidance.

In conjunction with issuance of the Interpretive Guidance, in this release we are adopting amendments to the existing requirements of Exchange Act Rules 13a-15(c) and 15d-15(c) that management of each company subject to the Exchange Act periodic reporting requirements evaluate, as of the end of each fiscal year, the effectiveness of the company's ICFR. The amendments state that an evaluation that complies with the Interpretive Guidance will satisfy the annual evaluation requirement in Rules 13a-15(c) and 15d-15(c).

We are also adopting amendments to Rules 1-02 and 2-02 of Regulation S-X, and Item 308 of Regulations S-B and S-K, to state that the company's auditor must express only one opinion on a company's ICFR. This is a direct opinion by the auditor on the effectiveness of the company's ICFR. Prior to the amendments, auditors expressed two separate opinions: one on the effectiveness of a company's ICFR and another on management's assessment of the effectiveness of the company's ICFR. Finally, we are

⁵⁸ Release No. 34-54122 (July 11, 2006).

adopting an amendment to Exchange Act Rule 12b-2, and a corresponding amendment to Rule 1-02 of Regulation S-X, to define the term material weakness.

V. PAPERWORK REDUCTION ACT

Certain provisions of our ICFR requirements contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”). We submitted these collections of information to the Office of Management and Budget (“OMB”) for review in accordance with the PRA and received approval for the collections of information. We do not believe the rule amendments in this release will impose any new recordkeeping or information collection requirements, or other collections of information requiring OMB’s approval.

VI. COST-BENEFIT ANALYSIS

The rule amendments and the Interpretive Guidance that we are adopting are intended to facilitate more effective and efficient evaluations of ICFR by management and auditors. Rules 13a-15 and 15d-15, as initially adopted, and as amended, do not mandate any specific method for management to follow in performing an evaluation of ICFR. Instead, the rules recognize that the methods of conducting evaluations of ICFR will, and should, vary from company to company. Commenters have asserted that the lack of specific direction in either Section 404 of the Sarbanes-Oxley Act or the implementing rules on how management should conduct an evaluation of ICFR may have resulted in the auditing standards becoming the de facto standard for management’s evaluation in many cases, which likely contributed to excessive documentation and testing of internal controls by management in initial compliance efforts.

The benefits and costs to investors of the rule amendments and Interpretive Guidance are directly related to the extent to which issuers choose to rely on the Interpretive Guidance. In part, this is because compliance is voluntary. In addition, companies already subject to the reporting requirement have gained some efficiencies in the evaluation process,⁵⁹ and other sources have provided guidance on how to conduct an ICFR evaluation.⁶⁰ The very purpose of the rule amendments and the Interpretive Guidance is to ease the compliance burden created by Section 404 of the Sarbanes-Oxley Act. Because of this, and because the use of Interpretive Guidance is voluntary, it is unlikely that it could result in additional incremental cost to issuers. Issuers that choose to use Interpretive Guidance will likely do so because it reduces their overall compliance burden.

A. Benefits

Our issuance of specific Interpretive Guidance for management on how to conduct an ICFR evaluation should significantly lessen the pressures on management to look to the auditing standards for guidance as to how to conduct its evaluation.⁶¹ To the extent that these pressures have led to excessive testing and documentation in the past, the Interpretive Guidance and rule amendments should lead management to avoid

⁵⁹ Commenters on the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Release No. 34-54122 (Jul. 11, 2006) [71 FR 40866], available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>, expressed similar views. See, for example, letters from the American Institute of Certified Public Accountants, Crowe Chizek and Company LLC, and Kreisler Miller, all available at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

⁶⁰ See, for example, The Institute of Internal Auditor's Sarbanes-Oxley Section 404: A Guide for Management by Internal Control Practitioners, May 2006.

⁶¹ We are taking this action in conjunction with the PCAOB's elimination of the auditor's requirement to evaluate the efficacy of management's evaluation process.

excessive costs and aid them in determining the level of effort necessary to evaluate a company's ICFR.

The extent of the benefits of the rule amendments depends on a company's experience conducting an ICFR evaluation. As explained in the release setting forth the Interpretive Guidance, the effort necessary to conduct an initial evaluation of ICFR will vary depending on management's existing financial reporting risk assessment and control monitoring activities. After the first year of compliance, management's effort to identify financial reporting risks and controls should ordinarily be less because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the documentation of risks and controls will only need to be updated from the prior year or years, not recreated anew.

Through the risk and control identification process, management will have identified for testing only those controls that are needed to meet the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently. The nature and extent of procedures implemented to evaluate whether those controls continue to operate effectively can be tailored to the company's unique circumstances, thereby avoiding unnecessary compliance costs.

In addressing a number of the commonly identified areas of concerns, the Interpretive Guidance:

- Explains how to vary approaches for gathering evidence to support the evaluation based on risk assessments;

- Explains the use of “daily interaction,” self-assessment, and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- Allows for management and the auditor to have different testing approaches.

The Interpretive Guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements.

The second principle is that management’s evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments in low-risk areas, and perform more extensive testing in high-

risk areas. By following these two principles, companies of all sizes and complexities will be able to implement the rules effectively and efficiently.

The Interpretive Guidance reiterates the Commission's position that management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment of whether ICFR is effective. This allows management sufficient and appropriate flexibility to design such an evaluation process. Smaller public companies, which generally have less complex internal control systems than larger public companies, can scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.⁶² Applying the Interpretive Guidance may thus assist management of these companies in scaling and tailoring its evaluation methods and procedures to fit their own unique facts and circumstances in ways that may not be appropriate for larger companies with more complex internal control systems. Through the rule amendments, smaller companies can take advantage of the flexibility and scalability in Interpretive Guidance to conduct an evaluation of ICFR that is both efficient and effective at identifying material weaknesses.

By applying the principles set forth in the Interpretive Guidance, companies of all sizes and complexities will be able to comply with the rules more effectively and efficiently. The total benefit to investors of the Interpretive Guidance and rule amendments depends on the number of companies that implement these principles and the extent to which their practices under these principles depart from the principles and practices that they would otherwise follow.

⁶² Advisory Committee Report at pp. 39-40.

Given that non-accelerated filers have not yet been required to conduct an evaluation of ICFR, their use of Interpretive Guidance in their first year of conducting an ICFR evaluation may enable them to avoid some of the initial compliance costs and efforts that were incurred by larger public companies during their early years of compliance with Section 404's requirements. In this respect, investors in non-accelerated filers may benefit more from the amended rules and Interpretive Guidance than investors in larger public companies that already have been required to conduct an evaluation.

The amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) provide for a non-exclusive safe-harbor in that they do not require management to follow the Interpretive Guidance, but still provide assurance to management regarding its compliance obligations. Some of the commenters on the Proposal questioned the benefits of these rule amendments. As noted earlier in this release, three commenters suggested that the Interpretive Guidance does not contain specific, objective criteria that a company's management could use to demonstrate that its evaluation complies with the requirements of the Interpretive Guidance.⁶³ The Office of Advocacy of the Small Business Administration also stated in its comment letter that some of the participants in a roundtable it hosted on the Section 404 requirements asked for more details as to how the safe harbor protection could be claimed and what type of liability protection it would afford.

The rule amendments are intended to provide those choosing to follow the Interpretive Guidance with greater clarity and transparency about their obligations relative to Section 404. For example, the amendments to Exchange Act Rules 13a-15(c)

⁶³ See, for example, letters from Cleary, NYC Bar, and Reznick Group, P.C.

and 15d-15(c) add a specific reference to the Interpretive Guidance in the rules and thereby make the guidance more visible and accessible to the managers of companies subject to the ICFR evaluation requirement. When a company's management relies on the Interpretive Guidance to conduct its evaluation, the company does not have to take any special action to "claim" the assurance provided by the rule amendments. In addition, the transparency of the guidance may benefit investors by reducing costly second-guessing about the sufficiency of management's evaluation raised by any party, including the company's independent auditor. The Interpretive Guidance is specific enough to enable a company to demonstrate that its management followed the principles set forth in the Interpretive Guidance in conducting its ICFR evaluation to gain the assurance afforded by these rule amendments.

The rule amendments encourage the use of the Interpretive Guidance because it advises management to focus on the controls that address the highest risk of material misstatement. This will benefit investors by reducing the amount of testing and documentation conducted by management and thus reducing the cost of compliance.⁶⁴ The rule amendments can remove obstacles by giving management clearer information about its obligations and by reducing undue pressures from auditors.

The Commission did not receive any comments on the dollar magnitude of the likely reduction in compliance costs from the rule amendments in connection with the Proposal. However, the Commission did receive historical estimates of total Section 404 compliance costs from the early years of adoption. These estimates were obtained from

⁶⁴ Commenters expressed similar views. See, for example, letters from BHP, Employees' Retirement System of Rhode Island, Financial Services Forum, KPMG LLP, McGladrey & Pullen LLP, MSFT, and State Street Corporation.

surveys of companies with a public float above \$75 million in connection with our May 2006 Roundtable on Internal Control Reporting and Auditing Provisions. These historical estimates of the early compliance costs incurred by the relatively larger companies ranged from \$860,000 to \$5.4 million per company, depending on the survey.⁶⁵ The management cost that is the focus of the rule amendments appears to account for the majority of this estimate. One commenter indicated in its comment letter on the Proposal that it is especially important to reduce management costs, as these costs are the most significant costs associated with the Section 404 requirements, and can account for 70-75% of the total compliance costs.⁶⁶ Thus, even if the percentage decline in compliance cost under the rule amendment is small, companies and their investors could experience a substantial dollar benefit in terms of lower costs of compliance.

Commenters expressed the view that the rule amendments and Interpretive Guidance will result in more efficient and effective evaluations of internal control relative to what would otherwise occur. In commenting on the amendments, one commenter provided a quantitative estimate of the expected reduction in compliance costs. This commenter estimated that implementation of the Proposed Interpretive Guidance could result in a reduction in company compliance costs of approximately 10% in the first year of implementation (net of first year costs of implementation of the Interpretive Guidance). The commenter further estimated that implementation could result in an additional 15-20% cost reduction over costs incurred in the initial compliance year based

⁶⁵ See, for example, Financial Executives International Survey on Sarbanes-Oxley Section 404 Implementation (March, 2006) and CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update.

⁶⁶ See letter from The Committee on Capital Markets Regulation.

on its own experience in conducting an evaluation of internal control and its assessment of the potential efficiencies to be gained from the Interpretive Guidance.⁶⁷ The available qualitative and quantitative evidence is consistent with our view that issuers will implement the Interpretive Guidance to the benefit of investors.⁶⁸

We anticipate that the amendments to Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term “material weakness” will benefit companies and investors. Companies will now be able to refer to the definition in the Commission rules requiring management to conduct an ICFR evaluation, rather than having to refer to the definition in the audit standard. We believe that the definition appropriately describes the ICFR conditions that, if they exist, should be disclosed to investors and preclude a conclusion that ICFR is effective.

Commenters suggested that the rule amendments and Proposed Interpretive Guidance will not significantly reduce costs as long as there are significant differences between our management guidance and the Proposed Auditing Standard.⁶⁹ To address these comments and enhance the benefit of the rule amendments, we coordinated with the PCAOB to align our Interpretive Guidance and the PCAOB’s new auditing standard.

B. Costs

⁶⁷ See letter from CSC.

⁶⁸ Commenters, however, requested that we conduct an analysis of the costs and benefits of the amendments after implementation and assess whether the amendments and the Interpretive Guidance result in cost reductions. See, for example, letters from Biotechnology Industry Organization (BIO) and NVCA. We are sensitive to the costs and benefits of our Section 404 rules, and we intend to monitor the impact of the rule amendments and Interpretive Guidance.

⁶⁹ See, for example, letters from Allstate Corporation, Hudson, ICAEW, Minn-Dak Farmers Cooperative, Nasdaq, Supervalu Inc., and UnumProvident.

As stated above, the obligation for all companies, regardless of size, to comply with the ICFR requirements was established in 2002 when Congress directed the Commission to adopt rules to implement Section 404. The rule amendments and Interpretive Guidance are designed to reduce the burden of compliance with those requirements. The rule amendments and Interpretive Guidance do not impose any new compliance obligations on any reporting company. Because compliance with the Interpretive Guidance is voluntary, it is likely that companies and their management will choose to comply with the guidance only if they determine that the benefits exceed the costs.

Companies that have already completed one or more evaluations may choose to continue to use their existing procedures if they are satisfied with the effectiveness and efficiency of those procedures. Alternatively, a company that already has been complying with the ICFR requirements could choose to follow the Interpretive Guidance and to make adjustments to conform its evaluation procedures to the guidance. In that case, some commenters expressed the view that while changing from the current evaluation approaches to the top-down, risk-based approach laid out in the Interpretive Guidance could result in short-term cost increases, it would promote a cost-effective approach in the long-term.⁷⁰ It is reasonable to conclude that companies will not elect to follow the Interpretive Guidance if, from a cost standpoint, they determine that is not in their long-term interest to do so.

For smaller public companies that have not been required to comply with the ICFR requirements, the costs that they will incur are a direct result of the imposition by

⁷⁰ See, for example, letters from Ace Limited, Hutchinson, and Neenah.

the Congress of the statutory requirements of Section 404 of the Sarbanes-Oxley Act on them. They may be able to reduce their first-time evaluation costs by using the Interpretive Guidance as compared to what those costs would have been.

The Interpretive Guidance advises management on how to conduct an efficient evaluation of ICFR, which could result in management doing less work, and therefore produce cost savings for the company. Those cost savings, however, could be offset if a company's auditor does not choose to use management's work to the same extent it did before, due to management choosing to follow the Interpretive Guidance and doing less work as a result.⁷¹ Because use of the Interpretive Guidance is voluntary, it is reasonable to conclude that management would choose to reduce the extent and cost of its work only to the degree that it did not result in an increase in the overall costs of complying with Section 404, including auditor costs.⁷² On the other hand, the rule amendments and Interpretive Guidance could increase the possibility that the auditor will, during the Section 404 audit, perform additional testing of internal controls beyond that which management performed in reliance on the Interpretive Guidance.⁷³

VII. EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 3(f) of the Exchange Act⁷⁴ requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, also to consider whether the action will promote

⁷¹ See, for example, letters from Heritage Financial Corporation, MSFT and Neenah.

⁷² This cost-benefit analysis does not address the costs associated with the ICFR audit standard itself because the rule amendments do not affect the ICFR audit standard.

⁷³ See letter from UnumProvident.

⁷⁴ 15 U.S.C. 78c(f).

efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act⁷⁵ also requires the Commission, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits 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.

The rule amendments and Interpretive Guidance will promote efficiency, and capital formation. The Interpretive Guidance and related rule amendments promote efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of the company's financial statements. The guidance does not require management to identify every control in a process or to document the business practices affecting ICFR. Rather, management can focus its evaluation process and the documentation supporting the assessment on those controls that it determines adequately address the risk of a material misstatement of the financial statements.

One commenter expressed the view that the Section 404 requirements have provided significant benefits to investors and business by increasing the reliability of financial statements, strengthening internal controls, improving the efficiency of business operations and helping to reduce the risk of fraud.⁷⁶ To the extent that the rule amendments and Interpretive Guidance make the management evaluation process more efficient, these benefits can all be retained at a lower cost.

⁷⁵ 15 U.S.C. 78w(a)(2).

⁷⁶ See letter from The Committee on Capital Market Regulation.

Under the Sarbanes-Oxley Act, all companies, except registered investment companies, are subject to the requirement to conduct an evaluation of their ICFR. Compliance with the amendments to Exchange Act Rules 13a-15 and 15d-15 and Interpretive Guidance, however, will be voluntary rather than mandatory and, as such, companies will be able to choose whether or not to follow the Interpretive Guidance. The amendments therefore will not impose any costs on companies that they do not choose to incur. Presumably, companies will only choose to rely on the Interpretive Guidance if they think that the benefits of using the guidance outweigh the costs.

The rule amendments will encourage use of the Interpretive Guidance and thereby increase the efficiency with respect to the effort and resources associated with an evaluation of internal control over financial reporting and facilitate more efficient allocation of resources within a company. The guidance is designed to be scalable depending on the size of the company, which should reduce the potential for internal control reporting requirements to impose a higher cost burden on smaller companies relative to revenues.

Capital formation may be promoted to the extent the cost of compliance with the evaluation requirement is lowered. Smaller private companies may be able to access public capital markets earlier in their growth and at lower cost.

We do not believe the rule amendments or the Interpretive Guidance will impact competition. One commenter was concerned that the Interpretive Guidance could become the exclusive method by which companies would conduct an evaluation of ICFR over time, and could discourage the development of future alternative evaluation

frameworks.⁷⁷ However, the rules explicitly acknowledge that there are many different ways to conduct an evaluation and the Interpretive Guidance is not exclusive.

VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS

This Final Regulatory Flexibility Analysis (“FRFA”) has been prepared in accordance with the Regulatory Flexibility Act.⁷⁸ This FRFA relates to amendments to Exchange Act Rules 13a-15(c), 15d-15(c), and 12b-2, Rules 1-02 and 2-02 of Regulation S-X, and Item 308 of Regulations S-B and S-K. These rules require the management of an Exchange Act reporting company, other than a registered investment company, to evaluate, as of the company’s fiscal year-end, the effectiveness of the company’s ICFR. Furthermore, these rules also require the public accounting firm that issues an audit report on the company’s financial statements to attest to, and report on, management’s assessment of the company’s ICFR. We are amending these rules to: (1) provide companies with the assurance that an evaluation that complies with our Interpretive Guidance will satisfy the annual management ICFR evaluation requirement; (2) require a company’s auditor to express only one opinion on the effectiveness of the company’s ICFR; and (3) define the term “material weakness.” An Initial Regulatory Flexibility Analysis was prepared in accordance with the Regulatory Flexibility Act and included in the release proposing these amendments.⁷⁹ The Proposing Release solicited comments on this analysis.

A. Need for the Amendments

⁷⁷ See letter from NYC Bar.

⁷⁸ 5 U.S.C. 601.

⁷⁹ 5 U.S.C. 603.

The amendments are designed to facilitate more effective and efficient evaluations of ICFR by sanctioning the Interpretive Guidance as a method that can be used by management to conduct an ICFR evaluation. Companies already have a legal obligation to establish and maintain an adequate system of ICFR and to evaluate and report annually on those financial reporting controls. Our current rules do not prescribe a method or set of procedures for management to follow in performing an evaluation of ICFR. Commenters have asserted that the lack of direction in either Section 404 of the Sarbanes-Oxley Act or implementing rules on conducting this type of evaluation has led many companies to look to auditing standards as a guide to conducting the evaluation. This has likely contributed to excessive documentation and testing of ICFR.

While the rule amendments and Interpretive Guidance are designed to make ICFR evaluations by management more cost-effective for all reporting companies subject to the Section 404 requirements, they will be particularly useful to smaller public companies that have a public float below \$75 million. These companies have not yet been required to comply with the Section 404 requirements. The rule amendments and Interpretive Guidance will encourage managements of smaller companies to scale and tailor their evaluation methods and procedures to fit their companies' own particular facts and circumstances.

B. Significant Issues Raised by Public Comments

In the Proposing Release, we requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposed amendments, and the quantitative and qualitative nature of the impact. Commenters addressed several aspects of the proposed rule amendments and the Proposed Interpretive

Guidance that could potentially affect small entities. They expressed concern that the proposed amendments would not provide certainty for management because the Proposed Interpretive Guidance was too vague, did not provide adequate guidance for small companies to scale their evaluation procedures, and was inconsistent with several aspects of the PCAOB's Proposed Auditing Standard.⁸⁰

In response to these comments, including comments submitted by the Office of Advocacy of the Small Business Administration, we have coordinated with the PCAOB to harmonize the Interpretive Guidance and rule amendments with the proposed new auditing standard. We also have made revisions to our Proposed Interpretive Guidance to add clarity while still maintaining a principles-based approach. Other comments that we received are discussed below.

Smaller public companies and their investors could realize benefits from the rule amendments that, measured in proportion to their revenues, are greater than the benefits that would accrue to larger companies and their investors. This is because, as commenters on the Proposal and on previous Commission releases related to the Section 404 requirements pointed out, the burden of internal control reporting compliance costs is "disproportionately high" for smaller public companies compared to larger ones.⁸¹ To the extent that Interpretive Guidance and the rule amendments reduce the cost of

⁸⁰ See, for example, letters from AeA, BIO, IMA and U.S. Small Business Administration's Office of Advocacy (SBA).

⁸¹ See, for example, the letter from the Office of Advocacy of the Small Business Administration, citing the Advisory Committee Report at p. 33.

compliance with the requirements of Section 404, these cost savings will be disproportionately greater for smaller public companies and their investors.⁸²

C. Small Entities Subject to the Final Amendments

The amendments will affect some issuers that are “small entities.” Exchange Act Rule 0-10(a)⁸³ defines an issuer, other than an investment company, to be a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,110 issuers, other than investment companies, that may be considered small entities. The amendments will apply to any small entity, other than a registered investment company, that is subject to Exchange Act reporting requirements.

Overall, approximately 6,000 smaller public companies that are subject to the Exchange Act reporting requirements, but have a public float below \$75 million, will be required to comply with these requirements for the first time in their annual reports for fiscal years ending on or after December 15, 2007. The Interpretive Guidance and rule amendments are intended to reduce the cost of compliance for these companies. Overall, more than half of the reporting companies subject to the Section 404 requirements are smaller public companies that should benefit from the rule amendments and Interpretive Guidance.

D. Reporting, Recordkeeping, and other Compliance Requirements

⁸² Nearly 5,000 companies already are subject to the Section 404 requirements. Larger companies may also be able to perform more efficient ICFR evaluations based on the Interpretive Guidance, and gain assurance that changes they make in their evaluation procedures still comply with Commission rules.

⁸³ 17 CFR 240.0-10(a).

The rule amendments and Interpretive Guidance are designed to alleviate reporting and compliance burdens. They do not impose any new reporting, recordkeeping or compliance requirements on small entities. The amendments are designed to make compliance with existing requirements more efficient. Many factors contribute to the cost of compliance, including the size and complexity of the company and the rigor of its controls. The degree to which the rule amendments will reduce compliance costs will depend on these factors and on the company's prior experience and access to information about alternative methods of compliance with the Section 404 requirements. Therefore, it is difficult to quantify the benefits of the amendments for small entities.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the rule amendments and Interpretive Guidance, we considered alternatives, including establishing different compliance or reporting requirements that take into account the resources available to small entities, clarifying or simplifying compliance and reporting requirements under the rules for small entities, using design rather than performance standards, and exempting small entities from all or part of the Interpretive Guidance and rule amendments.

Regarding the first alternative, the Commission has effectively established different compliance requirements for smaller entities by making the Interpretive Guidance scalable in order to take into account the resources available to smaller public companies, including those that are small entities. Regarding the second alternative, the

Interpretive Guidance and rule amendments clarify and simplify the Section 404 reporting requirements for all reporting companies, including small entities. The final rules create a principles-based set of guidelines for management that will produce more effective and efficient evaluations of ICFR for small entities, as well as other reporting companies subject to the Section 404 requirements.

The Interpretive Guidance describes a top-down, risk-based approach to evaluating ICFR. It promotes efficiency for companies of all sizes by allowing management to focus its efforts on those controls that are needed to adequately address the risk of a material misstatement in a company's financial statements.

Regarding the third alternative, the rule amendments and Interpretive Guidance set forth primarily performance rather than design standards, in particular to aid the management of non-accelerated filers (including small entities) in conducting an evaluation of ICFR. The amendments provide assurance that compliance with the Interpretive Guidance will satisfy the management evaluation requirement in Exchange Act Rules 13a-15 and 15d-15. The rule amendments and Interpretive Guidance afford companies choosing to follow the Interpretive Guidance considerable flexibility to scale and tailor their evaluation methods to fit the particular circumstances of the company. This flexibility is especially beneficial to non-accelerated filers (including small entities).

For example, in many smaller companies senior management is more involved in the day-to-day operations of the company. The Interpretive Guidance describes how management's daily interaction, as well as other forms of on-going monitoring activities, can provide evidence in the evaluation process. This flexibility should enable smaller

companies to keep costs of compliance with the management evaluation requirement as low as possible.

The rule amendments explicitly state that a company's management does not need to comply with the Interpretive Guidance. The amendments provide assurance, however, to a company choosing to follow the guidance that it has satisfied management's obligation to conduct an evaluation of internal control in an appropriate manner. Small entities should be able to reduce the amount of testing and documentation by relying on the Interpretive Guidance rather than auditing standards to plan and conduct their evaluations of ICFR.

Regarding the final alternative, we believe that an exclusion of small entities from the Interpretive Guidance and the rule amendments would discourage small entities from using the principles-based Interpretive Guidance and would be inconsistent with our goal of developing a more effective and flexible ICFR evaluation process that is scaled and tailored to meet the small entity's particular circumstances.

IX. STATUTORY AUTHORITY AND TEXT OF RULE AMENDMENTS

The amendments described in this release are being adopted under the authority set forth in Sections 12, 13, 15, 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 228, 229 and 240

Reporting and recordkeeping requirements, Securities.

TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission amends title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Amend §210.1-02 by:
 - a. revising paragraph (a)(2);
 - b. redesignating paragraphs (p) through (bb) as paragraphs (q) through (cc); and
 - c. adding new paragraph (p).

The revision and additions read as follows:

§210.1-02 Definition of terms used in Regulation S-X (17 CFR part 210).

* * * * *

(a)(1) * * *

(2) Attestation report on internal control over financial reporting. The term attestation report on internal control over financial reporting means a report in which a registered public accounting firm expresses an opinion, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter),

except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion.

* * * * *

(p) Material weakness. The term material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter) such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.

* * * * *

3. Amend §210.2-02 by revising paragraph (f) to read as follows:

§210.2-02 Accountants' reports and attestation reports.

* * * * *

(f) Attestation report on internal control over financial reporting. Every registered public accounting firm that issues or prepares an accountant's report for a registrant, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), that is included in an annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must clearly state the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public

accounting firm which would result in the accounting firm disclaiming an opinion. The attestation report on internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and indicate that the accountant has audited the effectiveness of internal control over financial reporting. The attestation report on internal control over financial reporting may be separate from the accountant's report.

* * * * *

4. Amend §210.2-02T by revising the section heading to read as follows:

§210.2-02T Accountants' reports and attestation reports on internal control over financial reporting.

* * * * *

PART 228 – INTEGRATED DISCLOSURE FOR SMALL BUSINESS ISSUERS

5. The authority citation for Part 228 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 et seq.: and 18 U.S.C. 1350.

* * * * *

6. Amend §228.308 by revising paragraphs (a)(4) and (b) to read as follows:

§228.308 (Item 308) Internal control over financial reporting.

- (a) * * *

- (4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by

this Item has issued an attestation report on the small business issuer's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. Provide the registered public accounting firm's attestation report on the small business issuer's internal control over financial reporting in the small business issuer's annual report containing the disclosure required by this Item.

* * * * *

PART 229 – STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 – REGULATION S-K

7. The authority citation for Part 229 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

8. Amend §229.308 by revising paragraphs (a)(4) and (b) to read as follows:

§229.308 (Item 308) Internal control over financial reporting.

(a) * * *

4. A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on the registrant's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. Provide the registered public accounting firm’s attestation report on the registrant’s internal control over financial reporting in the registrant’s annual report containing the disclosure required by this Item.

* * * * *

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

9. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq., and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

10. Amend §240.12b-2 by adding the definition of “Material weakness” in alphabetical order to read as follows:

§240.12b-2 Definitions.

* * * * *

Material weakness. The term material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis.

* * * * *

11. Amend §240.13a-15 by revising paragraph (c) to read as follows:

§240.13a-15 Controls and procedures.

* * * * *

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

* * * * *

12. Amend §240.15d-15 by revising paragraph (c) to read as follows:

§240.15d-15 Controls and procedures.

* * * * *

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or

780(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

* * * * *

By the Commission.



Nancy M. Morris
Secretary

June 20, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 241

[RELEASE NOS. 33-8810; 34-55929; FR-77; File No. S7-24-06]

Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The SEC is publishing this interpretive release to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. An evaluation that complies with this interpretive guidance is one way to satisfy the evaluation requirements of Rules 13a-15(c) and 15d-15(c) under the Securities Exchange Act of 1934.

EFFECTIVE DATE: [insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Josh K. Jones, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551-5300, or N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551-3430, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The amendments to Rules 13a-15(c)¹ and 15d-15(c)² under the Securities Exchange Act of 1934³ (the "Exchange Act"), which

¹ 17 CFR 240.13a-15(c).

² 17 CFR 240.15d-15(c).

³ 15 U.S.C. 78a *et seq.*

clarify that an evaluation of internal control over financial reporting that complies with this interpretive guidance is one way to satisfy those rules, are being made in a separate release.⁴

I. Introduction

Management is responsible for maintaining a system of internal control over financial reporting (“ICFR”) that provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The rules we adopted in June 2003 to implement Section 404 of the Sarbanes-Oxley Act of 2002⁵ (“Sarbanes-Oxley”) require management to annually evaluate whether ICFR is effective at providing reasonable assurance and to disclose its assessment to investors.⁶ Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. This evidence will also allow a third party, such as the company’s external auditor, to consider the work performed by management.

ICFR cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override. Because of such limitations, ICFR cannot prevent or detect all misstatements, whether unintentional errors or fraud. However, these inherent limitations are known features of the financial

⁴ Release No. 34-55928 (Jun. 20, 2007).

⁵ 15 U.S.C. 7262.

⁶ Release No. 33-8238 (Jun. 5, 2003) [68 FR 36636] (hereinafter “Adopting Release”).

reporting process, therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

The “reasonable assurance” referred to in the Commission’s implementing rules relates to similar language in the Foreign Corrupt Practices Act of 1977 (“FCPA”).⁷ Exchange Act Section 13(b)(7) defines “reasonable assurance” and “reasonable detail” as “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”⁸ The Commission has long held that “reasonableness” is not an “absolute standard of exactitude for corporate records.”⁹ In addition, the Commission recognizes that while “reasonableness” is an objective standard, there is a range of judgments that an issuer might make as to what is “reasonable” in implementing Section 404 and the Commission’s rules. Thus, the terms “reasonable,” “reasonably,” and “reasonableness” in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

Since companies first began complying in 2004, the Commission has received significant feedback on our rules implementing Section 404.¹⁰ This feedback included requests for further guidance to assist company management in complying with our ICFR

⁷ Title I of Pub. L. 95-213 (1977).

⁸ 15 U.S.C. 78m(b)(7). The conference committee report on the 1988 amendments to the FCPA also noted that the standard “does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.” Cong. Rec. H2116 (daily ed. Apr. 20, 1988).

⁹ Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].

¹⁰ Release Nos. 33-8762; 34-54976 (Dec. 20, 2006) [71 FR 77635] (hereinafter “Proposing Release”). For a detailed history of the implementation of Section 404 of Sarbanes-Oxley, see Section I, Background, of the Proposing Release. An analysis of the comments we received on the Proposing Release is included in Section III of this release.

evaluation and disclosure requirements. This guidance is in response to those requests and reflects the significant feedback we have received, including comments on the interpretive guidance we proposed on December 20, 2006. In addressing a number of the commonly identified areas of concerns, the interpretive guidance:

- Explains how to vary evaluation approaches for gathering evidence based on risk assessments;
- Explains the use of “daily interaction,” self-assessment, and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- Allows for management and the auditor to have different testing approaches.

The Interpretive Guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation

process and the documentation supporting the assessment on those controls that it determines adequately address the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas. By following these two principles, we believe companies of all sizes and complexities will be able to implement our rules effectively and efficiently.

The Interpretive Guidance reiterates the Commission's position that management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment of whether ICFR is effective. This allows management sufficient and appropriate flexibility to design such an evaluation process.¹¹

¹¹ Exchange Act Rules 13a-15 and 15d-15 [17 CFR 240.13a-15 and 15d-15] require management to evaluate the effectiveness of ICFR as of the end of the fiscal year. For purposes of this document, the term "evaluation" or "evaluation process" refers to the methods and procedures that management implements to comply with these rules. The term "assessment" is used in this document to describe the disclosure required by Item 308 of Regulations S-B and S-K [17 CFR 228.308 and 229.308]. This disclosure must include discussion of any material weaknesses

Smaller public companies, which generally have less complex internal control systems than larger public companies, can use this guidance to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances. We encourage smaller public companies¹² to take advantage of the flexibility and scalability to conduct an evaluation of ICFR that is both efficient and effective at identifying material weaknesses.

The effort necessary to conduct an initial evaluation of ICFR will vary among companies, partly because this effort will depend on management's existing financial reporting risk assessment and control monitoring activities. After the first year of compliance, management's effort to identify financial reporting risks and controls should ordinarily be less, because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the documentation of risks and controls will only need to be updated from the prior year(s), not recreated anew. Through the risk and control identification process, management will have identified for testing only those controls that are needed to meet the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently. The nature and extent of procedures

which exist as of the end of the most recent fiscal year and management's assessment of the effectiveness of ICFR, including a statement as to whether or not ICFR is effective. Management is not permitted to conclude that ICFR is effective if there are one or more material weaknesses in ICFR.

¹² While a company's individual facts and circumstances should be considered in determining whether a company is a smaller public company and the resulting implications to management's evaluation, a company's public market capitalization and annual revenues are useful indicators of its size and complexity. The Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>, defined smaller companies, which included microcap companies, and the SEC's rules include size characteristics for "accelerated filers" and "non-accelerated filers" which approximately fit the same definitions.

implemented to evaluate whether those controls continue to operate effectively can be tailored to the company's unique circumstances, thereby avoiding unnecessary compliance costs.

The guidance assumes management has established and maintains a system of internal accounting controls as required by the FCPA. Further, it is not intended to explain how management should design its ICFR to comply with the control framework management has chosen. To allow appropriate flexibility, the guidance does not provide a checklist of steps management should perform in completing its evaluation.

The guidance in this release shall be effective immediately upon its publication in the Federal Register.¹³

As a companion¹⁴ to this interpretive release, we are adopting amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) and revisions to Regulation S-X.¹⁵ The amendments to Rules 13a-15(c) and 15d-15(c) will make it clear that an evaluation that is conducted in accordance with this interpretive guidance is one way to satisfy the annual management evaluation requirement in those rules. We are also amending our rules to define the term "material weakness" and to revise the requirements regarding the auditor's attestation report on ICFR. Additionally, we are seeking additional comment on the definition of the term "significant deficiency."¹⁶

¹³ The Commission finds good cause under 5 U.S.C. 808(2) for this interpretation to take effect on the date of Federal Register publication. Further delay would be unnecessary and contrary to the public interest because following the guidance is voluntary. Additionally, delay may deter companies from realizing all the efficiencies intended by this guidance, and immediate effectiveness will assist in preparing for 2007 evaluations and assessments of internal control over financial reporting.

¹⁴ Release No. 34-55928.

¹⁵ 17 CFR 210.1-01 et seq.

¹⁶ Release No. 34-55930 (Jun. 20, 2007).

II. Interpretive Guidance – Evaluation and Assessment of Internal Control Over Financial Reporting

The interpretive guidance addresses the following topics:

A. The Evaluation Process

1. Identifying Financial Reporting Risks and Controls

- a. Identifying Financial Reporting Risks
- b. Identifying Controls that Adequately Address Financial Reporting Risks
- c. Consideration of Entity-Level Controls
- d. Role of Information Technology General Controls
- e. Evidential Matter to Support the Assessment

2. Evaluating Evidence of the Operating Effectiveness of ICFR

- a. Determining the Evidence Needed to Support the Assessment
- b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR
- c. Evidential Matter to Support the Assessment

3. Multiple Location Considerations

B. Reporting Considerations

1. Evaluation of Control Deficiencies
2. Expression of Assessment of Effectiveness of ICFR by Management
3. Disclosures about Material Weaknesses
4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR
5. Inability to Assess Certain Aspects of ICFR

A. The Evaluation Process

The objective of internal control over financial reporting¹⁷ (“ICFR”) is to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (“GAAP”). The purpose of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses¹⁸ in ICFR exist as of the end of the fiscal year.¹⁹ To accomplish this, management identifies the risks to reliable financial reporting, evaluates whether controls exist to address those risks, and evaluates evidence about the operation of the controls

¹⁷ Exchange Act Rules 13a-15(f) and 15d-15(f) [17 CFR 240.13a-15(f) and 15d-15(b)] define internal control over financial reporting as:

A process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the registrant; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer’s assets that could have a material effect on the financial statements.

¹⁸ As defined in Exchange Act Rule 12b-2 [17 CFR 240.12b-2] and Rule 1-02 of Regulation S-X [17 CFR 210.1-02], a material weakness is a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis. See Release No. 34-55928.

¹⁹ This focus on material weaknesses will lead to a better understanding by investors about the company’s ICFR, as well as its inherent limitations. Further, the Commission’s rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrate attention on the most important internal control issues.

included in the evaluation based on its assessment of risk.²⁰ The evaluation process will vary from company to company; however, the top-down, risk-based approach which is described in this guidance will typically be the most efficient and effective way to conduct the evaluation.

The evaluation process guidance is described in two sections. The first section explains the identification of financial reporting risks and the evaluation of whether the controls management has implemented adequately address those risks. The second section explains an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. Both sections explain how entity-level controls²¹ impact the evaluation process, as well as how management should focus its evaluation efforts on the highest risks to reliable financial reporting.²²

²⁰ If management's evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may conclude that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of such remediated material weaknesses is appropriate or required under Item 307 or Item 308 of Regulations S-K or S-B or other Commission disclosure rules.

²¹ The term "entity-level controls" as used in this document describes aspects of a system of internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (for example, management's philosophy and operating style, integrity and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. The terms "company-level" and "entity-wide" are also commonly used to describe these controls.

²² Because management is responsible for maintaining effective ICFR, this interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be reasonably knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.

Under the Commission's rules, management's annual assessment of the effectiveness of ICFR must be made in accordance with a suitable control framework's²³ definition of effective internal control.²⁴ These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system. In assessing effectiveness, management evaluates whether its ICFR includes policies, procedures and activities that address the elements of internal control that the applicable control framework describes as necessary for an internal control system to be effective. The framework elements describe the characteristics of an internal control system that may be relevant to individual areas of the company's ICFR, pervasive to many areas, or entity-wide. Therefore, management's evaluation process includes not only controls involving particular areas of financial reporting, but also the entity-wide and other pervasive elements of internal control defined by its selected control framework. This guidance is not intended to replace the elements of an effective system of internal control as defined within a control framework.

²³ In the Adopting Release, the Commission specified characteristics of a suitable control framework and identified the Internal Control—Integrated Framework (1992) created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as an example of a suitable framework. We also cited the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants ("CoCo") and the report published by the Institute of Chartered Accountants in England & Wales Internal Control: Guidance for Directors on the Combined Code (known as the Turnbull Report) as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their ICFR. We encourage companies to examine and select a framework that may be useful in their own circumstances; we also encourage the further development of existing and alternative frameworks.

²⁴ For example, both the COSO framework and the Turnbull Report state that determining whether a system of internal control is effective is a subjective judgment resulting from an assessment of whether the five components (that is, control environment, risk assessment, control activities, monitoring, and information and communication) are present and functioning effectively. Although CoCo states that an assessment of effectiveness should be made against twenty specific criteria, it acknowledges that the criteria can be regrouped into different structures, and includes a table showing how the criteria can be regrouped into the five-component structure of COSO.

1. Identifying Financial Reporting Risks and Controls

Management should evaluate whether it has implemented controls that will achieve the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting). The evaluation begins with the identification and assessment of the risks to reliable financial reporting (that is, materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls placed in operation (that is, in use) that are designed to adequately address those risks. Management ordinarily would consider the company's entity-level controls in both its assessment of risks and in identifying which controls adequately address the risks.

The evaluation approach described herein allows management to identify controls and maintain supporting evidential matter for its controls in a manner that is tailored to the company's financial reporting risks (as defined below). Thus, the controls that management identifies and documents are those that are important to achieving the objective of ICFR. These controls are then subject to procedures to evaluate evidence of their operating effectiveness, as determined pursuant to Section II.A.2.

a. Identifying Financial Reporting Risks

Management should identify those risks of misstatement that could, individually or in combination with others, result in a material misstatement of the financial statements ("financial reporting risks"). Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions. Management must provide investors with financial statements that fairly present the company's financial position, results of operations and cash flows in accordance with GAAP. A lack of fair presentation arises

when one or more financial statement amounts or disclosures (“financial reporting elements”) contain misstatements (including omissions) that are material.

Management uses its knowledge and understanding of the business, and its organization, operations, and processes, to consider the sources and potential likelihood of misstatements in financial reporting elements. Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to a risk of misstatement. Risks of misstatement may also arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements. Management may find it useful to consider “what could go wrong” within a financial reporting element in order to identify the sources and the potential likelihood of misstatements and identify those that could result in a material misstatement of the financial statements.

The methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company. These characteristics include, among others, the size, complexity, and organizational structure of the company and its processes and financial reporting environment, as well as the control framework used by management. For example, to identify financial reporting risks in a larger business or a complex business process, management’s methods and procedures may involve a variety of company personnel, including those with specialized knowledge. These individuals, collectively, may be necessary to have a sufficient understanding of GAAP, the underlying business transactions and the process activities, including the role of computer technology, that are required to initiate, authorize, record and process transactions. In contrast, in a small company that operates on a centralized basis with less complex

business processes and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

Management's evaluation of the risk of misstatement should include consideration of the vulnerability of the entity to fraudulent activity (for example, fraudulent financial reporting, misappropriation of assets and corruption), and whether any such exposure could result in a material misstatement of the financial statements.²⁵ The extent of activities required for the evaluation of fraud risks is commensurate with the size and complexity of the company's operations and financial reporting environment.²⁶

Management should recognize that the risk of material misstatement due to fraud ordinarily exists in any organization, regardless of size or type, and it may vary by specific location or segment and by individual financial reporting element. For example, one type of fraud risk that has resulted in fraudulent financial reporting in companies of all sizes and types is the risk of improper override of internal controls in the financial reporting process. While the identification of a fraud risk is not necessarily an indication that a fraud has occurred, the absence of an identified fraud is not an indication that no

²⁵ For example, COSO's Internal Control Over Financial Reporting – Guidance for Smaller Public Companies (2006), Volume 1: Executive Summary, Principle 10: Fraud Risk (page 10) states, "The potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives."

²⁶ Management may find resources such as "Management Antifraud Programs and Controls – Guidance to Help Prevent, Deter, and Detect Fraud," which was issued jointly by seven professional organizations and is included as an exhibit to AU Sec. 316, Consideration of Fraud in a Financial Statement Audit (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T) helpful in assessing fraud risks. Other resources also exist (for example, the American Institute of Certified Public Accountants' (AICPA) Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention (2005)), and more may be developed in the future.

fraud risks exist. Rather, these risk assessments are used in evaluating whether adequate controls have been implemented.

b. Identifying Controls that Adequately Address Financial Reporting Risks

Management should evaluate whether it has controls²⁷ placed in operation (that is, in use) that adequately address the company's financial reporting risks. The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about whether the controls, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the financial statements.²⁸ If management determines that a deficiency in ICFR exists, it must be evaluated to determine whether a material weakness exists.²⁹ The guidance in Section II.B.1. is designed to assist management with that evaluation.

Management may identify preventive controls, detective controls, or a combination of both, as adequately addressing financial reporting risks.³⁰ There might

²⁷ A control consists of a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control's impact on ICFR may be entity-wide or specific to an account balance, class of transactions or application. Controls have unique characteristics – for example, they can be: automated or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets; preventing or detecting error or fraud. Controls within a process may consist of financial reporting controls and operational controls (that is, those designed to achieve operational objectives).

²⁸ Companies may use "control objectives," which provide specific criteria against which to evaluate the effectiveness of controls, to assist in evaluating whether controls can prevent or detect misstatements.

²⁹ A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed.

³⁰ Preventive controls have the objective of preventing the occurrence of errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the

be more than one control that addresses the financial reporting risks for a financial reporting element; conversely, one control might address the risks of more than one financial reporting element. It is not necessary to identify all controls that may exist or identify redundant controls, unless redundancy itself is required to address the financial reporting risks. To illustrate, management may determine that the risk of a misstatement in interest expense, which could result in a material misstatement of the financial statements, is adequately addressed by a control within the company's period-end financial reporting process (that is, an entity-level control). In such a case, management may not need to identify, for purposes of the ICFR evaluation, any additional controls related to the risk of misstatement in interest expense.

Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. When more than one control exists and each adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently. Moreover, when adequate information technology ("IT") general controls exist and management has determined that the operation of such controls is effective, management may determine that automated controls are more efficient to evaluate than manual controls. Considering the efficiency with which the operation of a control can be evaluated will often enhance the overall efficiency of the evaluation process.

In addition to identifying controls that address the financial reporting risks of individual financial reporting elements, management also evaluates whether it has

financial statements. Preventive and detective controls may be completely manual, involve some degree of computer automation, or be completely automated.

controls in place to address the entity-level and other pervasive elements of ICFR that its chosen control framework prescribes as necessary for an effective system of internal control. This would ordinarily include, for example, considering how and whether controls related to the control environment, controls over management override, the entity-level risk assessment process and monitoring activities,³¹ controls over the period-end financial reporting process,³² and the policies that address significant business control and risk management practices are adequate for purposes of an effective system of internal control. The control frameworks and related guidance may be useful tools for evaluating the adequacy of these elements of ICFR.

When identifying the controls that address financial reporting risks, management learns information about the characteristics of the controls that should inform its judgments about the risk that a control will fail to operate as designed. This includes, for example, information about the judgment required in its operation and information about the complexity of the controls. Section II.A.2. discusses how these characteristics are considered in determining the nature and extent of evidence of the operation of the controls that management evaluates.

At the end of this identification process, management has identified for evaluation those controls that are needed to meet the objective of ICFR (that is, to provide

³¹ Monitoring activities may include controls to monitor results of operations and controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs.

³² The nature of controls within the period-end financial reporting process will vary based on a company's facts and circumstances. The period-end financial reporting process may include matters such as: procedures to enter transaction totals into the general ledger; the initiation, authorization, recording and processing of journal entries in the general ledger; procedures for the selection and application of accounting policies; procedures used to record recurring and non-recurring adjustments to the annual and quarterly financial statements; and procedures for preparing annual and quarterly financial statements and related disclosures.

reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently.

c. Consideration of Entity-Level Controls

Management considers entity-level controls when identifying financial reporting risks and related controls for a financial reporting element. In doing so, it is important for management to consider the nature of the entity-level controls and how those controls relate to the financial reporting element. The more indirect the relationship to a financial reporting element, the less effective a control may be in preventing or detecting a misstatement.³³

Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. These controls might affect the other controls management determines are necessary to adequately address financial reporting risks for a financial reporting element. However, it is unlikely that management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element.

Other entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. For example, an entity-level control that monitors the results of operations may be designed to detect potential misstatements and investigate whether a breakdown in lower-level controls occurred. However, if the amount of potential

³³ Controls can be either directly or indirectly related to a financial reporting element. Controls that are designed to have a specific effect on a financial reporting element are considered directly related. For example, controls established to ensure that personnel are properly counting and recording the annual physical inventory relate directly to the existence of the inventory.

misstatement that could exist before being detected by the monitoring control is too high, then the control may not adequately address the financial reporting risks of a financial reporting element.

Entity-level controls may be designed to operate at the process, application, transaction or account-level and at a level of precision that would adequately prevent or detect on a timely basis misstatements in one or more financial reporting elements that could result in a material misstatement of the financial statements. In these cases, management may not need to identify or evaluate additional controls relating to that financial reporting risk.

d. Role of Information Technology General Controls

Controls that management identifies as addressing financial reporting risks may be automated,³⁴ dependent upon IT functionality,³⁵ or a combination of both manual and automated procedures.³⁶ In these situations, management's evaluation process generally considers the design and operation of the automated or IT dependent application controls and the relevant IT general controls over the applications providing the IT functionality. While IT general controls alone ordinarily do not adequately address financial reporting risks, the proper and consistent operation of automated controls or IT functionality often depends upon effective IT general controls. The identification of risks and controls within IT should not be a separate evaluation. Instead, it should be an integral part of

³⁴ For example, application controls that perform automated matching, error checking or edit checking functions.

³⁵ For example, consistent application of a formula or performance of a calculation and posting correct balances to appropriate accounts or ledgers.

³⁶ For example, a control that manually investigates items contained in a computer generated exception report.

management's top-down, risk-based approach to identifying risks and controls and in determining evidential matter necessary to support the assessment.

Aspects of IT general controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. For purposes of the evaluation of ICFR, management only needs to evaluate those IT general controls that are necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks. For example, management might consider whether certain aspects of IT general control areas, such as program development, program changes, computer operations, and access to programs and data, apply to its facts and circumstances.³⁷ Specifically, it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness of a company's operations, but which are not relevant to addressing financial reporting risks.

e. Evidential Matter to Support the Assessment

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment.³⁸ Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risks, including the entity-level and other pervasive elements necessary for effective ICFR, is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (for example, paper documents, electronic, or other media). Also, the documentation

³⁷ However, the reference to these specific IT general control areas as examples within this guidance does not imply that these areas, either partially or in their entirety, are applicable to all facts and circumstances. As indicated, companies need to take their particular facts and circumstances into consideration in determining which aspects of IT general controls are relevant.

³⁸ See instructions to Item 308 of Regulations S-K and S-B.

can be presented in a number of ways (for example, policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc). The documentation does not need to include all controls that exist within a process that impacts financial reporting. Rather, the documentation should be focused on those controls that management concludes are adequate to address the financial reporting risks.³⁹

In addition to providing support for the assessment of ICFR, documentation of the design of controls also supports other objectives of an effective system of internal control. For example, it serves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company.

2. Evaluating Evidence of the Operating Effectiveness of ICFR

Management should evaluate evidence of the operating effectiveness of ICFR. The evaluation of the operating effectiveness of a control considers whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The evaluation procedures that management uses to gather evidence about the operation of the controls it identifies as adequately addressing the financial reporting risks for financial reporting elements (pursuant to Section II.A.1.b) should be tailored to management's assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, ICFR risk). Management should ordinarily focus its evaluation of the operation of controls on areas posing the highest ICFR risk. Management's

³⁹ Section II.A.2.c also provides guidance with regard to the documentation required to support management's evaluation of operating effectiveness.

assessment of ICFR risk also considers the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management's judgments about the risks of failure for particular controls.

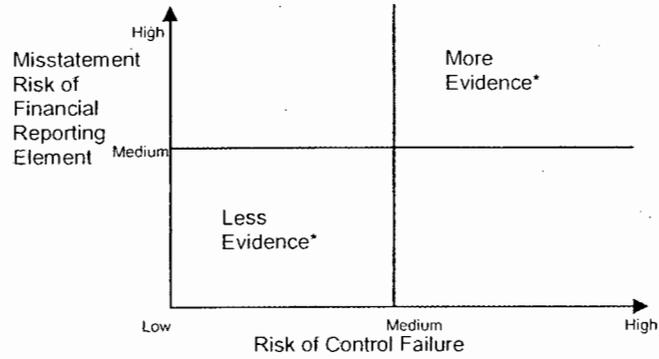
Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities. The nature, timing and extent of evaluation procedures necessary for management to obtain sufficient evidence of the effective operation of a control depend on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (for example, sample size), but also the qualitative characteristics of the evidence. The qualitative characteristics of the evidence include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity⁴⁰ of those evaluating the controls, and, in the case of on-going monitoring activities, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence. The sufficiency of evidence is not necessarily determined by any of these attributes individually.

⁴⁰ In determining the objectivity of those evaluating controls, management is not required to make an absolute conclusion regarding objectivity, but rather should recognize that personnel will have varying degrees of objectivity based on, among other things, their job function, their relationship to the control being evaluated, and their level of authority and responsibility within the organization. Personnel whose core function involves permanently serving as a testing or compliance authority at the company, such as internal auditors, normally are expected to be the most objective. However, the degree of objectivity of other company personnel may be such that the evaluation of controls performed by them would provide sufficient evidence. Management's judgments about whether the degree of objectivity is adequate to provide sufficient evidence should take into account the ICFR risk.

a. Determining the Evidence Needed to Support the Assessment

Management should evaluate the ICFR risk of the controls identified Section II.A.1.b as adequately addressing the financial reporting risks for financial reporting elements to determine the evidence needed to support the assessment. This evaluation should consider the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. This concept is illustrated in the following diagram.

Determining the Sufficiency of Evidence Based on ICFR Risk



* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).

Management's consideration of the misstatement risk of a financial reporting element includes both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to a misstatement that could be material to the financial statements. As the materiality of a financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of misstatement risk for the financial reporting element generally would correspondingly increase. In addition, management considers the extent to which the financial reporting elements include transactions, account balances or other supporting information that are prone to material misstatement. For example, the extent to which a financial reporting element: (1) involves judgment in determining the recorded amounts; (2) is susceptible to fraud; (3) has complex accounting requirements; (4) experiences change in the nature or volume of the underlying transactions; or (5) is sensitive to changes in environmental factors, such as technological and/or economic developments, would generally affect management's judgment of whether a misstatement risk is higher or lower.

Management's consideration of the likelihood that a control might fail to operate effectively includes, among other things:

- The type of control (that is, manual or automated) and the frequency with which it operates;
- The complexity of the control;
- The risk of management override;
- The judgment required to operate the control;

- The competence of the personnel who perform the control or monitor its performance;
- Whether there have been changes in key personnel who either perform the control or monitor its performance;
- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The degree to which the control relies on the effectiveness of other controls (for example, IT general controls); and
- The evidence of the operation of the control from prior year(s).

For example, management's judgment of the risk of control failure would be higher for controls whose operation requires significant judgment than for non-complex controls requiring less judgment.

Financial reporting elements that involve related party transactions, critical accounting policies,⁴¹ and related critical accounting estimates⁴² generally would be assessed as having a higher misstatement risk. Further, when the controls related to these financial reporting elements are subject to the risk of management override, involve

⁴¹ "Critical accounting policies" are defined as those policies that are most important to the financial statement presentation, and require management's most difficult, subjective, or complex judgments, often as the result of a need to make estimates about the effect of matters that are inherently uncertain. See Release No. 33-8040 (Dec. 12, 2001) [66 FR 65013].

⁴² "Critical accounting estimates" relate to estimates or assumptions involved in the application of generally accepted accounting principles where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and the impact of the estimates and assumptions on financial condition or operating performance is material. See Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056]. For additional information, see, for example, Release No. 33-8098 (May 10, 2002) [67 FR 35620].

significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

When a combination of controls is required to adequately address the risks related to a financial reporting element, management should analyze the risk characteristics of the controls. This is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics. For example, a financial reporting element involving significant estimation may require a combination of automated controls that accumulate source data and manual controls that require highly judgmental determinations of assumptions. In this case, the automated controls may be subject to a system that is stable (that is, has not undergone significant change) and is supported by effective IT general controls and are therefore assessed as lower risk, whereas the manual controls would be assessed as higher risk.

The consideration of entity-level controls (for example, controls within the control environment) may influence management's determination of the evidence needed to sufficiently support its assessment of ICFR. For example, management's judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need to evaluate the operation of the control in some manner.

b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR

Management should evaluate evidence that provides a reasonable basis for its assessment of the operating effectiveness of the controls identified in Section II.A.1.

Management uses its assessment of ICFR risk, as determined in Section II.A.2 to

determine the evaluation methods and procedures necessary to obtain sufficient evidence. The evaluation methods and procedures may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation. Activities that are performed for other reasons (for example, day-to-day activities to manage the operations of the business) may also provide relevant evidence. Further, activities performed to meet the monitoring objectives of the control framework may provide evidence to support the assessment of the operating effectiveness of ICFR.

The evidence management evaluates comes from direct tests of controls, on-going monitoring, or a combination of both. Direct tests of controls are tests ordinarily performed on a periodic basis by individuals with a high degree of objectivity relative to the controls being tested. Direct tests provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities. On-going monitoring includes management's normal, recurring activities that provide information about the operation of controls. These activities include, for example, self-assessment⁴³ procedures and procedures to analyze performance measures designed to track the operation of controls.⁴⁴ Self-assessment is a broad term that can refer to different types of procedures performed by individuals with varying degrees of objectivity. It includes assessments made by the personnel who operate the control as well as members of management who are not responsible for operating the control. The evidence provided

⁴³ For example, COSO's 1992 framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities."

⁴⁴ Management's evaluation process may also consider the results of key performance indicators ("KPIs") in which management reconciles operating and financial information with its knowledge of the business. The procedures that management implements pursuant to this section should evaluate the effective operation of these KPI-type controls when they are identified pursuant to Section II.A.1.b. as addressing financial reporting risk.

by self-assessment activities depends on the personnel involved and the manner in which the activities are conducted. For example, evidence from self-assessments performed by personnel responsible for operating the control generally provides less evidence due to the evaluator's lower degree of objectivity.

As the ICFR risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example, management can increase the evidence from on-going monitoring activities by utilizing personnel who are more objective and/or increasing the extent of validation through periodic direct testing of the underlying controls. Management can also vary the evidence obtained by adjusting the period of time covered by direct testing. When ICFR risk is assessed as high, the evidence management obtains would ordinarily consist of direct testing or on-going monitoring activities performed by individuals who have a higher degree of objectivity. In situations where a company's on-going monitoring activities utilize personnel who are not adequately objective, the evidence obtained would normally be supplemented with direct testing by those who are independent from the operation of the control. In these situations, direct testing of controls corroborates evidence from on-going monitoring activities as well as evaluates the operation of the underlying controls and whether they continue to adequately address financial reporting risks. When ICFR risk is assessed as low, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required. Further, management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end.

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR. Knowledge from daily interaction includes information obtained by on-going direct involvement with and direct supervision of the execution of the control by those responsible for the assessment of the effectiveness of ICFR. Management should consider its particular facts and circumstances when determining whether its daily interaction with controls provides sufficient evidence to evaluate the operating effectiveness of ICFR. For example, daily interaction may be sufficient when the operation of controls is centralized and the number of personnel involved is limited. Conversely, daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR would not ordinarily be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily utilize direct testing or on-going monitoring-type evaluation procedures to obtain reasonable support for the assessment.

Management evaluates the evidence it gathers to determine whether the operation of a control is effective. This evaluation considers whether the control operated as designed. It also considers matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. If management determines that the operation of the control is not effective, a deficiency exists that must be evaluated to determine whether it is a material weakness.

c. Evidential Matter to Support the Assessment

Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of ICFR risk of the underlying controls and other circumstances. Reasonable support for an assessment would include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence.

The evidential matter may take many forms and will vary depending on the assessed level of ICFR risk for controls over each of its financial reporting elements. For example, management may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, the basis for management's conclusion about the effectiveness of controls related to the financial reporting elements and the entity-level and other pervasive elements that are important to management's assessment of ICFR.

If management determines that the evidential matter within the company's books and records is sufficient to provide reasonable support for its assessment, it may determine that it is not necessary to separately maintain copies of the evidence it evaluates. For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation created specifically for the evaluation of ICFR. However, in these instances, management should consider whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence.

This documentation might include memoranda, e-mails, and instructions or directions to and from management to company employees.

Further, in determining the nature of supporting evidential matter, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement of the financial statements. As these factors increase, management may determine that evidential matter supporting the assessment should be separately maintained. For example, management may decide that separately maintained documentation in certain areas will assist the audit committee in exercising its oversight of the company's financial reporting.

The evidential matter constituting reasonable support for management's assessment would ordinarily include documentation of how management formed its conclusion about the effectiveness of the company's entity-level and other pervasive elements of ICFR that its applicable framework describes as necessary for an effective system of internal control.

3. Multiple Location Considerations

Management's consideration of financial reporting risks generally includes all of its locations or business units.⁴⁵ Management may determine that financial reporting risks are adequately addressed by controls which operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. When the controls necessary to address financial reporting risks operate at more than one

⁴⁵ Consistent with the guidance in Section II.A.1., management may determine when identifying financial reporting risks that some locations are so insignificant that no further evaluation procedures are needed.

location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

Management may determine that the ICFR risk of the controls (as determined through Section II.A.2.a) that operate at individual locations or business units is low. In such situations, management may determine that evidence gathered through self-assessment routines or other on-going monitoring activities, when combined with the evidence derived from a centralized control that monitors the results of operations at individual locations, constitutes sufficient evidence for the evaluation. In other situations, management may determine that, because of the complexity or judgment in the operation of the controls at the individual location, the risk that controls will fail to operate is high, and therefore more evidence is needed about the effective operation of the controls at the location.

Management should generally consider the risk characteristics of the controls for each financial reporting element, rather than making a single judgment for all controls at that location when deciding whether the nature and extent of evidence is sufficient. When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that a control might fail to operate effectively. Additionally, there may be pervasive risk factors that exist at a location that cause all controls, or a majority of controls, at that location to be considered higher risk.

B. Reporting Considerations

1. Evaluation of Control Deficiencies

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management evaluates the severity of each control deficiency that comes to its attention. Control deficiencies that are determined to be a material weakness must be disclosed in management's annual report on its assessment of the effectiveness of ICFR. Control deficiencies that are considered to be significant deficiencies are reported to the company's audit committee and the external auditor pursuant to management's compliance with the certification requirements in Exchange Act Rule 13a-14.⁴⁶

Management may not disclose that it has assessed ICFR as effective if one or more deficiencies in ICFR are determined to be a material weakness. As part of the evaluation of ICFR, management considers whether each deficiency, individually or in combination, is a material weakness as of the end of the fiscal year. Multiple control deficiencies that affect the same financial statement amount or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness if there is a reasonable possibility⁴⁷ that a material misstatement of the financial statements

⁴⁶ Pursuant to Exchange Act Rules 13a-14 and 15d-14 [17 CFR 240.13a-14 and 240.15d-14], management discloses to the auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all material weaknesses and significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data. The term "material weakness" is defined in the Commission's rules in Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X. See Release No. 34-55928. The Commission is seeking additional comment on the definition of the term "significant deficiency" in the Commission's rules in Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X. See Release No. 34-55930.

⁴⁷ There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies. The use of the phrase "reasonable

would not be prevented or detected in a timely manner, even though such deficiencies may be individually less severe than a material weakness. Therefore, management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure, or component of internal control, to determine whether they collectively result in a material weakness.

The evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

Risk factors affect whether there is a reasonable possibility⁴⁸ that a deficiency, or a combination of deficiencies, will result in a misstatement of a financial statement amount or disclosure. These factors include, but are not limited to, the following:

- The nature of the financial reporting elements involved (for example, suspense accounts and related party transactions involve greater risk);

possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner" is intended solely to assist management in identifying matters for disclosure under Item 308 of Regulation S-K. It is not intended to interpret or describe management's responsibility under the FCPA or modify a control framework's definition of what constitutes an effective system of internal control.

⁴⁸ The evaluation of whether a deficiency in ICFR presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

- The susceptibility of the related asset or liability to loss or fraud (that is, greater susceptibility increases risk);
- The subjectivity, complexity, or extent of judgment required to determine the amount involved (that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies (that is, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement amounts or disclosures); and
- The possible future consequences of the deficiency.

Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in ICFR include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

Management should evaluate the effect of compensating controls⁴⁹ when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

In determining whether a deficiency or a combination of deficiencies represents a material weakness, management considers all relevant information. Management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it represents a material weakness:

- Identification of fraud, whether or not material, on the part of senior management;⁵⁰
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;⁵¹
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

When evaluating the severity of a deficiency, or combination of deficiencies, in ICFR, management also should determine the level of detail and degree of assurance that

⁴⁹ Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level.

⁵⁰ For purposes of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of Sarbanes Oxley as well as any other members of senior management who play a significant role in the company's financial reporting process.

⁵¹ See FAS 154, Accounting Changes and Error Corrections, regarding correction of a misstatement.

would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. If management determines that the deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP, then management should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

2. Expression of Assessment of Effectiveness of ICFR by Management

Management should clearly disclose its assessment of the effectiveness of ICFR and, therefore, should not qualify its assessment by stating that the company's ICFR is effective subject to certain qualifications or exceptions. For example, management should not state that the company's controls and procedures are effective except to the extent that certain material weakness(es) have been identified. In addition, if a material weakness exists, management may not state that the company's ICFR is effective. However, management may state that controls are ineffective for specific reasons.

3. Disclosures about Material Weaknesses

The Commission's rule implementing Section 404 was intended to bring information about material weaknesses in ICFR into public view. Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:⁵²

⁵² Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by Item 308(a).

- The nature of any material weakness,
- Its impact on the company's financial reporting and its ICFR, and
- Management's current plans, if any, or actions already undertaken, for remediating the material weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary to form an overall picture that is not misleading.⁵³ The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis that goes beyond describing the mere existence of a material weakness. There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. While management is required to conclude and state in its report that ICFR is ineffective when there are one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not.

4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

Item 308 of Regulation S-K requires disclosure of management's assessment of the effectiveness of the company's ICFR as of the end of the company's most recent fiscal year. When a material misstatement of previously issued financial statements is

⁵³ See Exchange Act Rule 12b-20 [17 CFR 240.12b-20].

discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR.

While there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material changes to ICFR, as required by Item 308(c) of Regulation S-K.

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading. With respect to the disclosures concerning ICFR and disclosure controls and procedures, the company may need to disclose in this context what impact, if any, the restatement has on its original conclusions regarding effectiveness of ICFR and disclosure controls and procedures.

5. Inability to Assess Certain Aspects of ICFR

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating

effectiveness of the controls over that process is necessary. However, the service organization may be unwilling to provide either a Type 2 SAS 70 report or to provide management access to the controls in place at the service organization so that management could assess effectiveness.⁵⁴ Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner. The Commission's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation.⁵⁵ Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

⁵⁴ AU Sec. 324, Service Organizations (as adopted on an interim basis by the Public Company Accounting Oversight Board ("PCAOB") in PCAOB Rule 3200T), defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report." This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

⁵⁵ See Item 308(a)(3) of Regulations S-K and S-B [17 CFR 229.308(a)(3) and 228.308(a)(3)].

III. Discussion of Comments on the Proposing Release

The Proposing Release proposed for public comment interpretive guidance for management regarding the annual evaluation of ICFR required by Rules 13a-15(c) and 15d-15(c) under the Exchange Act. We received letters from 211 commenters in response to the Proposing Release.⁵⁶ The majority of commenters were supportive of the Commission's efforts in developing this Interpretive Guidance. We have reviewed and considered all of the comments received on the proposal, and we discuss our conclusions with respect to the comments in more detail in the following sections.

A. Alignment between Management's Evaluation and Assessment and the External Audit

Commenters expressed concern that confusion and inefficiencies may arise from differences between the proposed guidance for management's evaluation of ICFR and the PCAOB's proposed auditing standard for ICFR.⁵⁷ Commenters cited a lack of alignment between the two with regard to the terminology and definitions used⁵⁸ as well as

⁵⁶ Of the 211 commenters, 43 were issuers, 33 professional associations and business groups, 19 foreign private issuers and foreign professional associations, 10 investor advocacy and other similar groups, 8 major accounting firms, 11 smaller accounting firms and Section 404 service providers, 8 banks and banking associations, 4 law firms and law associations, and 75 other interested parties including students, academics, and other individuals. The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington DC 20549 in File No. S7-24-06, or may be viewed at <http://www.sec.gov/comments/s7-24-06/s72406.shtml>.

⁵⁷ In PCAOB Release No. 2006-007 the PCAOB proposed for public comment An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements and Considering and Using the Work of Others in an Audit. See http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf (hereinafter "Proposed Auditing Standard").

⁵⁸ See, for example, letters from American Bar Association's Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law (ABA), Association of Chartered Certified Accountants (ACCA), Edison Electric Institute (EEI), European Federation of Accountants (FEE), Financial Executives International Committee on Corporate Reporting (FEI CCR), Frank Gorrell (F. Gorrell), Society of Corporate Secretaries and Governance Professionals, and The Institute of Chartered Accountants in England and Wales (ICAEW).

differences in the overall approach. Some commenters that were supportive of the principles-based approach to the proposed interpretive guidance expressed concern that improvements in the efficiency of management's evaluation of ICFR would be limited by what they viewed as comparatively more prescriptive guidance for external auditors in the Proposed Auditing Standard.⁵⁹ Other commenters suggested that maximizing their auditor's ability to rely on the work performed in management's evaluation would require aligning the evaluation approach for management with the Proposed Auditing Standard.⁶⁰ Even so, some of these commenters still viewed the interpretive guidance as an improvement because it provides management the ability to choose whether, and to what extent, it should align its evaluation with the auditing standard; whereas commenters said that management feels compelled to align with the auditing standard under the current rules. Other commenters suggested that the proposed interpretive guidance was compatible with the Proposed Auditing Standard and that improvements in implementation could be attained with close coordination between management and auditors.⁶¹

In response to the comment letters, we have revised our proposal to more closely align it with how we anticipate the PCAOB will revise its proposed auditing standard. For example, the definition of a material weakness and the related guidance for

⁵⁹ See, for example, letters from Eli Lilly and Company (Eli Lilly), FEI CCR, Hutchinson Technology Inc. (Hutchinson), Independent Community Bankers of America (ICBA), MetLife Inc. (MetLife), Procter & Gamble Company (P&G), and Supervalu Inc. (Supervalu).

⁶⁰ See, for example, letters from Heritage Financial Corporation and Southern Company.

⁶¹ See, for example, letters from BDO Seidman LLP (BDO), McGladrey & Pullen LLP (M&P), and PricewaterhouseCoopers LLP (PwC).

evaluating deficiencies, including indicators of a material weakness, have been revised.⁶²

In addition, alignment revisions were made to the guidance for evaluating whether controls adequately address financial reporting risks, including entity-level controls, the factors to consider when identifying financial reporting risks and the factors for assessing the risk associated with individual financial reporting elements and controls.

However, some differences between our final interpretive guidance for management and the PCAOB's audit standard remain. These differences are not necessarily contradictions or misalignment; rather they reflect the fact that management and the auditor have different roles and responsibilities with respect to evaluating and auditing ICFR. Management is responsible for designing and maintaining ICFR and performing an evaluation annually that provides it with a reasonable basis for its assessment as to whether ICFR is effective as of fiscal year-end. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to conduct the evaluation and the sufficiency of evidence it needs to assess the effectiveness of ICFR. In contrast, the auditor is responsible for conducting an independent audit that includes appropriate professional skepticism. Moreover, the audit of ICFR is integrated with the audit of the company's financial statements. While there is a close relationship between the work performed by management and its auditor, the ICFR audit will not necessarily be limited to the nature and extent of procedures management has already performed as part of its evaluation of ICFR. There will be differences in the approaches used by management and the auditor because the auditor does not have the same information and

⁶² The revisions made to the proposed definition of material weakness and the related guidance, including the strong indicators, are discussed in Section III.F. of this document.

understanding as management and because the auditor will need to integrate its tests of ICFR with the financial statement audit. We agree with those commenters that suggested coordination between management and auditors on their respective efforts will ensure that both the evaluation by management and the independent audit are completed in an efficient and effective manner.

B. Principles-based Nature of Guidance for Conducting the Evaluation

The guidance is intended to assist management in complying with two broad principles: (1) evaluate whether controls have been implemented to adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner and (2) evaluate evidence about the operation of controls based on an assessment of risk. We believe the guidance will enable companies of all sizes and complexities to comply with our rules effectively and efficiently.

Commenters expressed support for the proposed guidance's principles-based approach.⁶³ However, some requested that the proposal be revised to include additional guidance and illustrative examples in the following areas:⁶⁴

- the identification of controls that address financial reporting risks;⁶⁵
- the assessment of ICFR risk, including how evidence gained over prior periods should impact management's assessment of risks associated with

⁶³ See, for example, letters from ACE Limited (ACE), American Electric Power Company, Inc. (AEP), Business Roundtable (BR), Canadian Bankers Association, Center for Audit Quality (Center), Ernst & Young LLP (EY), Grant Thornton LLP (GT), ING Groep N.V. (ING), Manulife Financial (Manulife), PwC, P&G, and Reznick Group, P.C. (Reznick).

⁶⁴ See, for example, letters from Brown-Forman, Ford Motor Company, MasterCard Incorporated (MasterCard), Northrop Grumman Corporation, Supervalu, UFP Technologies (UFP), and UnumProvident Corporation (UnumProvident).

⁶⁵ See, for example, letter from Nina Stofberg (N. Stofberg).

controls identified and therefore, the evidence needed to support its assessment;⁶⁶

- how varying levels of risk impact the nature of the evidence necessary to support its assessment;⁶⁷
- when on-going monitoring activities, including self-assessments, could be used to support management's assessment and reduce direct testing;⁶⁸
- sampling techniques, sample sizes, and testing methods;⁶⁹
- the type and manner in which supporting evidence should be maintained;⁷⁰ including specific guidelines regarding the amount, form and medium of evidence;⁷¹ and
- how management should document the effectiveness of monitoring activities utilized to support its assessment, as well as how management should support the evidence obtained from its daily interaction with controls as part of its assessment.⁷²

⁶⁶ See, for example, letters from ISACA and IT Governance Institute (ISACA), Manulife, and Ohio Society of Certified Public Accountants (Ohio).

⁶⁷ See, for example, letters from Cardinal Health, Inc. (Cardinal), Cleary Gottlieb Steen & Hamilton LLP (Cleary), and ISACA.

⁶⁸ See, for example, letters from BASF Aktiengesellschaft (BASF), Cardinal, Computer Sciences Corporation (CSC), ING, ISACA, Ohio, PPL Corporation (PPL), R. Malcolm Schwartz, N. Stofberg, and UnumProvident.

⁶⁹ See, for example, letters from BDO, National Association of Real Estate Investment Trusts, Reznick, and UFP.

⁷⁰ See, for example, letters from AEP, BDO, Center, EEI, Frank Consulting, PLLP (Frank), The Hundred Group of Finance Directors (100 Group), Institut Der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW), Managed Funds Association (MFA), Nasdaq Stock Market, Inc. (Nasdaq), Ohio, N. Stofberg, and UFP.

⁷¹ See, for example, letter from Nasdaq.

⁷² See, for example, letters from BDO and Center.

We have considered the requests for additional guidance and decided to retain the principles-based nature of the proposed guidance. We believe an evaluation of ICFR will be most effective and efficient when management makes use of all available facts and information to make reasonable judgments about the evaluation methods and procedures that are necessary to have a reasonable basis for the assessment of the effectiveness of ICFR and the evidential matter maintained in support of the assessment. Additional guidance and examples in the areas requested would likely have the negative consequence of establishing “bright line” or “one-size fits all” evaluation approaches. Such an outcome would be contrary to our view that the evaluations must be tailored to a company’s individual facts and circumstances to be both effective and efficient. Moreover, an evaluation by management that is focused on compliance with detailed guidance, rather than the risks to the reliability of its financial reporting, would likely lead to evaluations that are inefficient, ineffective or both.

Detailed guidance and examples from the Commission may also limit or hinder the natural evolution and further development of control frameworks and evaluation methodologies as technology, control systems, and financial reporting evolve. As we have previously stated, the Commission supports and encourages the further development of control frameworks and related implementation guidance. For example, the July 2006 small business guidance issued by COSO addresses the identification of financial reporting risks and the related controls. Additionally, we note that COSO is currently working on a project to further define how the effectiveness of control systems can be

monitored.⁷³ As such, companies may find that there are other sources for the additional guidance in the areas they are seeking.

Commenters also expressed the view that companies may abuse the flexibility afforded by the proposed principles-based guidance to perform inadequate evaluations, thereby undermining the intended investor protection benefits.⁷⁴ Other commenters have observed that material weakness disclosures to investors are too often simultaneous with, rather than in advance of, the restatement of financial statements, which undermines the usefulness of the disclosures.⁷⁵ In response to these comments, we note that this principles-based guidance enables management to tailor its evaluation so that it focuses on those areas of financial reporting that pose the highest risk to reliable financial reporting. We believe that a tailored evaluation approach that focuses resources on areas of highest risk will improve, rather than degrade, the effectiveness of many company's evaluations and improve the timeliness of material weakness disclosures to investors.

C. Scalability and Small Business Considerations

Commenters believed that the proposed interpretive guidance can be scaled to companies of all sizes and will benefit smaller public companies in completing their

⁷³ In a press release on January 8, 2007, COSO announced that Grant Thornton LLP had been commissioned to develop guidance to help organizations monitor the quality of their internal control systems. According to that press release, the guidance will serve as a tool for effectively monitoring internal controls while complying with Sarbanes-Oxley. The press release is available at http://www.coso.org/Publications/COSO%20Monitoring%20GT%20Final%20Release_1.8.07.pdf.

⁷⁴ See, for example, letters from Joseph V. Carcello, Consumer Federation of America, Consumer Action, U.S. Public Interest Research Group (CFA), and Moody's Investors Service (Moody's).

⁷⁵ See, for example, letters from CFA and Moody's.

assessments.⁷⁶ However, some commenters requested more guidance to enable them to conduct the evaluation in an effective and efficient manner. For example, commenters requested more guidance on how some of the unique characteristics of smaller companies, including a lack of segregation of duties, should be considered in the evaluation.⁷⁷

Other commenters, mostly comprised of investor groups, requested that the guidance emphasize that scaled or tailored evaluation methods and procedures for smaller public companies should be based on both the size and complexity of the business and do not imply less rigorous evaluation methods and procedures.⁷⁸

Some commenters indicated that smaller public companies should continue to be exempt at least until a thorough examination is conducted of both the Interpretive Guidance and the new Auditing Standard to ensure that smaller companies are not disproportionately burdened.⁷⁹ Some commenters requested that the SEC further delay

⁷⁶ See, for example, letters from American Bankers Association (American Bankers), Anthony S. Chan, Chandler (U.S.A.), Inc. (Chandler), CNB Corporation & Citizens National Bank of Cheboygan (CNB), Financial Services Forum, GT, Greater Boston Chamber of Commerce, Minn-Dak Farmers Cooperative (MDFC), RAM Energy Resources, Inc., and San Jose Water Company.

⁷⁷ See, for example, letters from American Electronics Association (AeA), EY, Financial Executives International Small Public Company Task Force (FEI SPCTF), Frank, Institute of Management Accountants (IMA), MFA, U.S. Chamber of Commerce (Chamber), and U.S. Small Business Administration's Office of Advocacy (SBA).

⁷⁸ See, for example, letters from California Public Employees' Retirement System (CalPERS), CFA, Council of Institutional Investors, Ethics Resource Center, International Brotherhood of Teamsters, and Pension Reserves Investment Management Board (PRIMB).

⁷⁹ See, for example, letters from AeA, Biotechnology Industry Organization, Committee on Capital Markets Regulation (CCMR), Financial Reporting Committee of the Association of the Bar of the City of New York (NYC Bar), International Association of Small Broker Dealers and Advisers, National Venture Capital Association, SBA, Silicon Valley Leadership Group (SVLG), Small Business Entrepreneurship Council, TechNet, and Telecommunications Industry Association.

the implementation for one additional year⁸⁰ or continued to call for a complete exemption from Section 404 for smaller public companies.⁸¹ Other commenters requested that smaller public companies not be exempted.⁸²

We believe the principles-based guidance permits flexible and scalable evaluation approaches that will enable management of smaller public companies to evaluate and assess the effectiveness of ICFR without undue cost burdens. The guidance recognizes that internal control systems and the methods and procedures necessary to evaluate their effectiveness may be different in smaller public companies than in larger companies. However, the flexibility provided in the guidance is not meant to imply that evaluations for smaller public companies be conducted with less rigor, or to provide anything less than reasonable assurance as to the effectiveness of ICFR at such companies. Rather, smaller public companies should utilize the flexibility provided in the guidance to cost-effectively tailor and scale their methods and approaches for identifying and documenting financial reporting risks and the related controls and for evaluating whether operation of controls is effective (for example, by utilizing evidence gathered through management's daily interaction with its controls), so that they provide the evidence needed to assess whether ICFR is effective.

In addition, as previously mentioned, companies may find that there are other sources for guidance, such as the July 2006 guidance for applying the COSO framework to smaller public companies. We believe our guidance, when used in conjunction with

⁸⁰ See, for example, letters from American Bankers, America's Community Bankers, Chandler, CNB, FEI SPCTF, F. Gorrell, ICBA, MFA, and Washington Legal Foundation (WLF).

⁸¹ See, for example, letters from American Stock Exchange, ICBA, UFP, and WLF.

⁸² See, for example, letters from American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), CalPERS, Frank, F. Gorrell, PRIMB, and WithumSmith+Brown Global Assurance, LLC.

other such guidance, will enable smaller public companies to have a better understanding of the requirements of a control framework, its role in effective internal control systems and the relationship to our evaluation and disclosure requirements. This should enable management to plan and conduct its evaluation in an effective and efficient manner.

The Commission believes that compliance with the ICFR evaluation and assessment requirements by smaller public companies will further the primary goal of Sarbanes-Oxley which is to enhance the quality of financial reporting and increase investor confidence in the fairness and integrity of the securities markets. We note that all financial statements filed with the Commission, even those by smaller public companies, result from a system of internal controls. Such systems are required by the FCPA to operate at a level that provides “reasonable assurance” about the reliability of financial reporting. Our rules implementing Section 404 direct management of all companies to evaluate and assess whether the company’s system of internal controls is effective at achieving reasonable assurance. Our guidance is intended to help them do so in a cost-effective manner. Given the principles-based nature of our guidance and the flexibility it provides, we do not believe further postponement of the evaluation requirements are needed for smaller companies. We believe that the timing of the issuance of the Interpretive Guidance is adequate to allow for its effective implementation in 2007 evaluations.

D. Identifying Financial Reporting Risks and Controls

1. Summary of the Proposal

The proposal directed management to consider the sources and potential likelihood of misstatements, including those arising from fraudulent activity, and identify

those that could result in a material misstatement of the financial statements (that is, financial reporting risks). The proposal indicated that management's consideration of the risk of misstatement generally includes all of its locations or business units and that the methods and procedures for identifying financial reporting risks will vary based on the characteristics of the individual company. The proposal discussed factors for management to consider in selecting methods and procedures for evaluating financial reporting risks and in identifying the sources and potential likelihood of misstatement.

The proposal directed management to evaluate whether controls were placed in operation to adequately address the financial reporting risks it identifies. The proposal indicated that controls were not adequate when their design was such that there was a reasonable possibility that a misstatement in a financial reporting element that could result in a material misstatement of the financial statements would not be prevented or detected in a timely manner. The proposal discussed the fact that some controls may be automated or may depend upon IT functionality. In these situations, the proposal stated that management's evaluation should consider not only the design and operation of the automated or IT dependent controls, but also the aspects of IT general controls necessary to adequately address financial reporting risks.

The proposal also indicated that entity-level controls should be considered when identifying financial reporting risks and related controls for a financial reporting element. The proposal discussed the nature of entity-level controls, how they relate to a financial reporting element and the need to consider whether they would prevent or detect material misstatements. If a financial reporting risk for a financial reporting element is adequately addressed by an entity-level control, the proposal indicated that no further controls

needed to be identified and tested by management for purposes of the evaluation of ICFR.

2. Comments on the Proposal and Revisions Made

The Commission received a number of comments on the proposed guidance for identifying financial reporting risks and controls. As discussed in Section III.B above, many of these commenters requested more examples or more detailed guidance. Other comments received related to the identification of fraud risks and related controls; entity-level controls; and IT general controls.

Identification of fraud risks and related controls

Commenters suggested the guidance be revised to more strongly emphasize management's responsibility to identify and evaluate fraud risks and the related controls that address those risks.⁸³ Commenters also discussed the nature of fraud risks that most often lead to materially misstated financial statements and requested additional guidance regarding which fraud related controls are within the scope of the evaluation;⁸⁴ whether management can consider the risk of fraud through the overall risk assessment or if a specific fraud threat analysis is required;⁸⁵ and examples of the types of fraud that should be considered.⁸⁶ Other commenters noted that there is existing guidance for management, beyond what was referenced in the proposal, for assessing fraud risks and

⁸³ See, for example, letters from ACE, ACCA, BDO, Center, CSC, Deloitte & Touche LLP (Deloitte), GT, IMA, KPMG LLP (KPMG), M&P, Moody's, and PwC.

⁸⁴ See, for example, letters from BASF, BDO, and GT.

⁸⁵ See, for example, letter from Tatum LLC (Tatum).

⁸⁶ See, for example, letters from FEI CCR, P&G, and N. Stofberg.

the related controls. These commenters suggested that the proposal be revised to directly incorporate the most relevant elements of such guidance.⁸⁷

In response to the comments, the proposal was revised to clarify that fraud risks are expected to exist at every company and that the nature and extent of the fraud risk assessment activities should be commensurate with the size and complexity of the company. Additionally, we expanded the references to existing guidance to include the AICPA's 2005 Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention and COSO's July 2006 Guidance for Smaller Public Companies. Given the availability of existing information and guidance on fraud and consistent with the principles-based nature of the interpretive guidance, we determined that it was unnecessary to provide a list of fraud risks expected to be present at every company or a list of the areas of financial reporting expected to have a risk of material misstatement due to fraud. Moreover, providing such a list may result in a "checklist" type approach to fraud risk assessments that would likely be ineffective as financial reporting changes over time, or given the wide variety of facts and circumstances that exist in different companies and industries. While management may find such checklists a useful starting point, effective fraud risk assessments will require sound and thoughtful judgments that reflect a company's individual facts and circumstances.

Entity-Level Controls

Commenters requested further clarification of how entity-level controls can address financial reporting risks in a top-down, risk based approach.⁸⁸ Commenters also

⁸⁷ See, for example, letters from Center, GT, KPMG, and M&P.

⁸⁸ See, for example, letters from EY, Frank, MetLife, and UnumProvident.

suggested that the guidance place more emphasis on entity-level controls given their pervasive impact on all other aspects of ICFR.⁸⁹

In response to the comments received, we expanded the discussion of entity-level controls and how they relate to financial reporting elements. This discussion further clarifies that some entity-level controls, such as controls within the control environment, have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. While these controls might affect the other controls management determines are necessary to address financial reporting risks for a financial reporting element, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk. Further, the guidance clarifies that some entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. In these cases, management would identify the additional controls needed to adequately address financial reporting risks, which may include those that operate at the transaction or account balance level. Consistent with the proposal, management does not need to identify or evaluate additional controls relating to a financial reporting risk if it determines that the risk is being adequately addressed by an entity-level control.

We have also revised the proposed guidance to further clarify that the controls management identifies in Section II.A.1 should include the entity-level and pervasive elements of its ICFR that are necessary to have a system of internal control that provides reasonable assurance as to the reliability of financial reporting. Management can use the

⁸⁹ See, for example, letters from ACCA, ACE, Eli Lilly, European Association of Listed Companies (EALIC), and PwC.

existing control frameworks and related guidance to assist them in evaluating the adequacy of these aspects of their ICFR.

Information Technology General Controls

Commenters expressed concern that the proposal's guidance on IT general controls was too vague or that it lacked sufficient clarity⁹⁰ and requested further guidance and illustrative examples⁹¹ to clarify the extent to which IT general controls are within the scope of the ICFR evaluation.⁹² Commenters also suggested that the Commission directly incorporate the May 16, 2005 Staff Guidance⁹³ on IT general controls⁹⁴ and that we clarify that IT general controls alone, without consideration of application controls, will not sufficiently address the risk of material misstatement.⁹⁵ One commenter noted that providing such guidance could have the unintended consequence of setting a precedent for providing more detailed guidance in other areas of the evaluation.⁹⁶

Commenters also suggested that we revise the proposal to clarify how a top-down approach considers IT general controls,⁹⁷ that we encourage a "benchmarking" approach for evaluating automated controls,⁹⁸ and that we permit companies who implement IT

⁹⁰ See, for example, letters from Aerospace Industries Association, MasterCard, and Nasdaq.

⁹¹ See, for example, letter from Microsoft Corporation (MSFT).

⁹² See, for example, letters from Faisal Danka, ISACA, MSFT, Rod Scott, and The Travelers Companies, Inc. (Travelers).

⁹³ Division of Corporation Finance and Office of the Chief Accountant: Staff Statement on Management's Report on Internal Control Financial Reporting (May 16, 2005), available at <http://www.sec.gov/spotlight/soxcom/.htm>.

⁹⁴ See, for example, letters from FEI CCR and P&G.

⁹⁵ See, for example, letter from IDW.

⁹⁶ See, for example, letter from ICAEW.

⁹⁷ See, for example, letters from Cardinal and ISACA.

⁹⁸ See, for example, letter from CSC.

systems late in the year to do so while still being able to satisfy their ICFR responsibilities.⁹⁹

We made several revisions to the proposed guidance based on the comment letters. We revised the proposal to explain that the identification of risks and controls within IT should be integral to, and not separate from, management's top-down, risk-based approach to evaluating ICFR and in determining the necessary supporting evidential matter. We clarified that controls which address financial reporting risks may be automated, dependent upon IT functionality, or require a combination of both manual and automated procedures and that IT general controls alone, without consideration of application controls, ordinarily do not adequately address financial reporting risks. We also incorporated guidance from the May 16, 2005 Staff Statement which explains that it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness of operations, but which are not relevant to addressing financial reporting risks.

We have declined to further specify categories or areas of IT general controls that will be relevant to the ICFR evaluation for all companies. We continue to believe that such determinations require consideration of each company's individual facts and circumstances. Moreover, we have concluded it is not necessary to include a discussion of a "benchmarking" approach to evaluating automated controls. The lack of such discussion in our guidance does not preclude management from taking such an approach if they believe it to be both efficient and effective.

⁹⁹ See, for example, letter from Chamber.

Additionally, we did not revise the proposed guidance to discuss implementation of IT systems, or changes thereto, late in the year because we do not believe such decisions should be impacted by the requirement to evaluate and assess the effectiveness of ICFR. Even without the evaluation and assessment requirements, the implementation of an IT system late in the year does not change management's responsibility to maintain a system of internal control that provides reasonable assurance regarding the reliability of financial reporting. Allowing an exclusion from the evaluation for controls placed in operation late in the year could have the unintended consequence of negatively impacting the reliability of financial reporting. Management has the ability to mitigate the risk of material misstatement that arises from ineffective controls in a new IT system. For example, management may perform pre-implementation testing of the IT controls needed to adequately address financial reporting risks. Additionally, management may implement compensating controls, such as manual reconciliations and verification, until such time that management has concluded that the IT controls within the system are adequate. Accordingly, we do not believe it is necessary or appropriate to exclude new IT systems or changes to existing systems from the scope of the evaluation of ICFR.

E. Evaluating Evidence of the Operating Effectiveness of ICFR

1. Summary of the Proposal

Our proposal indicated that management should consider both the risk characteristics of the financial reporting elements to which the controls relate and the risk characteristics of the controls themselves (collectively, ICFR risk) in making judgments about the nature and extent of evidence necessary to provide a reasonable basis for the assessment of whether the operation of controls is effective. The proposal identified

significant accounting estimates, related party transactions and critical accounting policies as examples of financial reporting areas that generally would be assessed as having a higher risk of misstatement and control failure. However, the proposed guidance recognizes that since not all controls have the same risk characteristics, when a combination of controls is required to adequately address the risks to a financial reporting element, management should analyze the risk characteristics of each control separately. Further, under the proposed guidance, when evaluating risks in multi-location environments, management should generally consider the risk characteristics of the controls related to each financial reporting element, rather than making a single judgment for all controls at a particular location when determining the sufficiency of evidence to support its assessment.

Our proposal indicated that the evidence of the operation of controls that management evaluates may come from a combination of on-going monitoring and direct testing and that management should vary the nature, timing and extent of these based on its assessment of the ICFR risk. Our proposal stated that this evidence would ordinarily cover a reasonable period of time during the year and include the fiscal year-end. The proposal also acknowledged that, in smaller companies, those responsible for assessing the effectiveness of ICFR may, through their on-going direct knowledge and supervision of the operation of controls (that is, daily interaction) have a reasonable basis to evaluate the effectiveness of some controls without performing direct tests specifically for purposes of the evaluation.

The proposal explained that the evidential matter constituting reasonable support for the assessment would generally include the basis for management's assessment and

documentation of the evaluation methods and procedures for gathering and evaluating evidence. Additionally, the proposal indicated that the nature of the supporting evidential matter, including documentation, may take many forms and may vary based on management's assessment of ICFR risk. For example, management may determine that it is not necessary to maintain separate copies of the evidence evaluated if such evidence already exists in the company's books and records. The proposal also indicates that as the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element increase, management may determine that separate evidential matter supporting a control's operation should be maintained.

2. Comments on the Proposal and Revisions Made

The Commission received a number of comments on the proposed guidance for evaluating whether the operation of controls was effective. As discussed in Section III.B above, many of these commenters requested more examples or more detailed guidance. Other comments received related to the appropriateness of various "rotational" approaches to evaluating evidence of whether the operation of controls was effective; the nature of on-going monitoring activities, including self-assessments and daily interaction; the time period to be covered by evaluation procedures; and supporting evidential matter.

Rotational Approaches to Evaluating Evidence

Commenters requested that the guidance explicitly allow management to rotate its evaluation of evidence of the operation of controls and a variety of different approaches for doing so were suggested. These approaches included, for example, a rotational

approach for lower risk controls,¹⁰⁰ a rotational approach in areas where management determines there are no changes in the controls since the previous assessment,¹⁰¹ or a rotational approach where there is both lower risk and no changes in controls.¹⁰² In addition, some suggested a “benchmarking” approach, similar to that used for IT controls, be allowed for non-IT controls.¹⁰³ Other commenters agreed with the proposal’s requirement that management consider evidence of the operation of controls each year.¹⁰⁴ Others noted that while they believed it is appropriate for management to consider the results of its prior year assessments, the guidance should make it clear that the evaluation of operating effectiveness is an annual requirement.¹⁰⁵

Other commenters raised the issue of a rotational approach specific to multi-location considerations. For example, commenters suggested that the guidance allow for rotation of locations based upon risk (for example, once every three years).¹⁰⁶ However, some commenters suggested that the risk-based approach provided in the proposed guidance would appropriately allow companies to vary testing in locations based more on risk than coverage, which would improve the efficiency of their assessment.¹⁰⁷

After considering the comments, the Commission has retained the guidance substantially as proposed. We did not introduce a concept that allows management to

¹⁰⁰ See, for example, letters from CSC, EALIC, ING, MasterCard, and NYC Bar.

¹⁰¹ See, for example, letters from P&G and Travelers.

¹⁰² See, for example, letters from EEI and Supervalu.

¹⁰³ See, for example, letters from Eli Lilly and FEI CCR.

¹⁰⁴ See, for example, letters from CCMR, Deloitte, and KPMG.

¹⁰⁵ See, for example, letters from AFL-CIO, Center, CFA, Deloitte, and PwC.

¹⁰⁶ See, for example, letter from CSC.

¹⁰⁷ See, for example, letters from MSFT, New York State Society of Certified Public Accountants, and Plains Exploration & Production Company.

eliminate from its annual evaluation those controls that are necessary to adequately address financial reporting risks. For example, management cannot decide to include controls for a particular location or process within the scope of its evaluation only once every three years or exclude controls from the scope of its evaluation based on prior year evaluation results. To have a reasonable basis for its assessment of the effectiveness of ICFR, management must have sufficient evidence supporting the operating effectiveness of all aspects of its ICFR as of the date of its assessment. The guidance provides a framework to assist management in making judgments regarding the nature, timing and extent of evidence needed to support its assessment. Management can use this framework to scale its evaluation methods and procedures in response to the risks associated with both the financial reporting elements and related controls in its particular facts and circumstances.

However, the guidance has been clarified to reflect that management's experience with a control's operation both during the year and as part of its prior year assessment(s) may influence its decisions regarding the risk that controls will fail to operate as designed. This, in turn, may have a corresponding impact on the evidence needed to support management's conclusion that controls operated effectively as of the date of management's assessment.

Nature of On-Going Monitoring Activities

Commenters expressed concern that, as defined in the proposal, some on-going monitoring activities would not be deemed to provide sufficient evidence.¹⁰⁸ Other commenters were concerned that the guidance placed too much emphasis on the amount

¹⁰⁸ See, for example, letters from BASF and Cees Klumper & Matthew Shepherd (C. Klumper & M. Shepherd).

of evidence that could be obtained from on-going monitoring activities and called for further examples of when they may provide sufficient evidence and when direct testing would be required.¹⁰⁹ With regard to self-assessments, commenters suggested that self-assessments can be an integral source of evidence when their effective operation is verified by direct testing over varying periods of time based on the manner in which the self-assessments were conducted and on the level of risk associated with the controls.¹¹⁰ Other commenters requested the proposed guidance be revised to clarify how, based on the definitions provided, self-assessments differed from direct testing.¹¹¹

Some commenters questioned the sufficiency of evidence that would result from management's daily interaction with controls and requested more specifics on when it would be appropriate as a source of evidence¹¹² and how management should demonstrate that its daily interaction with controls provided it with sufficient evidence to have a reasonable basis to assess whether the operation of controls was effective.¹¹³

Based on the feedback received, we modified the discussion of on-going monitoring activities, including self-assessments, and direct testing to clarify how the evidence obtained from each of the activities can vary. As commenters in this area noted, on-going monitoring, including self-assessments, encompasses a wide array of activities that can be performed by a variety of individuals within an organization. These individuals have varying degrees of objectivity, ranging from internal auditors to the personnel involved in business processes, and can include both those responsible for

¹⁰⁹ See, for example, letters from Center and EY.

¹¹⁰ See, for example, letters from GT and C. Klumper & M. Shepherd.

¹¹¹ See, for example, letter from Cardinal.

¹¹² See, for example, letters from BDO, EY, Ohio, and Tatum.

¹¹³ See, for example, letter from Ohio.

executing a control as well as those responsible for overseeing its effective operation. Because of the varying degrees of objectivity, the sufficiency of the evidence management obtains from on-going monitoring activities is determined by the nature of the activities (that is, what they entail and how they are performed).

We clarified the proposed guidance to indicate that when evaluating the objectivity of personnel, management is not required to make an absolute conclusion regarding objectivity, but rather should recognize that personnel will have varying degrees of objectivity based on, among other things, their job function, their relationship to the control being evaluated, and their level of authority and responsibility within the organization. Management should consider the ICFR risk of the controls when determining whether the objectivity of the personnel involved in the monitoring activities results in sufficient evidence. For example, for areas of high ICFR risk, management's on-going monitoring activities may provide sufficient evidence when the monitoring activities are carried out by individuals with a high degree of objectivity. However, when management's support includes evidence obtained from activities performed by individuals who are not highly objective, management would ordinarily supplement the evidence with some degree of direct testing by individuals who are independent from the operation of the control to corroborate the information from the monitoring activity.

With regard to requests for more guidance related to management's daily interaction, we have adopted the guidance substantially as proposed. We believe that in smaller companies, management's daily interaction with the operation of controls may provide it with sufficient evidence to assess whether controls are operating effectively. The guidance is not intended to limit management's flexibility with regard to the areas of

ICFR where its interaction can provide it with sufficient evidence or the manner by which management obtains knowledge of the operation of the controls. However, as noted in the guidance, daily interaction as a source of evidence for the operation of controls applies to management who are responsible for assessing the effectiveness of ICFR and whose knowledge about the effective operation is gained from its on-going direct knowledge and direct supervision of controls. In addition, the evidence management maintains in support of its assessment should include the design of the controls that adequately address the financial reporting risks as well as how its interaction provides an adequate basis for its assessment of the effectiveness of ICFR.

Time Period Covered by Evaluation Procedures

Commenters requested that the guidance allow for, and encourage, management to gather evidence throughout the year to support its assessment in lieu of having to gather some evidence close to or as-of year-end.¹¹⁴ These commenters believed that such guidance would encourage companies to better integrate their evaluation procedures into the normal activities of their daily operations, spread the effort more evenly throughout the year, and help reduce the strain on resources at year-end when company personnel are preparing the annual financial statements and complying with other financial reporting activities.

We agree with the comments received in this area with respect to allowing management the flexibility to gather evidence in support of its assessment during the year. Since management's assessment is performed as of the end of its fiscal year-end, the evidence management utilizes to support its assessment would ordinarily include a

¹¹⁴ See, for example, letters from Eli Lilly, The Financial Services Roundtable, and Neenah Paper, Inc.

reasonable period of time during the year, including some evidence as of the date of its assessment. However, the proposal was not intended to limit management's flexibility to conduct its evaluation activities during the year. Rather, the proposed guidance was intended to provide management with the ability to perform a variety of activities covering periods of time that vary based on its assessment of risk in order to provide it with a sufficient basis for its evaluation. This could include, for example, a strategy that employs direct testing over a control during the year (but prior to year-end), that is supplemented with a self-assessment activity at year-end. As a result, we have adopted the guidance related to the period of time for which management should obtain evidence of the operation of controls substantially as proposed.

Supporting Evidential Matter

Commenters expressed support for the guidance in the proposal related to the supporting evidential matter and believed it would allow management to make better judgments and allow for sufficient flexibility to vary the nature and extent of evidence based on the company's particular facts and circumstances.¹¹⁵ Other commenters observed that a certain level of documentation was required in order to facilitate an efficient and effective audit and suggested the guidance explicitly state this fact and/or clarify how the guidance for management was intended to interact with the requirements provided to auditors.¹¹⁶ One commenter requested that we clarify our intention related to

¹¹⁵ See, for example, letters from BR, EY, Hudson Financial Solutions (HFS), and MSFT.

¹¹⁶ See, for example, letters from Center, Deloitte, EY, GT, M&P, MetLife, MDFC, PwC, and N. Stofberg.

the audit committee's involvement in the review of evidential matter prepared by management in support of its assessment.¹¹⁷

After consideration of the comments, we are adopting the guidance substantially as proposed. We continue to believe that management should have considerable flexibility as to the nature and extent of the documentation it maintains to support its assessment, while at the same time maintaining sufficient evidence to provide reasonable support for its assessment. Providing specific guidelines and detailed examples of various types of documentation would potentially limit the flexibility we intended to afford management.

With respect to the concerns raised regarding the interaction of the proposed guidance and the audit requirements, we determined that no changes were necessary. Similar to an audit of the financial statements, the nature and extent of evidential matter maintained by management may impact how an auditor conducts the audit and the efficiency of the audit. We believe that the most efficient implementation by management and the auditor is achieved when flexibility exists to determine the appropriate manner by which to complete their respective tasks. However, we also believe that the Proposed Auditing Standard allows auditors sufficient flexibility to consider various types of evidence utilized by management. The audit standard allows auditors to adjust their approach in certain circumstances, if necessary, so that audit procedures should not place any undue burden or expense on management's evaluation process.

¹¹⁷ See, for example, letter from ABA.

F. Evaluation of Control Deficiencies

1. Summary of the Proposal

The proposal directed management to evaluate each control deficiency that comes to its attention in order to determine whether the deficiency, or combination of control deficiencies, is a material weakness. The proposal defined a material weakness as a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR. The proposal contained guidance on the aggregation of deficiencies by indicating that multiple control deficiencies that affect the same financial reporting element increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may be individually insignificant. The proposal also highlighted four circumstances that were strong indicators that a material weakness in ICFR existed. In summary, the following four items were listed:

- An ineffective control environment, including identification of fraud of any magnitude on the part of senior management; significant deficiencies that remain unaddressed after some reasonable period of time; and ineffective oversight by the audit committee (or entire board of directors if no audit committee exists).
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.

- Identification by the auditor of a material misstatement of financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function.

2. Comments on the Proposal and Revisions Made

Definition of Material Weakness

Commenters expressed concern about differences between our proposed definition of material weakness and that proposed by the PCAOB in its Proposed Auditing Standard and requested that the two definitions be aligned.¹¹⁸ Commenters provided feedback on the reasonably possible threshold for determining the likelihood of a potential material misstatement as well as the reference to interim financial statements for determining whether a potential misstatement could be material. Commenters also suggested that a single definition of material weakness be established for use by both auditors and management and that definition be established by the SEC in its rules.¹¹⁹ Based on comments on the proposal, we are amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term material weakness. Further discussion and analysis of the definition of material weakness and commenter feedback can be found in that rule release.¹²⁰

¹¹⁸ See, for example, letters from EEI, FEI CCR, FEI SPCTF, ICAEW, N. Stofberg, and SVLG.

¹¹⁹ See, for example, letters from FEE and ICAEW.

¹²⁰ Release No. 34-55928.

Strong Indicators of a Material Weakness

Commenters noted there were differences in the list of strong indicators included in the proposal and the list of strong indicators included in the Proposed Auditing Standard, raising concern that the failure of the two proposals to provide similar guidance would cause unnecessary confusion between management and auditors.¹²¹ Commenters also provided suggested changes, additions or deletions to circumstances that were included on the list of strong indicators. For example, commenters raised questions about the “identification of fraud of any magnitude on the part of senior management,” questioning the appropriateness of the term “of any magnitude” or which individuals were encompassed in the term “senior management.”¹²² Commenters also felt the Commission’s proposed list of indicators should be expanded to include the indicator relating to an ineffective internal audit function or risk assessment function that was included in the Proposed Auditing Standard.¹²³ One commenter felt that the list of strong indicators needed to be made more specific, and should include more illustrative examples.¹²⁴ Another commenter stated that the indicator of “significant deficiencies that have been identified and remain unaddressed after some reasonable period of time” should be clarified to mean unremediated deficiencies.¹²⁵ Other commenters suggested that the list of strong indicators be eliminated completely, stating that designating these items as strong indicators creates a presumption that such items are, in fact, material

¹²¹ See, for example, letters from BDO, BR, Center, Cleary, CSC, Deloitte, KPMG, M&P, and Schneider Downs & Co., Inc. (Schneider).

¹²² See, for example, letters from 100 Group, Eli Lilly, FEI CCR, and P&G.

¹²³ See, for example, letters from BR, Crowe Chizek & Company LLC (Crowe), Deloitte, and M&P.

¹²⁴ See, for example, letter from Chamber.

¹²⁵ See, for example, letter from EEI.

weaknesses, and may impede the use of judgment to properly evaluate the identified control deficiency in light of the individual facts and circumstances.¹²⁶ Commenters also felt the Commission should clearly indicate that a company may determine that no deficiency exists despite the fact that one of the identified strong indicators was present.¹²⁷

After consideration of the comments, we have decided to modify the proposed guidance. We believe judgment is imperative in determining whether a deficiency is a material weakness and that the guidance should encourage management to use that judgment. As a result, we have modified the guidance to emphasize that the evaluation of control deficiencies requires the consideration of all of the relevant facts and circumstances. We agreed with the concerns that an overly detailed list may create a list of de facto material weaknesses or inappropriately suggest that identified control deficiencies not included in the list are of lesser importance. At the same time, however, we continue to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information for management. As a result, rather than referring to “strong indicators,” the final guidance refers simply to “indicators.” This change should further emphasize that the presence of one of the indicators does not mandate a conclusion that a material weakness exists. Rather management should apply professional judgment in this area. These examples include indicators related to the results of the financial statement audit, such as material audit adjustments and restatements, and indicators related to the overall evaluation of the company’s oversight of financial reporting, such as the effectiveness of the audit committee and incidences of

¹²⁶ See, for example, letters from Cleary, Institute of Internal Auditors (IIA), and NYC Bar.

¹²⁷ See, for example, letters from Chamber, Cleary, CSC, PPL, and Schneider.

fraud among senior management. These examples are by no means an exhaustive list. For example, under COSO, risk assessment and monitoring are two of the five components of an effective system of internal control. If management concludes that an internal control component is not effective, or if required entity-level or pervasive elements of ICFR are not effective, it is likely that internal control is not effective.

Lastly, we agreed with commenters that it is appropriate for the Commission's guidance in this area to mirror the PCAOB's auditing standard. As a result, we have worked with the PCAOB in reaching conclusions regarding the guidance in this area, and we anticipate the PCAOB's auditing standard will align with our final management guidance.

G. Management Reporting and Disclosure

Comment letters expressed various viewpoints regarding the information management provides as part of its report on the effectiveness of ICFR. For example, commenters raised concerns regarding the "point in time" assessment and suggested various alternative approaches.¹²⁸ Commenters also made suggestions regarding the disclosures management provides when a material weakness has occurred. Certain commenters felt the suggested disclosures indicated in the proposing release should be mandatory,¹²⁹ while other commenters wanted the Commission to specify where in the Form 10-K management must provide its disclosures.¹³⁰ Commenters also requested that

¹²⁸ See, for example, letters from BHP Billiton Limited, Eli Lilly, and IIA.

¹²⁹ See, for example, letters from HFS, IDW, and Tatum.

¹³⁰ See, for example, letters from Crowe and KPMG.

the Commission include in its release additional possible disclosures for consideration by management to include in its report.¹³¹

In addition, commenters expressed concerns regarding the language in the Proposing Release with respect to management's ability to determine that ICFR is ineffective due solely to, and only to the extent of, the identified material weakness(es). Some commenters felt that this language was essentially the same as a qualified opinion, which is prohibited by the guidance,¹³² while two others stated that the Commission needed to provide additional guidance around the circumstances under which this approach would be appropriate.¹³³

Based on the feedback we received, we have eliminated this from the final interpretive guidance and revised the proposed guidance to simply state that management may not state that the company's ICFR is effective. However, management may state that controls are ineffective for specific reasons.

Additionally, certain of the requests received seemed inconsistent with the statutory obligation. For example, Section 404(a)(2) of Sarbanes-Oxley requires that management perform the assessment as of the end of its most recent fiscal year. As a result, we do not believe any further changes to the proposed guidance around management's expression of its assessment of the effectiveness of ICFR are necessary.

¹³¹ See, for example, letters from PCG Worldwide Limited and PepsiCo, Inc. (Pepsi).

¹³² See, for example, letters from BDO and CFA.

¹³³ See, for example, letters from Crowe and Deloitte.

H. Previous Staff Guidance and Staff Frequently Asked Questions

Commenters raised questions regarding the status of guidance previously issued by the Commission and its staff, on May 16, 2005,¹³⁴ as well as the Frequently Asked Questions (“FAQs”).¹³⁵ Some commenters requested the FAQs be retained in their entirety,¹³⁶ while others requested that some particular FAQs be retained.¹³⁷ As we indicated in the proposed guidance, the May 2005 guidance remains relevant.

Additionally, we have instructed the staff to review the FAQs and, as a result of the final issuance of this guidance, update them as appropriate.

I. Foreign Private Issuers

The Commission received comments directed towards the information included in the proposed guidance related to foreign private issuers. While three commenters noted that no additional guidance for foreign private issuers was necessary,¹³⁸ other commenters suggested changes. Commenters raised concerns regarding potential duplicative efforts and costs foreign registrants are subject to, as a result of similar regulations in their local jurisdictions.¹³⁹ These commenters requested that the Commission attempt to minimize or remove any duplicative requirements, with some

¹³⁴ Commission Statement on Implementation of Internal Control Reporting Requirements, Press Release No. 2005-74 (May 16, 2005); Division of Corporation Finance and Office of the Chief Accountant: Staff Statement on Management’s Report on Internal Control Financial Reporting (May 16, 2005), available at <http://www.sec.gov/spotlight/soxcom/.htm>.

¹³⁵ Office of the Chief Accountant and Division of Corporation Finance: Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised Oct. 6, 2004), available at <http://www.sec.gov/info/accountants/controlfaq1004.htm>.

¹³⁶ See, for example, letters from BP p.l.c. (BP), GT, IIA, ISACA, MSFT, and Tatum.

¹³⁷ See, for example, letters from BDO, EY, KPMG, and Stantec Inc.

¹³⁸ See, for example, letters from BP, Manulife, and Pepsi.

¹³⁹ See, for example, letters from 100 Group, Banco Itaú Holding Financeira SA, CCMR, Eric Fändrich, and FEI CCR.

requesting the Commission exempt foreign registrants entirely from the ICFR reporting requirements if the registrant was subject to similar regulations in their home country. Other commenters raised concerns relating to the unique challenges that foreign registrants face in evaluating their ICFR, including language and cultural differences and international legal differences.¹⁴⁰

Commenters also made suggestions regarding how the reconciliation to U.S. GAAP should be handled in the evaluation of ICFR. Certain commenters expressed support for the Commission's position that foreign private issuers should scope their evaluation effort based on the financial statements prepared in accordance with home country GAAP, rather than based on the reconciliation to U.S. GAAP.¹⁴¹ However, other commenters requested that the Commission exempt the reconciliation to U.S. GAAP from the scope of the evaluation altogether,¹⁴² while others sought further clarification as to whether and how the reconciliation was included in the evaluation of ICFR,¹⁴³ with one commenter suggesting the Commission staff publish additional Frequently Asked Questions to address any implementation issues.¹⁴⁴ One commenter requested the Commission exclude from the evaluation process those financial statement disclosures that are required by home country GAAP but not under U.S. GAAP to minimize the differences in the ICFR evaluation efforts between U.S. registrants and foreign filers as much as possible.¹⁴⁵

¹⁴⁰ See, for example, letters from IIA and GT.

¹⁴¹ See, for example, letters from 100 Group, BDO, and ICAEW.

¹⁴² See, for example, letters from CCMR, Cleary, EALIC, and NYC Bar.

¹⁴³ See, for example, letters from Deloitte, EY, KPMG, and N. Stofberg.

¹⁴⁴ See, for example, letter from Ohio.

¹⁴⁵ See, for example, letter from ING.

After considering the comments received, the Commission has determined not to exempt foreign registrants from the ICFR reporting requirements, regardless of whether they are subject to similar home country requirements. The Commission's requirement for all issuers to complete an evaluation of ICFR is not derived from the Commission's Interpretive Guidance for Management; this requirement has been established by Congress. Further, the Commission does not believe it is appropriate to exclude the U.S. GAAP reconciliation from the scope of the evaluation as long as it is a required element of the financial statements. Currently, however, the Commission is evaluating, as part of another project, the acceptance of International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board ("IASB") without reconciliation to U.S. GAAP.¹⁴⁶

In light of the comment letters, the Commission realizes that there are certain implementation concerns and issues that are unique to foreign private issuers. As a result, the Commission has instructed the staff to consider whether these items should be addressed in a Frequently Asked Questions document.

¹⁴⁶ In a press release on April 24, 2007, the Commission announced its next steps pertaining to acceptance of IFRS without reconciliation to U.S. GAAP. In that press release, the Commission stated that it anticipates issuing a Proposing Release in summer 2007 that will request comments on proposed changes to the Commission's rules which would allow the use of IFRS, as published by the IASB, without reconciliation to U.S. GAAP in financial reports filed by foreign private issuers that are registered with the Commission. The press release is available at <http://www.sec.gov/news/press/2007/2007-72.htm>.

List of Subjects

17 CFR Part 241

Securities.

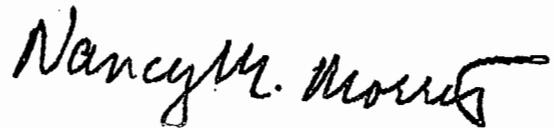
TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission is amending Title 17, chapter II, of the Code of Federal Regulations as follows:

**PART 241 – INTERPRETATIVE RELEASES RELATING TO THE SECURITIES
EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS
THEREUNDER**

Part 241 is amended by adding Release No. 34-55929 and the release date of June 20, 2007 to the list of interpretative releases.

By the Commission.



Nancy M. Morris
Secretary

Dated: June 20, 2007

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 21, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12663

_____ :
In the Matter of :

American Teletronics, Inc. (n/k/a
Shine Holdings, Inc.), :

Respondent :
_____ :

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. RESPONDENT

1. American Teletronics, Inc. (CIK No. 314888) ("American Teletronics") (n/k/a Shine Holdings, Inc.) is a dissolved Colorado corporation formerly located in Dallas, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). In 2006, American Teletronics, through a reverse merger, changed its name to Shine Holdings, Inc., a company located in Cary, North Carolina, but did not update its EDGAR filer information in the Commission's computer records as required by Commission rules. American Teletronics' securities are quoted on the Pink Sheets under the name Shine Holdings, Inc. (Ticker symbol: "SHDG"). American Teletronics is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1996, which reported a net loss of \$1,514,087 for the prior three quarters.

B. DELINQUENT PERIODIC FILINGS

2. Respondent is delinquent in its periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), has repeatedly failed to meet

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its obligations to file timely periodic reports, and failed to respond to a delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

3. 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).

4. As a result of the foregoing, Respondent 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 are true and, in connection therewith, to afford the Respondent 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 revoke, the registration of each class of securities of the Respondent registered pursuant to Section 12 of the Exchange Act.

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 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 Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, 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 Respondent personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

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

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

Appendix 1

**Chart of Delinquent Filings of
American Teletronics, Inc., n/k/a Shine Holdings, Inc.**

Form Type	Period Ended	Due Date	Months Delinquent (rounded up)
10-K	Dec. 31, 1996	Mar. 31, 1997	123
10-Q	Mar. 31, 1997	May 15, 1997	121
10-Q	June 30, 1997	Aug. 14, 1997	118
10-Q	Sept. 30, 1997	Nov. 14, 1997	115
10-K	Dec. 31, 1997	Mar. 31, 1998	111
10-Q	Mar. 31, 1998	May 15, 1998	109
10-Q	June 30, 1998	Aug. 14, 1998	106
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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55942 / June 22, 2007

Admin. Proc. File No. 3-12404

In the Matter of the Application of

WARREN E. TURK
c/o Lawrence Iason, Esq.
Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer, P.C.
565 Fifth Avenue
New York, NY 10017

For Review of Disciplinary Action Taken by

the New York Stock Exchange, Inc.

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE -- REVIEW OF DISCIPLINARY
PROCEEDING

Failure to Provide Requested Testimony

Former associated person of member firm and member of registered securities association asserted the privilege against self-incrimination in response to association's request for testimony. Held, the proceeding is remanded for further consideration.

APPEARANCES:

Lawrence Iason and Kristy Watson Milkov, of Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer, P.C., for Warren E. Turk.

Susan Light, Julie Han Broderick, Marianne Paoli, and Allen D. Boyer, for the Division of Enforcement, New York Stock Exchange, Inc.

Appeal filed: August 14, 2006

Last brief received: November 27, 2006

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I.

Warren E. Turk, a former member of the New York Stock Exchange, Inc. (“NYSE” or the “Exchange”) and a former specialist with NYSE member firm Van der Moolen Specialists USA LLC (“Van der Moolen”), appeals from NYSE disciplinary action. The NYSE found that Turk failed to comply with requests by the NYSE that Turk provide testimony in connection with an NYSE investigation concerning matters that occurred while he was a specialist at Van der Moolen, in violation of NYSE Rule 477, and that Turk was, therefore, subject to discipline pursuant to NYSE Rules 476(a) and 477. ^{1/} The NYSE censured Turk and permanently barred him from membership, allied membership, approved person status, and from employment or association in any capacity with any member or member organization. For the reasons given below, we have determined to remand the proceeding to the NYSE for further consideration consistent with this opinion. To the extent we make findings, we base them on an independent review of the record.

II.

On September 17, 2004, the NYSE Division of Enforcement (“NYSE Enforcement”) requested that Turk appear for testimony in connection with NYSE Enforcement’s investigation into allegations of improper trading practices by NYSE specialists during the period from 1999 to 2003. Turk initially agreed to testify before NYSE Enforcement, and his testimony was scheduled for November 22, 2004. Our Division of Enforcement also issued a subpoena to Turk in connection with a Commission investigation of improper trading practices by NYSE specialists. On November 8, 2004, Turk appeared before Commission staff and testified. According to Turk, he “testified for a full day before the SEC and answered every question he was asked.”

On November 12, 2004, Van der Moolen informed Turk that it was removing him from the NYSE trading floor and placing him on administrative leave. According to Turk, a Van der Moolen official told Turk that Van der Moolen was acting at the request of the office of the United States Attorney for the Southern District of New York (the “United States Attorney”). Soon thereafter, Turk informed the NYSE that he would not be appearing for testimony as scheduled. On November 19, 2004, Turk’s counsel sent an email to an NYSE staff attorney that

^{1/} NYSE Rule 476(a) provides that NYSE members and employees of NYSE members who violate any provision of any NYSE rule are subject to the imposition of disciplinary sanctions, including censure and bar, by the NYSE. NYSE Rule 477 states that NYSE members, or employees of NYSE members, who do not comply with an NYSE request to provide testimony, while they are a member or an employee of an NYSE member and during the one-year period after the termination of membership or employment by an NYSE member, are subject to the imposition of disciplinary sanctions, including a bar.

read, in its entirety, "I am writing to confirm that Warren Turk will not appear for testimony on Monday, November 22, 2004." 2/

On April 12, 2005, the Commission instituted proceedings against Turk and nineteen other NYSE specialists, charging Turk with violations of the antifraud provisions of the securities laws by inter-positioning orders in Van der Moolen's proprietary account between customer orders and by trading ahead of customer orders using Van der Moolen's proprietary account. 3/ Also on April 12, 2005, the NYSE announced the issuance of charges resulting from its investigation of Turk. 4/ The NYSE press release stated, "The illegal conduct engaged in by the specialists, namely inter-positioning and trading ahead of customer orders, resulted in public-customer orders being disadvantaged and a riskless profit for their firms' dealer accounts." 5/ By letter dated December 21, 2006, Turk informed the NYSE that, because it "now appears" that no criminal charges will be brought against Turk, he would be willing to "appear before NYSE Enforcement and testify on the record." 6/

2/ It is unclear how or when Turk first informed the NYSE that he would not testify, or whether he told the NYSE that he would not testify because, as Turk asserts here, Van der Moolen's action "ma[de] it clear to Mr. Turk that he was a focus of the government's investigation."

Van der Moolen subsequently filed a Form U-5 Uniform Termination Notice for Securities Industry Registration pertaining to Turk, in which it stated that Turk's date of termination from Van der Moolen was December 31, 2004.

3/ The Commission's Order Instituting Proceedings charged Turk with violations of Section 17(a) of the Securities Act of 1933, Sections 10(b) and 11(b) of the Securities Exchange Act of 1934, and Exchange Act Rules 10b-5 and 11b-1, 15 U.S.C. § 77q(a), 15 U.S.C. § 78j(b), 15 U.S.C. § 78k(b), 17 C.F.R. § 240.10b-5, and 17 C.F.R. § 240.11b-1, respectively.

4/ The record includes the NYSE's press release announcing the issuance of the charges against Turk and against sixteen other NYSE specialists, but does not include the charging document itself.

5/ The NYSE charged Turk and the other specialists with violations of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and various NYSE Rules.

6/ As Turk's letter indicates, the United States Attorney has not brought criminal charges against Turk, although the United States Attorney did bring criminal charges against fifteen other NYSE specialists on April 15, 2005. In a January 10, 2007 letter to Turk's counsel, the NYSE staff acknowledged, but did not accept, Turk's offer to testify, describing the offer as "empty and illusory." In that letter, NYSE Enforcement stated that "the relevant investigation has been completed."

(continued...)

III.

In order to sustain disciplinary action by a self-regulatory organization (“SRO”) such as the NYSE, we must determine whether Turk engaged in the conduct found by the NYSE, whether the conduct violated the NYSE rules he was found to have violated, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act. ^{7/} As discussed below, we have concluded that we are unable to make all of the findings required to sustain the NYSE’s action against Turk and have determined, therefore, to remand the case to the NYSE for further proceedings.

Turk acknowledges that he failed to appear for testimony, as alleged and found by the Exchange. Such a failure establishes a prima facie violation of NYSE Rules 476 and 477. ^{8/} Turk argues, however, that he could not be forced to testify at the NYSE because he could invoke the Fifth Amendment’s right against self-incrimination. ^{9/} Turk argues that the right against self-incrimination applied to the NYSE because the Exchange is a “state actor” generally or, alternatively, because, under the particular circumstances of this case, the Exchange engaged in “state action” in conducting its investigation of Turk.

According to Turk, the NYSE and other SROs are state actors, subject to the right against self-incrimination, because “Congress has effectively required that anyone who wants to work in the securities business must be a member of a self-regulatory organization or must be employed by a member of a self-regulatory organization.” Numerous courts and we have repeatedly held, however, that the SROs generally are not state actors, and we see no basis for deviating from that

^{6/} (...continued)

According to Turk, “both [the Commission and NYSE] proceedings have been stayed pending resolution of the criminal proceedings.” There is nothing else in the record regarding the current status of the Commission and NYSE proceedings against Turk based on allegations of inter-positioning and trading ahead of customer orders.

^{7/} See Exchange Act Section 19(e)(1), 15 U.S.C. § 78s(e)(1); Justin F. Ficken, Securities Exchange Act Rel. No. 54,699 (Nov. 3, 2006), 89 SEC Docket 685.

^{8/} See, e.g. Louis F. Albanese, 53 S.E.C. 294, 297-98 (1997) (sustaining NYSE disciplinary action for violation of NYSE Rule 477 where respondent failed to cooperate immediately with NYSE investigation); Wallace E. Lin, 50 S.E.C. 196 (1990) (sustaining NYSE findings of violation of Rule 477 where respondent refused to testify in Exchange investigation). Cf. Ficken, 89 SEC Docket at 690-91 (“The failure to respond to NASD’s requests for testimony demonstrates a prima facie violation of [analogous NASD Rule]”).

^{9/} The Fifth Amendment to the United States Constitution provides that no person shall be compelled in any criminal case to be a witness against himself. U.S. Const. amend. V.

established precedent. ^{10/} As the Second Circuit has held, in articulating a standard that would apply equally to other SROs, including the Exchange, “The NASD is a private actor, not a state actor. It is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee.” ^{11/}

Alternatively, Turk argues that the NYSE engaged in state action under the circumstances of this specific case because, according to Turk, “NYSE Enforcement has worked in concert with the SEC and the United States Attorney’s office in investigating specialists and coordinating the civil and criminal charges brought against them.” We recently addressed the question of whether an SRO, although not generally a state actor, can, under certain circumstances, engage in state action such that it becomes subject to the right against self-incrimination. In Frank P.

^{10/} See United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975) (“NYSE’s inquiry . . . was in pursuance of its own interests and obligations, not as an agent of the SEC. It is not enough to create an agency relationship that Solomon’s conduct violated both a rule of NYSE, thereby subjecting him to disciplinary action by that body, and federal law, with consequent liability to civil and criminal enforcement proceedings by the Government”); Marchiano v. National Ass’n of Secs. Dealers, Inc., 134 F. Supp.2d 90, 95 (D.D.C. 2001) (“[T]he court is aware of no case . . . in which NASD Defendants were found to be state actors either because of their regulatory responsibilities or because of any alleged collusion with criminal prosecutors”); Vladislav Steven Zubkis, 53 S.E.C. 794, 797 n.2 (1998) (stating that privilege against self-incrimination does not apply in SRO disciplinary proceedings).

^{11/} D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002) (citing Desiderio v. National Ass’n of Secs. Dealers, Inc., 191 F.3d 198, 206 (2d Cir. 1999), cert. denied, 531 U.S. 1069 (2001)). See also Perpetual Secs., Inc. v. Tang, 290 F.3d 132, 138 (2d Cir. 2002) (citing Desiderio and stating, “It is clear that NASD is not a state actor . . .”).

Turk further argues, “The Supreme Court of the United States has repeatedly ruled that a witness cannot be deprived of his or her employment for declining to provide testimony that could be used against the witness in a criminal prosecution,” citing Lefkowitz v. Cunningham, 431 U.S. 801 (1977); Lefkowitz v. Turley, 414 U.S. 70 (1973); Gardner v. Broderick, 392 U.S. 273 (1968); Uniformed Sanitation Men Assoc. v. Comm’r of Sanitation, 392 U.S. 280 (1968); Garrity v. State of New Jersey, 385 U.S. 493 (1967); and Spevack v. Klein, 385 U.S. 511 (1967). However, those cases all involved the government, rather than a private entity such as the NYSE, forcing an individual to choose between testifying and losing his employment. This precedent has possible relevance to the NYSE only to the extent that it engages in state action.

Quattrone, 12/ where we set aside NASD's action based on procedural deficiencies, we noted that the Fifth Amendment restricts only governmental conduct, and will constrain a private entity only insofar as its actions are found to be "fairly attributable" to the government. 13/ A violation of the Fifth Amendment, therefore, requires "state action" on the part of the private entity whose actions are being challenged. 14/

Although SROs are not, as discussed above, generally state actors, under certain limited circumstances, they may engage in state action. As we noted in Quattrone, the Supreme Court has held that private parties' actions may constitute state action if there is such a "close nexus between the State and the challenged action" that the seemingly private behavior "may be fairly treated as that of the State itself." 15/ According to the Court, "no one fact can function as a necessary condition across the board for finding state action; nor is any one set of circumstances absolutely sufficient, for there may be some countervailing reason against attributing activity to the government." 16/ The Court has identified certain facts "that can bear on the fairness of such an attribution," such as whether a challenged activity "results from the State's exercise of its 'coercive power'"; whether "the State provides 'significant encouragement, either overt or covert'"; or whether "a private actor operates as a 'willful participant in the joint activity with the State or its agents.'" 17/ Some courts have described this last fact pattern as the "joint action" test, and have focused on inquiries such as whether "the state has so far insinuated itself into a position of interdependence with the private entity that it must be recognized as a joint participant in the challenged activity" or whether "the particular actions challenged are inextricably intertwined with those of the government." 18/

12/ Exchange Act Rel. No. 53547 (Mar. 24, 2006), 87 SEC Docket 2155.

13/ Id., 87 SEC Docket at 2163 n.22 (citing D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 161 (2d Cir. 2002) (citing Lugar v. Edmondson Oil Co., 457 U.S. 922, 937 (1982))).

14/ Id.

15/ Brentwood Acad. v. Tennessee Secondary Sch. Ath. Ass'n, 531 U.S. 288, 295 (2001).

16/ Id. at 295-296.

17/ Id. at 296.

18/ See, e.g., Kirtley v. Rainey, 326 F.3d 1088, 1092, 1094 (9th Cir. 2003) (stating that "joint action" test and "government compulsion" test are separate tests for establishing state action and under the former considering whether "the state has so far insinuated itself into a position of interdependence with the private entity that it must be recognized as a joint participant in the challenged activity" and under the latter considering whether "the coercive influence or 'significant encouragement' of the state effectively converts the

(continued...)

In D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., the court found that NASD Enforcement issued certain requests for information “as a product of its private investigation” and accepted NASD testimony that “none of the demands [for information] was generated by governmental persuasion or collusion” ^{19/} However, the court also observed that, although NASD Enforcement had not acted in concert with government regulators when NASD Enforcement issued its information requests in that case, NASD could nevertheless, in certain circumstances, be deemed a state actor. The court noted that NASD’s Criminal Prosecution Assistance Unit, which, at the time, was a self-contained group within NASD Enforcement, “was in fact working with the government, and when it does it may well be a state actor.” ^{20/}

In another recent decision involving the question of whether NASD can become subject to the right against self-incrimination by engaging in state action, Justin F. Ficken, we determined to remand the case to NASD for further development of the evidentiary record where the applicant had been limited in his ability to introduce evidence on that question. ^{21/} In remanding that case to NASD, we noted, among other things, that the case had been considered by NASD prior to the issuance of our decision in Quattrone.

Turk argues that our decisions in Quattrone and Ficken support setting aside the Exchange’s action against him or, at a minimum, justify remanding the case to the Exchange for further proceedings. The record shows that the parties did not litigate extensively the issue of state action before the Exchange and introduced only limited evidence regarding this issue. Turk notes, however, that the evidentiary hearing in this case occurred before either Quattrone or Ficken had been decided.

^{18/} (...continued)
private action into a government action”); Bass v. Parkwood Hospital, 180 F.3d 234, 241-242 (5th Cir. 1999) (similar); Mathis v. PG&E, 75 F.3d 498, 503, 504 (9th Cir. 1995) (in discussing “inextricably intertwined” inquiry, stating, in dicta, that had a private entity’s internal investigation produced a coerced confession and been conducted in close cooperation with a county task force, that would likely support a finding of state action on a joint action theory); cf. People v. Sporleder, 666 P.2d 135, 138-39 & n.3 (Col. 1983) (stating, in dicta, that the installation of a pen register on defendant’s telephone line by a telephone company in the context of a joint investigation by the telephone company and the district attorney’s office of harassing telephone calls strongly suggested state action).

^{19/} D.L. Cromwell, 279 F.3d at 163.

^{20/} Id.

^{21/} Ficken, 89 SEC Docket at 696. In Quattrone, we concluded that NASD’s grant of summary disposition on the issue of liability against Quattrone was inappropriate and not in accordance with its rules. Quattrone, 87 SEC Docket at 2166.

The evidence Turk identifies to support his contention that the Exchange engaged in state action includes: (1) that the Commission and the NYSE requested Turk's testimony concerning his activities as a specialist within one month of each other; (2) that the Commission and the NYSE brought charges in connection with their respective investigations of NYSE specialists on the same day in April 2005 and that the United States Attorney brought criminal charges against other NYSE specialists three days after the Commission and the NYSE brought their proceedings; 22/ (3) that press releases issued by the Commission, the NYSE, and the United States Attorney in connection with their investigations indicated that the regulators cooperated with and assisted each other; 23/ and (4) that Van der Moolen told Turk, at the time that Van der Moolen informed Turk that it placed him on administrative leave, thus removing him from the NYSE trading floor, that it was acting upon a request by the United States Attorney's office. Turk has also indicated at various points in the proceeding that he hoped to develop additional unspecified evidence beyond what he has cited on appeal if the proceeding were remanded to the NYSE for further fact-finding.

We have held that the burden of demonstrating joint activities sufficient to render an SRO a state actor is high, and that burden falls on the party asserting state action. 24/ The evidence Turk has presented to date does not meet that standard. That evidence by itself indicates that, in investigating Turk, government and NYSE personnel cooperated to some extent. We have observed previously that cooperation and information sharing between the Commission and an SRO will rarely render the SRO a state actor, and the mere fact of such cooperation is generally

22/ As noted above, the United States Attorney has not brought charges against Turk.

23/ The press releases to which Turk refers were issued on April 12, 2005. The Commission's press release, announcing the institution of proceedings against twenty NYSE specialists including Turk, states, in relevant part, "The staff acknowledges the assistance of the U.S. Attorney's office, the FBI, and the NYSE Division of Enforcement." The NYSE press release states, in relevant part, "NYSE Regulation worked cooperatively in this matter with the U.S. Department of Justice and the U.S. Securities and Exchange Commission. The Exchange acknowledges their substantial support and assistance." In its press release announcing the indictments of fifteen NYSE specialists (as noted, not including Turk), the United States Attorney's office thanked the NYSE, "which has been cooperating with the Government in its continuing investigation." Turk included these press releases as exhibits to his reply brief to us. NYSE Enforcement has submitted no objection to the inclusion of the press releases in the record, nor has NYSE Enforcement sought to question the authenticity of the press releases Turk has adduced. We have therefore determined to include the press releases in our consideration of Turk's appeal.

24/ Ficken, 89 SEC Docket at 695.

insufficient, standing alone, to demonstrate state action. 25/ We also note that the court in D.L. Cromwell found no state action where NASD and government regulators “pursued similar evidentiary trails” in their parallel investigations because “their independent investigations were proceeding in the same direction” 26/

Nevertheless, while the evidence Turk identifies is insufficient to establish state action, he should have a further opportunity to develop and present his state action claim. Because the evidence presented to date might be the product of more than cooperation, and because Turk’s NYSE evidentiary hearing occurred before the issuance of our decisions in Quattrone and Ficken, 27/ we believe it is appropriate to provide Turk an opportunity to develop a full evidentiary record on the state action question.

On remand, Turk may seek discovery in connection with his efforts to prove that the NYSE engaged in state action. As we noted in Ficken, a party must be afforded “a full opportunity to conduct discovery” to obtain the “affirmative evidence” that is “essential to his opposition” to summary judgment, 28/ but he “may not use the discovery process to go on a fishing expedition in the hopes that some evidence will turn up to support an otherwise unsubstantiated theory.” 29/ Not every defense of state action deserves discovery and a hearing. A respondent must provide a reasonable and credible basis to conclude that the SRO’s relationship with the government in the case suggests such a “close nexus between the State and

25/ Quattrone, 87 SEC Docket at 2165. See also Scher v. NASD, 386 F. Supp. 2d 402, 408 (S.D.N.Y. 2005) (finding, where an NASD investigator shared information with the district attorney’s office with which he once worked approximately one year after plaintiff’s testimony, that “such collaboration,” which ultimately led to plaintiff’s criminal prosecution, “does not in itself demonstrate that a ‘close nexus’ existed between the challenged conduct of the NASD and a state actor”).

26/ D.L. Cromwell, 279 F.3d at 162-63.

27/ We wish to observe that, as noted, the burden of establishing state action is on the applicant and that, normally, an applicant’s failure to introduce sufficient evidence on this point will justify the dismissal of his appeal if a claim of state action represents his sole defense. We nevertheless have determined to remand here because of the unusual posture of this appeal. Moreover, we expect that, in the future, parties will seek to introduce any evidence related to the state action issue during the initial evidentiary hearing, so that the record is fully developed in the first instance when the case is before the SRO.

28/ Ficken, 89 SEC Docket at 695 n. 35 (citing Anderson v. Liberty Lobby, 477 U.S. 242, 250 n.5 & 256-257 (1986)).

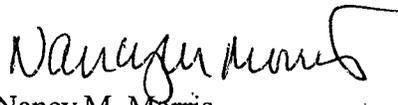
29/ Id. at 695 n. 36 (citing G.K. Scott & Co., Inc., 51 S.E.C. 961, 973 (1994); accord John Montelbano, Exchange Act Rel. No. 47227 (Jan. 22, 2003), 79 SEC Docket 1474, 1493).

the challenged action” that the seemingly private behavior “may be fairly treated as that of the State itself.” 30/

Turk will be required on remand to state “the precise manner in which [the facts he does possess] support[] his claims,” to explain “why he needs additional discovery,” to “state with some precision the materials he hope[s] to obtain with further discovery,” and to explain “exactly how” the further information would support his claims. 31/ Turk must be able to satisfy these standards to obtain discovery in opposition to a properly supported motion for summary judgment. To the extent that Turk meets this burden, the NYSE will be expected to give due consideration to any requests Turk makes for additional discovery. 32/ We do not intend to suggest any view on the outcome of this remand.

An appropriate order will issue. 33/

By the Commission (Chairman COX and Commissioners ATKINS, CAMPOS, NAZARETH and CASEY).


Nancy M. Morris
Secretary

30/ See supra note 15.

31/ Ficken, 89 SEC Docket at 695-96 n. 37 (citing Krim v. BancTexas Group, Inc., 989 F.2d 1435, 1442-1443 (5th Cir. 1993)).

32/ See Ficken, 89 SEC Docket at 696.

33/ 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. 55942 / June 22, 2007

Admin. Proc. File No. 3-12404

In the Matter of the Application of

WARREN E. TURK
c/o Lawrence Iason, Esq.
Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer, P.C.
565 Fifth Avenue
New York, NY 10017

For Review of Disciplinary Action Taken by
the New York Stock Exchange, Inc.

ORDER REMANDING DISCIPLINARY PROCEEDING TO NATIONAL SECURITIES
EXCHANGE

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

ORDERED that this disciplinary proceeding with respect to Warren E. Turk be, and it hereby is, remanded to the New York Stock Exchange, Inc. for further consideration.

By the Commission.


Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 239

[Release No. 33-8813; File No. S7-11-07]

RIN 3235-AH13

REVISIONS TO RULE 144 AND RULE 145 TO SHORTEN HOLDING PERIOD FOR AFFILIATES AND NON-AFFILIATES

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. We are proposing a six-month holding period requirement under Rule 144 for “restricted securities” of companies that are subject to the reporting requirements of the Securities Exchange Act of 1934. The proposed six-month holding period for restricted securities of reporting companies would be extended, for up to an additional six months, by the amount of time during which the security holder has engaged in hedging transactions. Restricted securities of companies that are not subject to the Exchange Act reporting requirements would continue to be subject to a one-year holding period prior to any public resale. We also propose to substantially reduce the restrictions on the resale of securities by non-affiliates. In addition, we propose to simplify the Preliminary Note to Rule 144, eliminate the manner of sale restrictions with respect to debt securities, increase the Form 144 filing thresholds, and codify several staff interpretive positions that relate to Rule 144. We also solicit comment on how best to coordinate Form 144 and Form 4 filing requirements. Finally, we propose amendments to Securities Act Rule 145, which establishes resale limitations on certain persons who acquire securities in business

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combination transactions, to eliminate the presumptive underwriter position in Rule 145(c), except for transactions involving a shell company, and to revise the resale requirements in Rule 145(d). We believe that the proposed changes will increase the liquidity of privately sold securities and decrease the cost of capital for all companies without compromising investor protection.

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.shtml>); or
- Send an E-mail to rule-comments@sec.gov. Please include File Number S7-11-07 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 S7-11-07. 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 Web site (<http://www.sec.gov/rules/proposed.shtml>).

Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, 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: Katherine Hsu, Special Counsel, and Ray Be, Special Counsel, Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Rule 144,¹ Rule 145,² Rule 190,³ Rule 701⁴ and Form 144⁵ under the Securities Act of 1933.⁶

¹ 17 CFR 230.144.

² 17 CFR 230.145.

³ 17 CFR 230.190.

⁴ 17 CFR 230.701.

⁵ 17 CFR 239.144.

⁶ 15 U.S.C. 77a et seq.

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I. Background and Overview

The Securities Act requires registration of all offers and sales of securities in interstate commerce or by use of the U.S. mails, unless an exemption from the registration requirement is available.⁷ Section 4(1) of the Securities Act provides such an exemption for transactions by any person other than an issuer, underwriter or dealer.⁸

The definition of the term “underwriter” is key to the operation of the Section 4(1) exemption. Section 2(a)(11) of the Securities Act defines an underwriter as “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking.”⁹ The Securities Act does not, however, provide specific criteria for determining when a person purchases securities “with a view to . . . the distribution” of those securities. In 1972, the Commission adopted Rule 144 to provide a safe harbor from this definition of “underwriter” to assist security holders in determining whether the Section 4(1) exemption is available for their resale of securities.¹⁰ If a selling security holder satisfies all of Rule 144’s applicable conditions in connection with a transaction, he or she is deemed not to be an “underwriter,” and the Section 4(1) exemption would be available for the resale of the securities.

Since its adoption, we have reviewed and revised Rule 144 several times. We last made major changes in 1997.¹¹ At that time, we shortened the required holding period

⁷ See 15 U.S.C. 77e.

⁸ 15 U.S.C. 77d(1).

⁹ 15 U.S.C. 77b(a)(11).

¹⁰ Release No. 33-5223 (Jan. 14, 1972) [37 FR 591].

¹¹ See Release No. 33-7390 (Feb. 28, 1997) [62 FR 9242].

for securities that are defined as “restricted securities.”¹² Before the 1997 amendments, affiliates and non-affiliates could resell restricted securities, subject to limitation, after two years, and non-affiliates (who had not been affiliates during the prior three months) could resell restricted securities without limitation after three years.¹³ The 1997 amendments changed these two-year and three-year periods to one-year and two-year periods, respectively.

At the time we adopted those changes, we proposed and solicited comment on several possible additional changes to Rule 144, Rule 145 and Form 144, including reducing the holding period further.¹⁴ We received 38 comment letters on those proposed changes. As discussed more fully below, most commenters were divided between supporting further shortening of the holding period and waiting to see the results of the 1997 amendments. We have not taken further action to adopt the 1997 proposals.

Rule 144 regulates the resale of two categories of securities – restricted securities and control securities. Restricted securities are securities acquired pursuant to one of the transactions listed in Rule 144(a)(3).¹⁵ Although it is not a term defined in Rule 144,

¹² See 17 CFR 230.144(a)(3).

¹³ The term “affiliate” is defined in 17 CFR 230.144(a)(1) as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [the] issuer.”

¹⁴ Release No. 33-7391 (Feb. 28, 1997) [62 FR 9246] (“the 1997 proposing release”). In that release, we proposed to (1) revise the Preliminary Note to Rule 144 to restate the intent and effect of the rule, (2) add a bright-line test to the Rule 144 definition of “affiliate,” (3) eliminate the Rule 144 manner of sale requirements, (4) increase the Form 144 filing thresholds, (5) include in the definition of “restricted securities” securities issued pursuant to the Securities Act Section 4(6) exemption, (6) clarify the holding period determination for securities acquired in certain exchanges with the issuer and in holding company formations, (7) streamline and simplify several Rule 144 provisions, and (8) eliminate the presumptive underwriter provisions of Rule 145. We also solicited comment on (1) further revisions to the Rule 144 holding periods, (2) elimination of the trading volume tests to determine the amount of securities that can be resold under Rule 144, and (3) several possible regulatory approaches with respect to certain hedging activities.

¹⁵ 17 CFR 230.144(a)(3).

“control securities” is used commonly to refer to securities held by affiliates of the issuer, regardless of how the affiliates acquired the securities.¹⁶ Therefore, if an affiliate acquires securities in a transaction that is listed in Rule 144(a)(3), those securities would be both restricted securities and control securities.

Rule 144 states that a selling security holder shall be deemed not to be engaged in a distribution of securities and therefore not an underwriter with respect to such securities, thus making available the Section 4(1) exemption from registration, if the resale meets particular criteria. If the security holder is an affiliate of the issuer, or a non-affiliate that has held the restricted securities for less than two years,¹⁷ these criteria include the following:

- There must be available adequate current public information about the issuer;¹⁸
- If the securities being sold are restricted securities, the seller must have held the security for a specified holding period;¹⁹
- The resale must be within specified sales volume limitations;²⁰
- The resale must comply with the manner of sale conditions;²¹ and
- The selling security holder may be required to file a Form 144.²²

¹⁶ See the 1997 proposing release.

¹⁷ See 17 CFR 230.144(k).

¹⁸ 17 CFR 230.144(c).

¹⁹ 17 CFR 230.144(d).

²⁰ 17 CFR 230.144(e).

²¹ 17 CFR 230.144(f) and (g).

²² 17 CFR 230.144(h).

Under the current rule, a non-affiliate may publicly resell restricted securities without being subject to the above limitations if he or she has held the securities for two years and if he or she is not, and for the prior three months has not been, an “affiliate” of the issuer.²³

We now are proposing amendments that would:

- Simplify the Preliminary Note to Rule 144 and text of Rule 144, using plain English principles;²⁴
- Amend the Rule 144 holding period requirement for restricted securities of companies that are required to file reports under the Securities Exchange Act of 1934²⁵ to provide for a six-month holding period if the security holder has not engaged in certain hedging transactions;²⁶
- Require that security holders toll, or suspend, the holding period during the time they enter into certain hedging transactions, although under no circumstance would the holding period extend beyond one year;²⁷
- Substantially reduce the requirements for non-affiliates so that they can resell securities freely after the holding period (except that non-affiliates of reporting companies would be subject to the current public information requirement until one year after the acquisition of the securities);²⁸

²³ 17 CFR 230.144(k).

²⁴ See the proposed Preliminary Note, proposed paragraph (b), proposed paragraph (c) and related note, and proposed paragraphs (d)(3)(i), (e)(1), (e)(2)(vii) and (f).

²⁵ 15 U.S.C. 78a *et seq.*

²⁶ See proposed Rule 144(d).

²⁷ See proposed Rule 144(d)(3)(xi).

²⁸ See proposed Rules 144(b)(1) and (d).

- Eliminate the “manner of sale” limitations with respect to debt securities;²⁹
- Increase the thresholds that would trigger a Form 144 filing requirement;³⁰
- Codify the staff’s positions, as they relate to Rule 144, concerning the following issues:
 - Inclusion of securities acquired under Section 4(6) of the Securities Act in the definition of “restricted securities,”³¹
 - The effect that creation of a holding company structure has on a security holder’s holding period,³²
 - Holding periods for conversions and exchanges of securities,³³
 - Holding periods for the cashless exercise of options and warrants,³⁴
 - Aggregation of a pledgee’s resales with resales by other pledgees of the same security,³⁵
 - The extent to which securities issued by “reporting and non-reporting shell companies” are eligible for resale under Rule 144,³⁶ and
 - Representations required from security holders relying on Rule 10b5-1(c);³⁷ and

²⁹ See proposed Rule 144(f).

³⁰ See proposed Rule 144(h).

³¹ See proposed Rule 144(a)(3)(viii).

³² See proposed Rule 144(d)(3)(ix).

³³ See proposed Rule 144(d)(3)(ii).

³⁴ See proposed Rule 144(d)(3)(xi).

³⁵ See proposed note to Rule 144(e)(2)(ii).

³⁶ See proposed Rule 144(i).

³⁷ 17 CFR 240.10b5-1(c). See proposed amendments to Form 144.

- Eliminate the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and harmonize the resale requirements in Rule 145 with the resale provisions for the securities of shell companies in Rule 144.³⁸

We also solicit comment on delaying the Form 144 filing deadline to coincide with the deadline for filing a Form 4³⁹ under Section 16⁴⁰ of the Exchange Act and permitting persons who are subject to Section 16 to meet their Form 144 filing requirement by filing a Form 4.⁴¹

The following table briefly compares some of the most significant proposed amendments to the current regulatory scheme:

³⁸ See proposed Rule 145(d).

³⁹ 17 CFR 249.104.

⁴⁰ 15 U.S.C. 78p.

⁴¹ Section 16 applies to every person who is the beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the Exchange Act, and each officer and director (collectively, "reporting persons" or "insiders") of the issuer of such security. Section 16(a) of the Exchange Act requires that reporting persons report changes in their beneficial ownership of all equity securities of the issuer on Form 4 before the end of the second business day following the day on which the subject transaction (which caused the change in beneficial ownership) was executed.

	Current Regulations	Proposed Amendments
Resales of Restricted Securities by Non-Affiliates Under Rule 144	<p>-Limited resales after holding restricted securities for one year.</p> <p>-Unlimited resales after holding restricted securities for two years if they have not been affiliates during the prior three months.</p> <p>-No tolling of holding period as a result of hedging transactions.</p>	<p>-Unlimited resales after holding restricted securities of Exchange Act reporting companies for six months if they have not been affiliates during the prior three months, except that such resales would be subject to the current public information requirement between the end of the six-month holding period and one year after the acquisition date of the securities.</p> <p>-Unlimited resales after holding restricted securities of non-reporting companies for one year if they have not been affiliates during the prior three months.</p> <p>-Specific provision tolling the holding period when engaged in certain hedging transactions. Maximum one-year holding period.</p>
Resales by Affiliates Under Rule 144	<p>-Limited resales after holding restricted securities for one year.</p> <p>-No tolling of holding period as a result of hedging transactions.</p>	<p>-Limited resales after holding restricted securities of Exchange Act reporting companies for six months.</p> <p>- Limited resales after holding restricted securities of non-reporting companies for one year.</p> <p>-Specific provision tolling the holding period when engaged in certain hedging transactions. Maximum one-year holding period.</p>
Manner of Sale Restrictions	-Apply to resale of any type of security under Rule 144.	-Would not apply to resale of debt securities by affiliates or to any resale by non-affiliates.

	Current Regulations	Proposed Amendments
Form 144	-Filing threshold at 500 shares or \$10,000.	-With respect to affiliates, filing threshold at 1,000 shares or \$50,000. -No Form 144 filing required for non-affiliates.
Rule 145	-Presumptive underwriter provision applies to all Rule 145(a) transactions.	-Presumptive underwriter provision applies only to Rule 145(a) transactions involving shell companies, with revised resale requirements in Rule 145(d).

II. Discussion of Proposals

A. Simplification of the Preliminary Note and Text of Rule 144

As in the 1997 proposing release, we again are proposing amendments to simplify and clarify the Preliminary Note to Rule 144 and to incorporate plain English principles.⁴² The current Preliminary Note is complex and may be confusing to many security holders. These proposed amendments to the Preliminary Note are not intended to alter the substantive operation of the rule. The revised Preliminary Note would briefly explain the benefits of complying with the rule. It also would clarify that any person who sells restricted securities, and any affiliate or any person who sells restricted securities or other securities on behalf of an affiliate, shall not be deemed to be engaged in a distribution of such securities and therefore not an underwriter with respect to such securities if the sale in question is made in accordance with all the applicable provisions of the rule. The Preliminary Note would further clarify that, although Rule 144 provides a safe harbor for establishing the availability of the exemption provided by Section 4(1), it is not the exclusive means for reselling securities without registration. Therefore, it

⁴² In 1997, all commenters to such amendments favored the simplification of the Preliminary Note. We note, however, that the current proposal would result in a significantly shorter note than the Preliminary Note proposed in 1997.

does not eliminate or otherwise affect the availability of any other exemption for resales.⁴³

In the original adopting release for Rule 144, we stated:

In view of the objectives and policies underlying the Act, the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the rule, is part of a plan by such individual or entity to distribute or redistribute securities to the public. In such case, registration is required.⁴⁴

Consistent with this statement, we propose to add a statement to the Preliminary Note that the Rule 144 safe harbor is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.⁴⁵

In addition, we are proposing changes throughout the rule to attempt to make the rule less complex and easier to read.

Request for Comment

- Should we adopt the simplified Preliminary Note? Should we keep more detail in the Preliminary Note than proposed? Does the Preliminary Note need further revision? If so, how should we revise it?
- Does the proposed language of the Preliminary Note delete or omit any information that should be addressed? Does the proposed language change the meaning of any information in the existing Preliminary Note?

⁴³ Because we make this clarification in the Preliminary Note, we propose to delete current Rule 144(j), which currently provides that Rule 144 is a non-exclusive safe harbor.

⁴⁴ Release No. 33-5223.

⁴⁵ See proposed Preliminary Note to Rule 144. Similar language can also be found in other rules such as in the Preliminary Note to Securities Act Rule 144A [17 CFR 230.144A].

- Should we not make any changes to the Preliminary Note? Does the existing Preliminary Note provide useful background information on Rule 144, the Section 2(a)(11) definition of an underwriter, or the Section 4(1) exemption? Is the Preliminary Note necessary or helpful? Should we eliminate it entirely?
- We also have streamlined and proposed plain English changes to various portions of the rule other than the Preliminary Note. Would any of the proposed language inadvertently change the substantive requirements of the rule? Do any of the changes create ambiguity with respect to settled issues?

B. Amendments to Holding Period Requirement in Rule 144(d) for Restricted Securities and Reduction of Requirements Applicable to Non-Affiliates

1. Background

As stated above, in 1997, we reduced the Rule 144 holding periods for restricted securities for both affiliates and non-affiliates.⁴⁶ Before the 1997 amendments, under Rule 144(d), security holders could sell limited amounts of restricted securities after holding their securities for two years if they satisfied all other conditions imposed by Rule 144.⁴⁷ Under 144(k), non-affiliates could sell restricted securities without limitation and be subject to no other conditions after holding their securities for three years. The 1997 amendments to Rule 144 reduced the two-year Rule 144(d) holding period to one

⁴⁶ Release No. 33-7390 (Feb. 28, 1997) [62 FR 9242]. See 17 CFR 230.144(d) and (k).

⁴⁷ These other conditions included the availability of current public information, the volume of sale limitations, the manner of sale limitations, and the filing of a notice. See 17 CFR 230.144(c), (e), (f) and (h).

year and amended Rule 144(k) so that non-affiliates could freely sell an unlimited amount of securities after two years, instead of three.

In the 1997 proposing release, we solicited comment on whether these holding periods should be reduced even further, with a focus on six months for the Rule 144(d) holding period. We received numerous comments on this issue. Twelve commenters recommended that we further reduce the holding period to six months.⁴⁸ Two other commenters thought that we should maintain the holding periods adopted in 1997.⁴⁹ Eight commenters recommended that we gain more experience with the new holding periods created in 1997 before proposing further amendments to those holding periods.⁵⁰

2. Amendments to Holding Period in Rule 144(d)

a. Six-Month Holding Period for Exchange Act Reporting Companies

We now propose amendments to provide for a reduced holding period under Rule 144(d) for restricted securities of Exchange Act reporting companies held by affiliates and non-affiliates. Under the proposed revisions to Rule 144(d), affiliates and non-affiliates would both be permitted to resell restricted securities of Exchange Act reporting companies⁵¹ publicly after holding the securities for six months, subject to other

⁴⁸ See letters from American Society of Corporate Secretaries (ASCS); Association for Investment Management & Research (AIMR); Association of the City Bar of New York (NY City Bar); Baltimore Gas & Electric (BG&E); Investment Company Institute (ICI); Charles Lilienthal (Lilienthal); Loeb & Loeb; New York Bar Association (NY Bar); Schwartz Investments; Sullivan & Cromwell; Testa, Hurwitz & Thibault (Testa Hurwitz); and Willkie, Farr & Gallagher (Willkie Farr).

⁴⁹ See letters from Argent and The Corporate Counsel (Corporate Counsel).

⁵⁰ See letters from ABA; joint letter from Goldman Sachs, JP Morgan, Morgan Stanley and Salomon Brothers (Four Brokers); Lehman Brothers; Merrill Lynch; Morgan Stanley; Regional Investment Bankers Association (Regional Bankers); Securities Industry Association (SIA); and Smith Barney.

⁵¹ As proposed, the six-month holding period would apply to securities of the issuer that is, and has been for at least 90 days before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act. As proposed, a non-reporting issuer would be an issuer that is not, or has not been for at least 90 days immediately before the sale, subject to the reporting requirements

conditions of Rule 144, when applicable, if they have not engaged in hedging transactions with respect to the securities.⁵² We believe that shortening the holding period in this way would increase the liquidity of privately sold securities and decrease the cost of capital for reporting companies without compromising investor protection.⁵³ By reducing the holding period for restricted securities, the proposed amendments could enable companies to raise capital more often through the issuance of securities in unregistered transactions, such as offshore offerings under Regulation S⁵⁴ or other transactions not involving a public offering, rather than through financing structures such as extremely dilutive convertible securities.

The fundamental purpose of Rule 144 is to provide objective criteria for determining whether an investor is an underwriter or has acquired securities for distribution. At the same time, we do not want the holding period to be longer than necessary or impose any unnecessary costs or restrictions on capital formation. Assumption of the economic risk of investment is a critical factor in determining whether a security holder purchased the securities for distribution.⁵⁵ After observing the operation of Rule 144 since the 1997 amendments, with regard to reporting companies, we believe

of Section 13 or 15(d) of the Exchange Act. This delineation between reporting and non-reporting companies and the 90-day waiting period for reporting companies are similar to the provisions in Rule 144(c).

⁵² See proposed Rule 144(d)(1)(i). These proposed amendments would not change the Rule 144(d) requirement that, if the acquiror takes by purchase, the holding period will not commence until the full purchase price is paid.

⁵³ See Section VI. of this release.

⁵⁴ 17 CFR 230.901 through 230.905 and Preliminary Notes.

⁵⁵ See Release No. 33-5223 (Jan. 14, 1972) [37 FR 591].

that holding securities for six months is a reasonable indication that an investor has assumed the economic risk of investment in those securities.⁵⁶

Because we are concerned that the market does not have sufficient information and safeguards with respect to non-reporting companies, we propose that the holding period for restricted securities in non-reporting companies would remain at one year for affiliates and non-affiliates.⁵⁷ However, as discussed below, we propose to eliminate the resale restrictions imposed on non-affiliates of non-reporting companies after the one-year holding period. Non-affiliates of non-reporting companies would be subject to no other Rule 144 condition after meeting the one-year holding period under the proposals.⁵⁸

b. Tolling Provision

In 1990, we eliminated a Rule 144 provision that tolled the holding period of a security holder maintaining a short position in, or any put or other option to dispose of, securities equivalent to the restricted securities owned by the security holder.⁵⁹ We eliminated this provision in conjunction with an amendment to broaden a security

⁵⁶ See also letter to John W. White, Director, SEC Division of Corporation Finance, from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, ABA Section of Business Law (Mar. 22, 2007) ("the 2007 ABA Letter"), available at <http://www.abanet.org/buslaw/committees/CL410000pub/comments/20070322000000.pdf>. The 2007 ABA Letter recommended that the Commission reconsider the 1997 proposals and shorten the Rule 144(d) holding period to six months and the Rule 144(k) period to one year. The letter pointed out that, in light of the increased volatility of today's marketplace, holding periods of six months and one year represent greater economic risk than they did when the current holding periods were adopted, and they are more than long enough to ensure that a purchaser has assumed the economic risk of investment.

⁵⁷ See proposed Rule 144(d)(1)(ii). The 2007 ABA letter also recommended that in the case of non-reporting companies, the Commission should consider permitting resales without restriction under Rule 144 after a one-year holding period.

⁵⁸ The proposals would delete paragraph (k) of Rule 144 and permit non-affiliates to resell restricted securities of non-reporting companies freely after one year.

⁵⁹ See Release No. 33-6862 (Apr. 23, 1990) [55 FR 17933].

holder's ability to tack the holding periods of prior owners to the security holder's own holding period.⁶⁰

Despite the prior elimination of the tolling provision, we are concerned about the effect of hedging activities designed to shift the economic risk of investment away from the security holder with respect to restricted securities to be resold under Rule 144.⁶¹ It becomes more difficult to conclude that the security holder who engages in hedging transactions, and thereby transfers the economic risk of the investment to a third party, soon after acquiring the security, has held the security for investment purposes and not with a view to distribution.

For example, prior to the expiration of the required holding period, a security holder may enter into an equity swap agreement with a third party, under which the security holder exchanges the dividends received on the restricted securities for the dividends on, for example, a securities index. In addition, that shareholder may agree to exchange, at a set date, any price change in the security since the date of the agreement for any price change in the securities index. The effect of such a transaction would be the economic equivalent of selling the restricted securities before the holding period has expired and purchasing the securities index.

The concern regarding hedging transactions is particularly acute if we provide for a six-month holding period requirement, as proposed. At the time of the 1990 amendments, Rule 144 provided for a two-year holding period before a security holder

⁶⁰ We reasoned that, "a single period running from the date of the purchase from the issuer or an affiliate of the issuer is sufficient to prevent the distribution by the issuer of securities to the public." Release No. 33-6862.

⁶¹ For a discussion on hedging arrangements in prior releases, see Section IV.B of the 1997 proposing release and Section II.A of Release No. 33-7187 (Jul. 10, 1995) [60 FR 35645].

could sell limited amounts of restricted securities, and a three-year period before a non-affiliate security holder could sell an unlimited amount of the securities. The proposed six-month holding period requirement could make the entry into such hedging arrangements significantly easier and less costly because they would cover a much shorter period.

The 1997 proposing release proposed several alternatives for addressing these concerns.⁶² Seven commenters recommended that we adopt measures to eliminate or restrict hedging activities during the holding period.⁶³ Six commenters recommended maintaining the status quo.⁶⁴ Six commenters suggested that we adopt a safe harbor for certain hedging activities that would be deemed permissible under Rule 144.⁶⁵ Because the proposed shortening of the holding period requirement would make hedging arrangements significantly easier, we believe that it is appropriate to reintroduce a tolling provision to Rule 144. Therefore, we propose to add a new paragraph to Rule 144 to toll the holding period for restricted securities of Exchange Act reporting companies while an affiliate or a non-affiliate is engaged in certain hedging transactions.⁶⁶

⁶² See the 1997 proposing release. In that release, we proposed five different alternatives. These were the following: (1) make the Rule 144 safe harbor unavailable to persons who hedge during the restricted period; (2) independent of Rule 144, promulgate a rule that would define a sale for purposes of Section 5 to include specified hedging transactions; (3) adopt a shorter holding period during which hedging could not occur without losing the safe harbor; (4) reintroduce a tolling provision in Rule 144 similar to the provision that was included prior to 1990; or (5) maintain the status quo with no specific prohibition against hedging. We believe that the proposed tolling provision in this release offers a balanced approach to addressing hedging activities in Rule 144.

⁶³ See letters from ABA; AIMR; Argent; ASCS; Constantine Katsoris; Corporate Counsel; and Schwartz Investments.

⁶⁴ See letters from Bear Stearns; BG&E; Intel; Paine Webber; Wilkie Farr; and XXI Securities.

⁶⁵ See letters from Four Brokers; NY Bar; SIA; Merrill Lynch; Citibank; and Lehman Brothers.

⁶⁶ See proposed Rule 144(d)(3)(xi).

We also propose to expand the scope of the earlier tolling provision, which covered only short sales and options. Since 1990, many new risk-hedging products such as equity swaps and single stock futures have been introduced into the market that also have the effect of limiting or eliminating risk. We are proposing to exclude from the holding period any period in which the security holder had a short position, or had entered into a “put equivalent position,” as defined by Exchange Act Rule 16a-1(h),⁶⁷ with respect to the same class of securities (or in the case of nonconvertible debt, with respect to any nonconvertible debt securities of the same issuer).

Given that the proposed tolling provision would work in conjunction with the Rule 144 provisions that permit tacking of holding periods,⁶⁸ a selling security holder would be required to determine whether a previous owner of the securities had engaged in hedging activities with respect to the securities, if the holding period includes a period in which a previous owner held the securities. Accordingly, we propose to provide that the holding period should not include any period in which the previous owner held a short position or put equivalent position with respect to the securities. There would be no tolling of the previous owner’s holding period, if the security holder for whose account the securities are to be sold reasonably believes that no such short or put equivalent position was held by the previous owner.⁶⁹ In other words, the proposed provision would

⁶⁷ 17 CFR 240.16a-1(h). Rule 16a-1(h) defines a “put equivalent position” as a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option position.

⁶⁸ “Tacking” the holding period is the ability of the security holder to count the period that the securities are held by a previous owner as part of his or her own holding period for the purposes of Rule 144(d). Further discussion about tacking is located in Section II.E.2 of this release.

⁶⁹ See proposed Rule 144(d)(3)(xi)(C). If the security holder relying on Rule 144 is unable to determine that the previous owner did not engage in hedging activities with respect to the securities, then the security holder should omit the period in which the security holder is not able

permit a security holder to tack the period during which the security holder reasonably believes that the previous owner did not engage in hedging activities to his or her holding period. We are proposing a “reasonable belief” standard, because it may be difficult for a selling security holder to determine definitively whether a previous owner had engaged in hedging activities with respect to the securities.

Also, we believe that the proposed tolling provision should not result in a longer holding period than under the current rule. Because the fact that the current rule does not toll the one-year holding period while the security holder has engaged in hedging activities has not raised concerns, we believe, on balance, that one year between the acquisition date of the securities from the issuer or affiliate of the issuer and the resale date sufficiently protects against the indirect distribution of the securities by the issuer to the public. The proposed rule would therefore impose a ceiling on the proposed tolling provision so that, regardless of the security holder’s hedging transactions, the holding period, as computed under all other paragraphs in Rule 144(d), would in no event extend beyond one year.⁷⁰ Under the proposed rules, security holders who wish to rely on Rule 144 to resell restricted securities of non-reporting companies already would be required to hold their securities for at least one year, and therefore would not be subject to the tolling provision.

In concert with the proposed tolling provision, we also propose other related changes to Rule 144. First, we propose to require that information be provided in Form 144 regarding any short or put equivalent position held with respect to the securities prior

to determine whether the previous owner had a short position or a put equivalent position when calculating the holding period under Rule 144(d).

⁷⁰ See proposed note to Rule 144(d)(3)(xi).

to the resale of the securities. A similar requirement was part of Form 144 before the tolling provision was eliminated in 1990.⁷¹

The second related change concerns the manner of sale requirements in Rule 144(f), which we propose to retain for equity securities of affiliates. One option to meet the manner of sale requirements is to sell the securities through “brokers’ transactions” within the meaning of Section 4(4) of the Securities Act.⁷² Rule 144(g) specifies transactions by a broker that are deemed to be included as “brokers’ transactions.” One criteria for these “brokers’ transactions” is that the broker, after reasonable inquiry, is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with regard to the securities or that the transaction is a part of a distribution of the securities of an issuer. Existing Note (ii) of Rule 144(g)(3)⁷³ contains a list of some questions that brokers should ask in order to satisfy this inquiry. We are proposing to amend Note (ii) to Rule 144(g)(3) to explain that in order to satisfy the reasonable inquiry requirement, a broker should also inquire into, if the securities have been held for less than one year, the existence and character of any short position or put equivalent position with regard to the securities held by the person for whose account the securities are to be sold, whether such person has made inquiries into the existence and character of any short position or put equivalent position held by the previous owner of the securities, and the results of such person’s inquiries.⁷⁴ We believe that an inquiry into such positions would not impose an undue burden on brokers as part of their existing

⁷¹ See Release No. 33-5223.

⁷² 15 U.S.C. 77d(4).

⁷³ 17 CFR 230.144(g)(3).

⁷⁴ See proposed Paragraph 2 of Note 2 to Rule 144(g)(3).

inquiry. We believe that this proposed amendment would be a valuable component in determining and monitoring whether security holders have met their holding period requirement under Rule 144.

3. Significant Reduction of Requirements Applicable to Non-Affiliates

Non-affiliates currently are required to hold their restricted securities for one year under Rule 144(d). During this one-year period, non-affiliates are not permitted to resell any securities under the rule. When selling restricted securities that have been held for between one and two years, non-affiliates, like affiliates, are subject to all other applicable conditions of Rule 144, including the requirement that current information be publicly available about the issuer of the securities, limitations on the amount of securities that can be sold in any three-month period, manner of sale limitations and Form 144 filing requirements.⁷⁵ We believe that, for the most part, holding the securities for the length of the holding period should be a sufficient indication that these non-affiliates have assumed the economic risk of investment in those securities.⁷⁶ As such, we believe that it is appropriate to reduce the complexity of resale restrictions that may inhibit sales by, and impose costs on, non-affiliates.⁷⁷

⁷⁵ See 17 CFR 230.144(b) and (d). A person who has held restricted securities for more than two years and has not been an affiliate for at least the most recent three months may resell those securities without complying with Rule 144's other requirements. See 17 CFR 230.144(k).

⁷⁶ We have concerns, however, about the indirect distribution of securities through resales by non-affiliates when those non-affiliates hold securities in shell companies. As discussed below, we propose to codify the staff's interpretive position that security holders cannot rely on Rule 144 in the resale of securities of reporting and non-reporting shell companies.

⁷⁷ While the SEC Advisory Committee on Smaller Public Companies did not specifically address Rule 144 in its final report, the Committee acknowledged the need to reduce the complexity of our rules for the benefit of smaller companies. See Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006), available at <http://www.sec.gov/info/smallbus/acspc.shtml>. See also Report on the Advisory Committee on the Capital Formation and Regulatory Process (Jul. 24, 1996) (suggesting that the SEC minimize the resale restrictions on restricted securities), available at <http://www.sec.gov/news/studies/capform.htm>.

Because Rule 144 is relied upon by many individuals to resell their restricted securities, we believe that it would be particularly helpful to streamline and reduce the complexity of the rule as much as possible while retaining its integrity. We therefore propose to reduce the restrictions for a person who is not an affiliate of the issuer at the time of the sale of the securities and has not been an affiliate during the three months prior to the sale of the securities. These non-affiliates with restricted securities of reporting companies would be permitted to resell their securities after their holding period, subject only to the requirement in Rule 144(c) that current information regarding the issuer of the securities be publicly available.⁷⁸ We preliminarily believe that retaining the current public information requirement would continue to be important in this instance so that the market has adequate information regarding the issuer of the securities and also would not impose an undue burden on a non-affiliate selling security holder. Non-affiliates of both reporting and non-reporting companies would be able to freely resell their restricted securities publicly one year after the acquisition date of the securities (as computed under Rule 144(d)) and without having to comply with any of the other conditions of the rule.⁷⁹

The proposed requirements for the resale of restricted securities held by affiliates and non-affiliates under Rule 144 can be summarized as follows:

⁷⁸ See proposed Rule 144(b)(1)(i). As set forth in paragraphs (c) and (d) of the proposed rules, a reporting company is an issuer that is, and has been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act. A non-reporting company is an issuer that is not, or has not been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act.

⁷⁹ See proposed Rule 144(b)(1).

	Affiliate or Person Selling on Behalf of an Affiliate	Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)
Restricted Securities of Reporting Companies	<p><u>During six-month holding period*</u> - no resales under Rule 144 permitted.</p> <p><u>After six-month holding period*</u> - may resell in accordance with all Rule 144 requirements including:</p> <ul style="list-style-type: none"> • Current public information, • Volume limitations, • Manner of sale for equity securities, and • Filing of Form 144. 	<p><u>During six-month holding period*</u> - no resales under Rule 144 permitted.</p> <p><u>After six-month holding period* but before one year</u> – may resell in accordance with the current public information requirement.</p> <p><u>After one year</u> - unlimited public resale under Rule 144; need not comply with other Rule 144 requirements.</p>
Restricted Securities of Non-Reporting Companies	<p><u>During one-year holding period</u> - no resales under Rule 144 permitted. Tolling provision does not apply.</p> <p><u>After one-year holding period</u> - may resell in accordance with all Rule 144 requirements except holding period, including:</p> <ul style="list-style-type: none"> • Current public information, • Volume limitations, • Manner of sale for equity securities, and • Filing of Form 144. 	<p><u>During one-year holding period</u> - no resales under Rule 144 permitted. Tolling provision does not apply.</p> <p><u>After one-year holding period</u> - unlimited public resale under Rule 144; need not comply with other Rule 144 requirements</p>

* Such holding period may be longer than six months (but not longer than one year), depending on hedging activities.

Request for Comment

- Should the holding period requirement for restricted securities of reporting companies be shortened to six months? Is six months sufficient time to indicate that the affiliate has not acquired the securities for distribution? Are there any concerns that six months would lead to an increase in abuse

with regard to the resale of restricted securities? Should a six-month holding period requirement apply to restricted securities of reporting companies held by non-affiliates as well as affiliates? If you suggest that either affiliates or non-affiliates should be required to comply with a holding period that is shorter than six months, what objective criteria demonstrate that such holding period is sufficient to indicate that the security holder has not acquired the securities for distribution?

- Should the one-year holding period requirement continue to apply to restricted securities of non-reporting companies held by non-affiliates as well as affiliates? Should the holding period for restricted securities of non-reporting companies also be shortened to six months? Should affiliates and non-affiliates of non-reporting companies be subject to the same holding period, or should they be required to comply with a longer or shorter holding period?
- For the purposes of the holding period, is it appropriate that a reporting company is an issuer that is, and has been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act? Is there a more appropriate formulation?
- Should we amend Regulation S to conform the one-year distribution compliance period in Rule 903(b)(3)(iii)⁸⁰ to the proposed six-month holding period? When Regulation S was amended in 1998,⁸¹ the

⁸⁰ 17 CFR 230.903(b)(3)(iii).

⁸¹ Offshore Offers and Sales, Release No. 33-7505 (Feb. 17, 1998).

distribution compliance period applicable to U.S. companies (Category 3 issuers) was conformed to the one-year holding period under Rule 144. The purpose of the distribution compliance period in Regulation S is to ensure that during the offering period and the subsequent aftermarket trading that takes place offshore, the persons relying on the Rule 903 safe harbor (issuers, distributors and their affiliates) are not engaged in an unregistered, non-exempt distribution into the United States capital markets. We are now proposing to shorten the Rule 144 holding period for the resale of restricted securities of Exchange Act reporting companies to six months. Should we amend Regulation S to conform the one-year distribution compliance period for reporting U.S. companies under Rule 903(b)(3)(iii) to the proposed six-month holding period under Rule 144? In light of problematic practices with respect to offerings of U.S. companies under Regulation S, should the distribution compliance period for reporting U.S. companies remain one year consistent with the longest distribution compliance period that would be applicable to securities offered under Regulation S and with the default one-year holding period under Rule 144?

- Is it appropriate to retain the current public information requirement for non-affiliates with restricted securities in reporting companies during the period between the end of the six-month holding period (which may be longer depending on hedging activities) and one year after the securities

were acquired? Should non-affiliates be subject to the current public information condition for a longer period of time? If so, how long?

- Should non-affiliates with restricted securities of non-reporting companies remain subject after the holding period to all conditions of Rule 144 for an additional year, as under the current rule? Are there any specific conditions to which non-affiliates with restricted securities of reporting companies should still be subject after the holding period, other than the current public information requirement? Are there any specific conditions to which non-affiliates with restricted securities of non-reporting companies should still be subject after the holding period? For example, should non-affiliates continue to be subject to volume limitations during a specified period of time after the holding period? What should that specified time be (e.g., six months, one year)? Should non-affiliates be subject to some sort of notice requirement when they have made a sale above the specified threshold amount? What are the benefits if non-affiliates are still subject to such requirements or concerns if they are not?
- Is the proposed language requiring that the security holder toll the holding period if the holder had “a short position, or had entered into a ‘put equivalent position’ as defined by Exchange Act Rule 16a-1(h)” appropriate? Does the proposed tolling provision sufficiently cover the hedging transactions that would result in the circumvention of the purposes of Rule 144? Does it cover too few or too many hedging transactions? If too many, what specific forms of hedging transactions

should be excluded and why? If too few, what other forms of hedging transactions should be covered?

- Given that the proposed tolling provision is not applicable if the security holder has held the securities for one year, would a security holder be able to determine whether and how long previous owners entered into hedging transactions in order to properly calculate the holding period? Would the proposed tolling provision make it too difficult to determine whether a security holder has complied with the holding period requirement? By what other methods could we ensure that persons do not attempt to skirt the purposes of Rule 144 by engaging in hedging transactions?
- Should security holders be held to a “reasonable belief” standard with regard to the previous owner’s hedging activities, or is a “bona fide belief” or some other standard more appropriate? Should we specify what statements or documentation could security holders rely upon in order to formulate a reasonable belief that the previous owner has not engaged in hedging activities in the securities? If so, what documentation should they be permitted to rely upon?
- Is it unnecessarily restrictive to require tolling if the security holder has engaged in hedging transactions with respect to any of his or her securities of the same class (or, in the case of nonconvertible debt, with respect to any nonconvertible debt securities of the same issuer)? Are there any circumstances in which the proposed tolling provision would not be

appropriate? If so, describe the circumstances and explain why the proposed tolling provision would not be appropriate.

- Should we address hedging in a different manner? For example, should we preclude security holders who hedge securities during the holding period from relying on Rule 144? Should we treat such hedging transactions as “sales” of the securities?
- Should the tolling provision apply only during the first year after the date of the acquisition of the securities from the issuer or affiliate? Is one year the appropriate time period, or should the period be longer than one year?
- Is there any reason why we should not amend Note (ii) to Rule 144(g)(3) to add that if the securities have been held for less than one year, the broker’s reasonable inquiry should also include an inquiry into the existence and character of any short position or put equivalent position with regard to the securities held by the person for whose account the securities are to be sold and whether that person has made inquiries into the existence and character of any short position held by a previous owner with regard to the securities? Is the proposed amendment sufficiently clear? Does the proposed amendment place an undue burden on the broker or the holder of the securities? What level of inquiry should the brokers be required to conduct into the security holder’s hedging transactions or the previous owner’s hedging transactions? What statements or documentation, if any, regarding hedging transactions should security holders be required to provide to brokers?

- What level of due diligence did brokers conduct to determine compliance with the holding period requirement before we eliminated the Rule 144 tolling provision in 1990? Were there any problems with tracking hedging positions when the tolling provision was in place, especially in relation to the limited provisions that permitted tacking that existed prior to 1990?
- Is there any reason we should not amend Form 144 to require disclosure of hedging transactions? Is the proposed disclosure appropriate and should it be changed in any way?

C. Elimination of Manner of Sale Limitations for Debt Securities

Rule 144(f) currently requires that securities be sold in “brokers’ transactions,”⁸² or in transactions directly with a “market maker,” as that term is defined in Section 3(a)(38) of the Exchange Act.⁸³ Additionally, the rule prohibits a seller from: (1) soliciting or arranging for the solicitation of orders to buy the securities in anticipation of, or in connection with, the Rule 144 transaction; or (2) making any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities. These manner of sale limitations do not apply to securities sold for the account of a non-affiliate of an issuer after the two-year period in Rule 144(k) has elapsed.⁸⁴

The limitations on manner of sale were intended to assure that special selling efforts and compensation arrangements usually associated with a distribution are not

⁸² Current Rule 144(g) defines the term for purposes of Rule 144.

⁸³ 15 U.S.C. 78c(a)(38).

⁸⁴ The manner of sale requirements also do not apply to securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate, provided the estate or beneficiary is not an affiliate of the issuer.

present in a Rule 144 sale.⁸⁵ In the 1997 proposing release, we proposed to eliminate the manner of sale requirement entirely. Commenters were split as to that proposal. Eleven commenters supported the proposal,⁸⁶ while seven commenters opposed it.⁸⁷

Commenters who opposed the proposal noted that brokers act as gatekeepers to ensure selling shareholders are complying with the requirements of Rule 144. Two commenters supported the proposal because transfer agents would not transfer shares without a release from the issuer.⁸⁸

We agree that, as financial intermediaries, brokers serve an important function as gatekeepers for promoting compliance with Rule 144,⁸⁹ and we are concerned that eliminating the manner of sale limitations for equity securities may lead to abusive transactions. However, we believe that the fixed income securities market does not raise the same concerns, and that the manner of sale provision may place an unnecessary burden on the resale of such securities.⁹⁰ Such securities generally are traded in dealer transactions in which the dealer seeks buyers for securities to fill sell orders instead of through the means prescribed in Rule 144(f). Thus, we are proposing that the manner of sale limitations would not apply to resales of debt securities.⁹¹ This would allow holders of debt securities greater flexibility in the resale of their securities, including, as

⁸⁵ Release No. 33-5186 (Sept. 10, 1971) [36 FR 18586].

⁸⁶ See letters from ABA; AT&T; ASCS; Intel; BG&E; Lehman Brothers; Morgan Stanley; NY Bar; NY City Bar; Sullivan & Cromwell; and Testa Hurwitz.

⁸⁷ See letters from Corporate Counsel; Matthew Crain; Constantine Katsoris; Merrill Lynch; Regional Bankers; SIA; and Smith Barney.

⁸⁸ See letters from ASCS and BG&E.

⁸⁹ Brokers also must comply with the criteria set forth in Rule 144(g) in order to claim the “brokers’ transactions” exemption under Section 4(4) of the Securities Act.

⁹⁰ See also the 2007 ABA Letter.

⁹¹ See proposed Rule 144(f). As discussed above, we also propose to eliminate the manner of sale limitations for resales by non-affiliates.

discussed in the 1997 proposing release, the option to privately negotiate the resale of the securities.⁹²

In addition, we believe that non-participating preferred stock, which has debt-like characteristics, and asset-backed securities, where the predominant purchasers are institutional investors, including financial institutions, pension funds, insurance companies, mutual funds and money managers,⁹³ should be treated similarly to debt securities. Thus, we have included these securities in the “debt securities” category for the purpose of the proposed revisions to the manner of sale limitations in Rule 144.⁹⁴

Request for Comment

- Would eliminating the manner of sale requirement be appropriate for debt securities, as proposed? Is there a need for brokers to serve as an intermediary for such a secondary market? Would transfer agents be able to adequately confirm compliance with Rule 144?
- Should we eliminate the manner of sale requirement for equity securities as well? If so, why? What problems or abuses may arise if the proposal were extended to equity securities? Would removal of the manner of sale requirements for equity securities diminish security transaction transparency by encouraging more privately negotiated transactions? If so, would the markets be adversely affected, particularly for stocks of smaller companies and more thinly traded securities?

⁹² Section III.C. of the 1997 proposing release.

⁹³ See Release No. 33-8518 (Dec. 22, 2004) [70 FR 1506].

⁹⁴ See proposed Rule 144(f). This proposal is for Rule 144(f) purposes only and does not affect the classification of these securities as debt or equity for other purposes. This treatment is consistent with the treatment of such securities under Regulation S. See Release No. 33-7505.

- Are there other purposes served by the manner of sale requirements that justify retaining those requirements? How would the removal of the manner of sale requirements affect participants, such as transfer agents, brokers and market makers, in Rule 144 transactions? Would transfer agents assume a greater role in determining compliance with the resale provisions? How would removing the manner of sale limitations affect brokers' obligations with respect to their ability to qualify for the "brokers' transactions" exemption under Section 4(4) of the Securities Act?
- Is it appropriate to include asset-backed securities and non-participating preferred stock as debt securities for the purposes of this rule? Are there any other types of securities to which the limitations on manner of sale should not apply? If so, why?
- Are there any other conditions in Rule 144 to which debt securities should not be subject? For example, should we raise the volume limitations in Rule 144(e) for debt securities, or eliminate the volume limitations for debt securities altogether?⁹⁵

D. Increase of the Form 144 Filing Thresholds

Rule 144(h) requires a selling security holder to file Form 144 if the security holder's intended sale exceeds either 500 shares or \$10,000 within a three-month period.⁹⁶ These filing thresholds have been in place since 1972.⁹⁷ In the 1997 proposing

⁹⁵ See discussion in 2007 ABA Letter.

⁹⁶ 17 CFR 230.144(h).

release, we proposed to increase the filing thresholds to 1,000 shares or \$40,000.

Thirteen commenters supported raising the filing threshold and no commenters opposed it.⁹⁸ Six commenters suggested that we eliminate Form 144.⁹⁹ One commenter suggested raising the threshold to \$100,000.¹⁰⁰ Another commenter suggested raising it to \$250,000.¹⁰¹

As discussed above, under the proposed rules, only affiliates of the issuer would be required to file a notice of proposed sale on Form 144 when relying on Rule 144. We now are proposing to increase the Form 144 filing thresholds to trades of 1,000 shares or \$50,000 within a three-month period for affiliates.¹⁰² The purpose of raising the dollar threshold to \$50,000 is to adjust for inflation since 1972.¹⁰³ We believe that the 1,000 share threshold is an appropriate alternate threshold that would capture trades which merit notice but for which the dollar amount of the trades may not be as significant. In addition to this proposed amendment to Rule 144(h), we solicit comment below on how best to coordinate the filing deadline for Form 144 with the filing deadline for Form 4 and permit affiliates subject to Section 16 filing requirements to, at their option, satisfy

⁹⁷ The 500 share and \$10,000 thresholds have remained constant since Rule 144's inception in 1972. However, in 1978, we shortened the relevant time period during which sales volume is to be calculated from six months to three months to conform to a change shortening the time period in which sale volume should be calculated for the purposes of the Rule 144 volume limitation condition from six months to three months. Release No. 33-5995 (Nov. 8, 1978) [43 FR 54229].

⁹⁸ See letters from ABA; ASCS; AT&T; BG&E; Corporate Counsel; Merrill Lynch; Morgan Stanley; NY Bar; NY City Bar; Regional Bankers; SIA; Smith Barney; and Sullivan & Cromwell.

⁹⁹ See letters from ABA; Benesch, Friedlander, Coplan & Aranoff (Benesch Friedlander); NY Bar; NY City Bar; and Sullivan & Cromwell.

¹⁰⁰ See letter from ABA.

¹⁰¹ See letter from NY Bar.

¹⁰² See proposed Rule 144(h).

¹⁰³ The adjustment would be approximately \$42,000 if based on the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce. In addition, if based on the Consumer Price Index, the adjustment would be approximately \$50,000. To achieve a round number, we are proposing to raise the filing threshold to \$50,000.

their Form 144 filing requirements by timely filing a Form 4 to report the sale of their securities.

Request for Comment

- Should the dollar threshold be higher or lower than proposed (e.g., \$25,000, \$75,000, or \$100,000)? Should the threshold based on the number of shares be higher or lower than proposed (e.g., 500, 1,500, 2,000 or 2,500 shares)?
- Should the threshold be based solely on the number of shares sold, or solely on the dollar amount of the transaction? Should it be based on a formula using both variables? Should we allow for adjustments to the dollar amount threshold every five years that would reflect changes due to inflation?
- Should thresholds be based on a different number such as a percentage of the company's public float, or a different self-adjusting index?
- If you believe the thresholds should be different, please explain why your suggested threshold would be appropriate, including information and data to support your beliefs.

E. Codification of Several Staff Positions

The following are proposed codifications of staff positions issued by the Division of Corporation Finance. These codifications should simplify the rule by making these staff positions more transparent and readily available to the public. The first three proposals were included in the 1997 proposing release. The last four proposals are new proposed codifications of existing staff positions.

1. Securities acquired under Section 4(6) of the Securities Act are considered “restricted securities”

The 1997 proposing release proposed to codify the Division of Corporation Finance’s interpretive position that securities acquired from the issuer pursuant to an exemption from registration under Section 4(6) of the Securities Act¹⁰⁴ are considered “restricted securities” under Rule 144(a)(3).¹⁰⁵ We did not receive any comments on this proposal.

Section 4(6) provides for an exemption from registration for an offering that does not exceed \$5,000,000 that is made only to accredited investors, that does not involve any advertising or public solicitation by the issuer or anyone acting on the issuer’s behalf and for which a Form D has been filed.¹⁰⁶ Because the resale status of securities acquired in Section 4(6) exempt transactions should be the same as securities received in other non-public offerings that are included in the definition of restricted securities, we believe that securities acquired under Section 4(6) should be defined as restricted securities for purposes of Rule 144. Therefore, we are proposing an amendment to Rule 144 to codify the staff’s position that securities acquired under Section 4(6) of the Securities Act are “restricted securities” under Rule 144(a)(3).¹⁰⁷

¹⁰⁴ 15 U.S.C. 77d(6). Section 4(6) was included in the Securities Act pursuant to the Small Business Investment Incentive Act of 1980 [Pub. L. No. 96-477 (Oct. 21, 1980)].

¹⁰⁵ 17 CFR 230.144(a)(3). See the Division of Corporation Finance’s Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 104 (Rule 144(a)(3)), Question No. 104.03.

¹⁰⁶ See 15 U.S.C. 77d(6).

¹⁰⁷ See proposed Rule 144(a)(3)(viii).

2. Tacking of holding periods when a company reorganizes into a holding company structure

The 1997 proposing release also proposed codifying the Division of Corporation Finance's interpretive position that holders may tack the Rule 144 holding period in connection with transactions made solely to form a holding company.¹⁰⁸ In "tacking," holders may count the period that the securities are held before the transaction made to form a holding company as part of period they hold the securities used to meet the Rule 144(d) requirement. We did not receive any comments on this proposal.

We are proposing again to codify that interpretive position.¹⁰⁹ This provision would permit tacking of the holding period if the following three conditions are satisfied:

- The newly formed holding company's securities are issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
- Security holders receive securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor company, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and
- Immediately following the transaction, the holding company has no significant assets other than securities of the predecessor and its existing

¹⁰⁸ Morgan Olmstead (Jan. 8, 1988).

¹⁰⁹ See proposed Rule 144(d)(3)(ix).

subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.

In such transactions, tacking would be appropriate because the securities being exchanged are substantially equivalent, and there is no significant change in the economic risk of the investment in the restricted securities. We believe that the codification of this interpretation and as well as the codification of the following two interpretations below would assist security holders in determining whether they have met the Rule 144(d) holding period requirement.

3. Tacking of holding periods for conversions and exchanges of securities

The 1997 proposing release proposed codifying the Division of Corporation Finance's position that if the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.¹¹⁰ As noted in the 1997 release, Rule 144 does not state whether the surrendered securities must have been convertible by their terms in order for tacking to be permitted, which led to some confusion on how to calculate the Rule 144 holding period. We did not receive any comments on this proposal.

We are proposing again these amendments to Rule 144(d)(3)(ii).¹¹¹ In addition, we are proposing a note to this provision that clarifies the Division's position that if:

¹¹⁰ See Planning Research Corp. (Dec. 8, 1980).

¹¹¹ See proposed Rule 144(d)(3)(ii).

- The original securities do not permit cashless conversion or exchange by their terms;
- The parties amend the original securities to allow for cashless conversion or exchange; and
- The security holder provides consideration, other than solely securities of the issuer, for that amendment,

then shares will be deemed to have been acquired on the date that the original securities were so amended.¹¹²

4. Cashless exercise of options and warrants

Several commenters responding to the 1997 release suggested that we codify the Division of Corporation Finance's position that, upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired, even if the options or warrants originally did not provide for cashless exercise by their terms.¹¹³ We are proposing to revise Rule 144 to codify that position in response to those comments.¹¹⁴

In addition, we are proposing to add two notes to this new paragraph. The first note would codify the Division's position that if:

- The original options or warrants do not permit cashless exercise by their terms; and
- The holder provides consideration, other than solely securities of the issuer, to amend the options or warrants to allow for cashless exercise,

¹¹² See Morgan Stanley & Co., Inc. (June 30, 1993).

¹¹³ See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 212 (Rule 144(d)(3)), Interpretation No. 212.01.

then the options or warrants would be deemed to have been acquired on the date that the original options or warrants were so amended.¹¹⁵ This treatment is analogous to our treatment of conversions and exchanges.

The second note would codify the Division's position that the grant of certain options or warrants that are not purchased for cash or property does not create any investment risk in the holder in a manner that would justify identification of the holding period of the securities received upon exercise of the options or warrants with that of the options or warrants.¹¹⁶ This is the case for employee stock options. The note would clarify that in such instances, the holder would not be allowed to tack the holding period of the option or warrant and would be deemed to have acquired the underlying securities on the date the option or warrant was exercised, if the conditions of Rule 144(d)(1) and Rule 144(d)(2) are met at the time of exercise.

5. Aggregation of pledged securities

In response to suggestions from commenters, we are proposing to add a note to Rule 144(e)(2)(ii)¹¹⁷ that would address calculation of the volume of securities that a pledgee of securities may sell.¹¹⁸ It would codify the Division of Corporation Finance's position that, so long as the pledgees are not the same "person" under Rule 144(a)(2), a pledgee of securities may sell the pledged securities without having to aggregate the sale with sales by other pledgees of the same securities from the same pledgor, as long as

¹¹⁴ See proposed Rule 144(d)(3)(x).

¹¹⁵ See Morgan Stanley & Co., Inc. (June 30, 1993).

¹¹⁶ See Morgan Stanley & Co., Inc. (June 30, 1993) and Malden Trust Corporation (Feb. 21, 1989).

¹¹⁷ 17 CFR 230.144(e)(2)(ii).

¹¹⁸ If the proposed amendments eliminating certain requirements for non-affiliates are adopted, then the volume limitations in Rule 144(e) would apply only to affiliates.

there is no concerted action by those pledgees.¹¹⁹ As an example, assume that a security holder (the pledgor) pledges the securities he owns in Company A to two banks, Bank X and Bank Y (the pledgees). If the pledgor defaults:

- Upon default, Bank X does not have to aggregate its sales of Company A securities with Bank Y's sales of Company A securities unless Bank X and Bank Y are acting in concert, but
- Bank X individually still must aggregate its sales with the pledgor's sales, and
- Bank Y individually still must aggregate its sales with the pledgor's sales.

Provided that the loans and pledges are bona fide transactions and there is no concerted action among pledgees and no other aggregation provisions under Rule 144(e) apply, we do not believe that extra burdens on pledgees to track and coordinate resales by other pledgees are warranted.

6. Treatment of securities issued by "reporting and non-reporting shell companies"

A blank check company is a company that:

- Is in the development stage;
- Has no specific business plan or purpose, or has indicated that its business plan is to merge with or acquire an unidentified third party; and
- Issues penny stock.¹²⁰

¹¹⁹ See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 216 (Rule 144(e)(3)), Interpretation No. 216.01. See also Standard Chartered Bank (June 22, 1987).

¹²⁰ 17 CFR 230.419. The term "penny stock" is defined in 17 CFR 240.3a51-1.

Such companies historically have provided opportunity for abuse of the federal securities laws, particularly by serving as vehicles to avoid the registration requirements of the securities laws.¹²¹ Rule 419 under the Securities Act¹²² was adopted in 1992 to control the extent to which such companies are able to access funds from a public offering.

In 2005, we amended Securities Act Rule 405 to define a “shell company” to mean a registrant, other than an asset-backed issuer, that has:

- (1) no or nominal operations; and
- (2) either:
 - no or nominal assets;
 - assets consisting solely of cash and cash equivalents; or
 - assets consisting of any amount of cash and cash equivalents and nominal other assets.¹²³

On January 21, 2000, the Division of Corporation Finance concluded in a letter to NASD Regulation, Inc. that Rule 144 is not available for the resale of securities issued by companies that are, or previously were, blank check companies.¹²⁴ In an effort to curtail misuse of Rule 144 by security holders through transactions in the securities of blank

¹²¹ See Release No. 33-6932 (Apr. 28, 1992) [57 FR 18037].

¹²² 17 CFR 230.419.

¹²³ See 17 CFR 230.405 and Release No. 33-8587 (Jul. 15, 2005) [70 FR 42234].

¹²⁴ Ken Worm, NASD Regulation, Inc. (Jan. 21, 2000). In that letter, the Division stated that “transactions in blank check company securities by their promoters or affiliates . . . are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) [of the Securities Act] was designed to exempt.” The Division stated its view that “both before and after the business combination or transaction with an operating entity or other person, the promoters or affiliates of blank check companies, as well as their transferees, are ‘underwriters’ of the securities issued. . . . Rule 144 would not be available for resale transactions in this situation, regardless of technical compliance with that rule, because these resale transactions appear to be designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act.”

check companies, we are proposing to codify this position with some modifications.¹²⁵ First, we propose to modify the staff interpretation to address securities of all companies, other than asset-backed issuers, that meet the definition of “shell company.”¹²⁶ These companies would include any company, including a blank check company, that meets the definition. The category of companies to whom the staff interpretation is proposed to apply would be broader than the definition of “shell company” in Rule 405, however, as it would apply to any “issuer” meeting that standard, whereas the Rule 405 definition refers only to “registrants.” We believe that this provision better describes the companies that are the subject of the abuse that the staff interpretation is designed to address. For the purposes of the discussion in this release only, we call these companies, “reporting and non-reporting shell companies.” Under the proposed rule, a person who wishes to resell securities issued by a company that is, or was, a reporting or a non-reporting shell company, other than a business combination related shell company,¹²⁷ would not be able to rely on Rule 144 to sell the securities.

Second, because the reasons for prohibiting reliance on Rule 144 do not appear to be present after a reporting company has ceased to be a shell company and there is adequate disclosure in the market that would serve to protect against further abuse,¹²⁸ we propose to permit the availability of Rule 144 for resales under provisions that are similar

¹²⁵ See proposed Rule 144(i).

¹²⁶ See proposed paragraph (i)(1) of Rule 144.

¹²⁷ “Business combination related shell company” is defined in Securities Act Rule 405.

¹²⁸ We are not proposing a comparable provision for security holders of non-reporting companies that have ceased to be shell companies because they have business operations or more than nominal non-cash assets. We have not proposed a comparable provision for these companies, because we preliminarily believe that the information that a non-reporting company would provide to the market does not adequately protect against potential abuse in those situations.

to our provisions that permit the use of a Securities Act Form S-8¹²⁹ registration statement by reporting companies that were formally shell companies.¹³⁰ We propose to permit reliance on Rule 144 for resales by a security holder when:

- the issuer of the securities that was formally a reporting or non-reporting shell company has ceased to be a shell company;
- the issuer of the securities is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act;
- the issuer of the securities has filed all reports and material required to be filed during the preceding 12 months (or for such shorter period that the registrant was required to file such reports and materials); and
- at least 90 days have elapsed from the time the issuer files current “Form 10 information” with the Commission reflecting its status as an entity that is not a shell company.

Form 10 information is equivalent to information that a company would be required to file if it were registering a class of securities on Form 10, Form 10-SB, or Form 20-F under the Exchange Act,¹³¹ and such information is ordinarily filed on Form 8-K.¹³²

Under the proposed amendments, an affiliate security holder selling control securities would have to wait at least 90 days before being permitted to resell the

¹²⁹ 17 CFR 239.16b.

¹³⁰ See Release No. 33-8587. These provisions are consistent with the Form S-8 provisions for shell companies, except that Form S-8 requires a former shell company to wait 60 days, rather than 90 days, before it is able to use the form to register securities.

¹³¹ 17 CFR 249.210; 17 CFR 249.210b; and 17 CFR 249.220f.

¹³² 17 CFR 249.308. Items 2.01(f) and 5.01(a)(8) of Form 8-K require a company in a transaction where the company ceases being a shell company to file a current report on Form 8-K containing the information (or identifying the previous filing in which the information is included) that would be required in a registration statement on Form 10 or Form 10-SB to register a class of securities under Section 12 of the Exchange Act.

securities, and a security holder selling restricted securities would be required to wait the duration of the holding period before being permitted to resell the securities.¹³³ The 90-day delay or the duration of the holding period would provide the market with time to absorb the Form 10 information filed with the Commission regarding the company, and the 90-day delay here is consistent with the 90-day waiting period in Rule 144(c) and proposed Rule 144(d).

7. Representations required from security holders relying on Exchange Act Rule 10b5-1(c)

Rule 10b5-1¹³⁴ under the Exchange Act defines when a purchase or sale constitutes trading “on the basis of” material nonpublic information in insider trading cases brought under Exchange Act Section 10(b)¹³⁵ and Rule 10b-5.¹³⁶ Specifically, a purchase or sale of a security of an issuer is “on the basis of” material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale. However, Rule 10b5-1(c) provides an affirmative defense that a person’s purchase or sale was not “on the basis of” material nonpublic information. For this defense to be available, the person must demonstrate that:

¹³³ For the purposes of computing the holding period under the proposed rule, the securities shall be deemed to have been acquired either at the time the securities were acquired from the issuer or affiliate of the issuer, or at the time the “Form 10 information” is filed with the Commission, whichever is the latest date. See proposed Rule 144(d)(3)(xii).

¹³⁴ 17 CFR 240.10b5-1.

¹³⁵ 15 USC 78j(b).

¹³⁶ 17 CFR 240.10b-5. As stated in Rule 10b5-1(a), the “manipulative and deceptive devices” prohibited by Section 10(b) and Rule 10b-5 include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

- before becoming aware of the material nonpublic information, he or she had entered into a binding contract to purchase or sell the securities, provided instructions to another person to execute the trade for the instructing person's account, or adopted a written plan for trading the securities;
- the contract, instructions or written trading plan satisfy the conditions of Rule 10b5-1(c); and
- the purchase or sale that occurred was pursuant to the contract instruction or plan.

Currently, Form 144 requires a selling security holder to represent, as of the date that the form is signed, that he or she “does not know any material adverse information in regard to the current and prospective operations of the issuer of the securities to be sold which has not been publicly disclosed.” The Division of Corporation Finance has indicated that a selling security holder who satisfies Rule 10b5-1(c) may modify the Form 144 representation to indicate that he or she had no knowledge of material adverse information about the issuer as of the date on which the holder adopted the written trading plan or gave the trading instructions, specifying that date and indicating that the representation speaks as of that date.¹³⁷

In order to reconcile the Form 144 representation with Rule 10b5-1, we are proposing to codify this interpretive position. Under the proposed amendments, Form 144 filers would be able to make the required representation as of the date that they adopted written trading plans or gave trading instructions that satisfy Rule 10b5-1(c).

¹³⁷ See the Division of Corporation Finance Manual of Publicly Available Telephone Interpretations, Fourth Supplement (May 30, 2001), at Rule 10b5-1; Form 144, Interpretation No. 2.

Request for Comments

- Should we codify all of the above staff positions? Is the codification of the staff position on securities acquired under Section 4(6) appropriate and consistent with the purposes of Rule 144? Would codification of the staff positions on the Rule 144 holding period help to resolve any confusion regarding how to calculate the holding period? Would codification of the position on the aggregation of pledgees securities assist security holders in determining their volume limitations? If you believe we should not codify any of these positions, which one or ones should we not codify? If so, why?
- Should we revise any of the staff's existing positions on these matters? If so, which position and why? Does the wording of any of the proposed language suggest a change, or create ambiguity, in the staff's position?
- Would codification of the staff position on the treatment of securities issued by blank check companies protect against abuse relating to the resale of such securities? Should we expand the staff position to preclude reporting and non-reporting shell companies from relying on Rule 144?
- Should we permit reliance on Rule 144 for the resale of securities of former shell companies if the company is a reporting company, the company is no longer a shell company, the company has filed Form 10 information reflecting its status as an entity that is not a shell company, and either 90 days have elapsed since the filing of the Form 10 information or the holding period has been met? Is 90 days an appropriate

amount of time? Should the delay be longer (e.g., 180 days or one year)? Are there any reasons not to adopt such an amendment? Should we expand the proposed revision to permit reliance on Rule 144 also for the resale of securities of non-reporting companies that were formerly non-reporting shell companies where there is publicly available information (provided under Rule 15c2-11)¹³⁸ reflecting that such companies have obtained business operations or more than nominal assets?

F. Amendments to Rule 145

Securities Act Rule 145 provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations or transfers of assets that are subject to shareholder vote constitute sales of those securities. Rule 145(c) deems persons who were parties to such a transaction, other than the issuer, or affiliates of such parties to be underwriters. Rule 145(d) sets forth the restrictions on the resale of securities received in such transactions by persons deemed underwriters. In the 1997 proposal, we proposed to eliminate the presumed underwriter and resale provisions in Rule 145(c) and (d). Many commenters supported the 1997 proposal.¹³⁹

After reviewing comments on the proposal, we believe it is appropriate to eliminate the presumptive underwriter provision in Rule 145, as it is no longer necessary in most circumstances. However, based on our experience with business combinations involving shell companies that have resulted in abusive sales of securities, we believe that there continues to be a need to apply the presumptive underwriter provision to shell

¹³⁸ 17 CFR 240.15c2-11.

¹³⁹ See letters from ABA; ASCS; AT&T; BG&E; Brobeck, Phleger & Harrison, LLP (Brobeck); Corporate Counsel; Intel; NY Bar; NY City Bar; SIA; Smith Barney; Sullivan & Cromwell; and Testa Hurwitz.

companies and their affiliates and promoters. Accordingly, we propose amendments to Rule 145(c) and (d) that would:¹⁴⁰

- Eliminate the presumed underwriter status provision in Rule 145(c) except with regard to Rule 145(a) transactions that involve a shell company (other than a business related shell company);¹⁴¹ and
- Harmonize the requirements in Rule 145(d) with the proposed provisions in Rule 144 that would apply to securities of shell companies.¹⁴²

Under the proposed rule, parties to the transaction in Rule 145(a), other than the issuer, and their affiliates, where a party to the transaction is a shell company, other than a business combination related shell company, could resell securities acquired in connection with the transaction only in accordance with Rule 145(d).

Under proposed Rule 145(d), the persons and parties that are deemed presumed underwriters would be permitted to resell their securities to the same extent that affiliates of a shell company would be permitted to resell their securities under Rule 144, as proposed. The securities could be only sold after any company that was a shell company and a party to the transaction has ceased to be a shell company and at least 90 days have elapsed since the securities were acquired in the transaction, subject to Rule 144 conditions.¹⁴³ The 90 day-delay is consistent with the 90-day delay that we are

¹⁴⁰ We also propose to add the definition of “affiliate” to paragraph (e) and transfer the definition of “party” from paragraph (c) to paragraph (e).

¹⁴¹ See proposed Rule 145(c). The terms, “shell company” and “business combination related shell company,” are defined in Securities Act Rule 405. See also Release No. 33-8587 (Jul. 15, 2005) [70 FR 42233].

¹⁴² See proposed Rule 145(d).

¹⁴³ The securities acquired by the parties and persons deemed presumed underwriters would be acquired pursuant to an effective registration statement. As in the proposed Rule 144 amendments, this 90-day delay would allow the market extra time to absorb the information in the registration statement before these persons and parties can publicly resell the securities.

proposing in paragraph (i) of Rule 144 relating to the use of Rule 144 for the resale of securities of a former shell company. As in the proposed amendments to Rule 144, after six months have elapsed since the securities were acquired in the transaction, the persons and parties would be permitted to resell their securities, subject only to the current public information condition in Rule 144, provided that the sellers are not affiliates of the issuer at the time of sale and have not been affiliates during the three months before the sale. As in the proposed amendments to Rule 144, one year after the securities were acquired in the transaction the persons and parties would be permitted to freely resell their securities, provided that they are non-affiliates at the time of sale and have not been affiliates during the three months before the sale.

In addition, similar to the proposal for the Preliminary Note in Rule 144, we propose to add a note that Rule 145(c) and (d) are not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.¹⁴⁴ We also propose to clarify language in Rule 145(d) regarding the securities that were acquired in a transaction specified in paragraph Rule 145(a).¹⁴⁵

Request for Comment

- Should we limit the Rule 145 presumptive underwriter provision only to transactions involving shell companies? Are there any other transactions for which the presumptive underwriter provision should continue to

¹⁴⁴ See proposed Note to Paragraphs (c) and (d) of Rule 145.

¹⁴⁵ We propose to revise the phrase in Rule 145(d) relating to “registered securities” to say instead “securities acquired in a transaction specified in paragraph (a) that was registered under the Act,” which we believe is a more accurate description.

apply? Should we eliminate this provision with respect to transactions involving shell companies?

- Are the proposed amendments to Rule 145(d) appropriate? Should we retain the requirement that the issuer of the securities must meet the current public information requirements of Rule 144(c) for a prescribed period of time before the party is permitted to resell freely its securities in the issuer?
- Are the time periods that the parties and their affiliates must wait before being permitted to resell the securities in proposed Rule 145(d) appropriate? Is it appropriate to require those deemed underwriters to wait at least 90 days before being permitted to resell their securities? Should the requirement be shorter or longer (e.g., 30, 60, 120, or 180 days, or one year)? If so, why?
- Should we add the note that Rule 145(c) and (d) are not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act?

G. Conforming and Other Amendments

1. Underlying Securities in Asset-Backed Securities Transactions

The proposals we make today necessitate consideration of proposed changes to other rules that refer to Rule 144. In particular, we are proposing changes to the asset-backed rules. We adopted Securities Act Rule 190 to clarify when registration of the sale

of underlying securities in asset-backed securities transactions is required.¹⁴⁶ One of the basic premises underlying ABS offerings is that an investor is buying participation in the underlying assets. Therefore, if the assets being securitized are themselves securities under the Securities Act (commonly referred to as a “resecuritization”), the offering of the underlying securities must itself be registered or exempt from registration under the Securities Act. Rule 190 provides the framework for determining if registration of the sale of these underlying assets is required at the time of the registered ABS offering.

One of the requirements of Rule 190 is that the depositor would be free to publicly resell the securities without registration under the Securities Act.¹⁴⁷ This provision currently notes as an example that if the underlying securities are Rule 144 restricted securities, they must meet the condition of 144(k) (e.g., a two-year holding period by non-affiliates). Because of the manner of sale restrictions on asset-backed securities, this example means that in order to meet this condition under Rule 190, at least two years must have elapsed from the date the securities were acquired from the issuer of the underlying securities, or an affiliate, and the date they are pooled and resecuritized pursuant to Rule 190.

Our proposed revisions to Rule 144 with no concurrent revision to Rule 190 would allow privately placed debt or other ABS to be publicly resecuritized in as little as six months after their original issuance without registration of the underlying securities.¹⁴⁸ Given that that Rule 190 addresses the public distribution of privately

¹⁴⁶ 17 CFR 230.190 and Release No. 33-8518 (Dec. 22, 2004) [70 FR 1506].

¹⁴⁷ 17 CFR 230.190(a)(3).

¹⁴⁸ Although the ABS securities we are discussing may be privately placed, the issuing trust will have also registered the sale of other ABS and may have a reporting obligation under Section 15(d) for some time.

placed securities via resecuritization transactions, we are proposing revisions to Rule 190 in order to keep the current two-year period for resecuritizations that do not require registration of the underlying securities.¹⁴⁹

A particular issuance of asset-backed securities often involves one or more publicly offered classes (e.g., classes rated investment grade) as well as one or more privately placed classes (e.g., non-investment grade subordinated classes). In most instances, the subordinated classes act as structural credit enhancement for the publicly offered senior classes by receiving payments after, and therefore absorbing losses before, the senior classes. These unregistered asset-backed securities are typically rated below investment grade or are unrated and as such could not be offered on Form S-3. They typically are not fungible with registered securities from the same offering and are held by very few investors. Further, the trust or issuing entity usually ceases reporting under the Exchange Act with respect to the publicly offered classes after its initial Form 10-K is filed. We understand the privately placed subordinated securities in these transactions are often the types of securities that are pooled and resecuritized into new asset-backed securities.¹⁵⁰

Due to the particular circumstances of asset-backed securities and the established experience with a two-year period under both the ABS rules and the prior staff positions that were codified by those rules, we are not persuaded at this time that we should shorten the current two-year holding period for restricted securities that are to be sold into

¹⁴⁹ This proposed change would not in any way impact the disclosure requirements for resecuritizations.

¹⁵⁰ See Saskia Scholtes, Left in the Dark on Debt Obligations, FT.com (Mar. 27, 2007) (describing privately placed collateralized debt obligations (CDOs) vehicles used to repackage portfolios of other debt and noting that “the biggest category of deals, at 44%, consisted of CDOS backed by asset-backed securities such as those backed by subprime mortgages”).

publicly-registered securitizations. As a result, we are proposing to amend Rule 190 to provide that if the underlying securities are Rule 144 restricted securities, Rule 144 must be available for the sale of the securities in the resecuritization, except that at least two years must have elapsed since the later of the date the securities were acquired from the issuer of the underlying securities or from an affiliate of the issuer of the underlying securities. Of course, the underlying securities could still be resecuritized if they do not meet this requirement; their sale would just need to be concurrently registered with the offering of the asset-backed securities on a form for which the offering of the class of underlying securities would be eligible. In addition, nothing in Rule 190 as we propose to amend it would lengthen the holding period of the underlying securities for resales other than in connection with publicly registered resecuritizations.

2. Securities Act Rule 701(g)(3)

Securities Act Rule 701(g)(3)¹⁵¹ outlines the resale limitations for securities issued under Rule 701. The limitations for resales by non-affiliates includes references to paragraphs (e) and (h) of Rule 144, which under the proposed rules, would no longer apply to resales by non-affiliates. Accordingly, it is appropriate to propose a conforming amendment to remove references to Rule 144(e) and (h) from Rule 701.¹⁵²

Request for Comment

- Is the revision to Rule 190 appropriate? Are we correct in understanding that privately placed securities that are resecuritized pursuant to Rule 190 typically were acquired from the issuer two or more years ago? Should we shorten the two-year period for resecuritizations, but to not as short as

¹⁵¹ 17 CFR 230.701(g)(3).

the six months we propose for certain other resales under Rule 144? What interim length would be appropriate (e.g., one year)?

- Should we limit our revision to just underlying securities that are asset-backed securities and allow non-asset-backed securities such as corporate debt to be securitized without registration in the revised Rule 144 periods?
- Are there other instances where our rules reference Rule 144 or Rule 145 that would warrant change as a result of our proposed revisions to those rules?
- Is the proposed change to Rule 701 appropriate?

III. Coordination of Form 144 Filing Requirements with Form 4 Filing Requirements

Rule 144 requires a seller to transmit a Form 144 for filing concurrently with either the placing with a broker of an order to execute a sale of securities in reliance upon Rule 144 or the execution directly with a market maker of such a sale, if the sale has exceeded certain filing thresholds.¹⁵³ The proposed amendments above eliminate the Form 144 filing requirement for non-affiliates, and therefore, the Form 144 filing requirements would apply only to affiliates of the issuer.¹⁵⁴

Many affiliates of an issuer under Rule 144 are also insiders of the issuer under Section 16 of the Exchange Act.¹⁵⁵ Pursuant to Exchange Act Rule 16a-3,¹⁵⁶ insiders are

¹⁵² See proposed Rule 701(g)(3).

¹⁵³ See Rule 144(h). As noted above, we are proposing to raise the thresholds that trigger the Form 144 filing requirement.

¹⁵⁴ See Section II.B above.

¹⁵⁵ Section 16 requirements apply to every person who is directly or indirectly the beneficial owner of more than 10% of any class of any equity security (other than an exempted security) which is registered pursuant to Section 12, or who is a director or an officer of the issuer.

¹⁵⁶ 17 CFR 240.16a-3.

required to report changes in beneficial ownership, including purchases and sales of securities, on Form 4.¹⁵⁷ Some of the items required by Form 144 are duplicative of the requirements on Form 4. The Sarbanes-Oxley Act of 2002¹⁵⁸ changed the Form 4 filing deadline to two business days after the transaction is executed. As a result, affiliates selling securities under Rule 144 often are required to file a Form 4 just a few days after they file a Form 144 to report information regarding the same sale of securities.

In order to reduce duplicative requirements on individuals who are subject to both the Form 144 filing requirements and the Section 16 filing requirements, we solicit comment on how best to coordinate the Form 144 filing requirement with the filing requirements under Section 16 of the Exchange Act for an affiliate who wishes to rely on Rule 144 and is subject to the Section 16 filing requirements.¹⁵⁹ Specifically, we solicit comment on the following:

- Revising the filing deadline for Form 144 to coincide with the filing deadline for Form 4 (before the end of the second business day following the day on which the subject transaction was executed);¹⁶⁰
- Permitting affiliates subject to Section 16 filing requirements to, at their option, satisfy their Form 144 filing requirements by timely filing a Form 4 to report the sale of their securities; and

¹⁵⁷ 17 CFR 249.104 and 17 CFR 274.203.

¹⁵⁸ P. L. No. 107-204, 116 Stat. 745.

¹⁵⁹ See also letter from Corporate Counsel.

¹⁶⁰ See Exchange Act Rule 16a-3(g).

- Revising Item 701 of Regulations S-B and S-K¹⁶¹ to require additional disclosure about the resale status of securities issued in unregistered transactions at the time the company first issues the securities.

While Form 144 and Form 4 both provide information regarding the title of the class of securities sold, the number of shares subject to sale, the aggregate market value of those shares, and the date of sale, there are, however, some differences in the disclosure required by Form 144 and Form 4 with respect to sales of securities. For example, Form 4 does not request some information that is required to be provided in Form 144, including:

- the date that the securities were acquired;
- the nature of the acquisition transaction;
- the name of the person from whom the securities were acquired;
- the amount of securities acquired;
- the date of payment for the securities; and
- the nature of payment.

In addition, while Form 144 requires disclosure regarding securities sold in the three months prior to the sale, if a person has not been subject to the Section 16 reporting obligations for three months, that person's Section 16 reports would not provide complete information regarding sales of securities in the last three months. Also, Form 4 does not contain the proposed representation that is given by security holders that they do not

¹⁶¹ 17 CFR 228.701 and 229.701. We recently proposed to integrate Regulation S-B disclosure requirements into Regulation S-K disclosure requirements. See SEC Press Release No. 2007-102 (May 23, 2007), available at <http://www.sec.gov/news/press.shtml>.

know material adverse information about the company as of the date that they adopted a plan under Exchange Act Rule 10b5-1 or gave trading instructions, as applicable.¹⁶²

We preliminarily believe that if we permit a security holder to satisfy a Form 144 filing requirement by filing a Form 4, Form 4 should be amended to require the security holder that wishes to satisfy a Form 144 filing requirement to provide the following information regarding Rule 144 compliance in Form 4:

- the date that the securities were acquired (for purposes of the holding period calculation under Rule 144(d));¹⁶³
- the name of the person from whom the securities were acquired;
- the date of payment for the securities; and
- the nature of the payment.

Regarding the items in Form 144 relating to the nature of the acquisition transaction and the amount of securities acquired, we believe that such information or similar information could be available in a previously filed Form 4 reporting the purchase of the securities, unless the security holder was not subject to Section 16 requirements at the time the securities were acquired. We solicit comment on which Form 144 disclosure items we should preserve and transfer from Form 144 to Form 4, if we were to permit security holders to satisfy their Form 144 obligations with a Form 4.

We also solicit comment on whether Form 4 should be expanded to include these additional disclosure items. We have concerns, however, that simply combining the

¹⁶² See Section II.E.7 of this release.

¹⁶³ We believe that this item should be added to Form 4, because if the security holder was deemed to have acquired the securities on an earlier date under the tacking provisions in Rule 144(d), the date that the security holder acquired the securities for Rule 144 purposes could differ from the date that would have been previously reported on the Form 4 covering the acquisition transaction.

required disclosures on the two forms into Form 4 may be confusing to filing persons as well as other market participants. For example, because some of the information required on Form 144 is not relevant to all persons filing Form 4, a person filing a Form 4 who is not required to file a Form 144 should not be required to provide that information.

Similarly, the two forms also can report different events. Form 4 reports both purchases and sales, while Form 144 reports only sales. In short, much of the information in each form may not be relevant to filers of the other form and may cause confusion among filers of the forms and investors.

Because Form 4 is an electronic filing on the Commission's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR), one alternative may be to implement programming changes to EDGAR to modify the user interface for Form 4 in such a way as to provide access to the portion of that form that would request Rule 144 information only if the filer affirmatively asserts that he or she wishes to satisfy his or her Rule 144 notice obligations on Form 4. Programming changes also could be made to enable a filer to enter all relevant information on one user interface which would automatically create two separate filings, one on Form 4 and the other on Form 144. To the extent possible, we seek to reduce filing requirements without losing important disclosure or causing confusion to filers and users of Form 4 and Form 144.

Such coordination also would require a revision to the statement in Rule 144(g) that the broker would be deemed to be aware of any facts or statements contained in the notice required by Rule 144(h).¹⁶⁴ If a security holder has filed a Form 4 to satisfy his or

¹⁶⁴ Existing Note (i) of Rule 144(g)(3) also states that the broker, for his own protection, should obtain and retain in his files a copy of the notice required by paragraph (h).

her Form 144 filing requirement, we preliminarily believe that a broker should also be deemed to be aware of any facts contained in a Form 4 that are relevant to Rule 144, if this is the approach we adopt in the end. We request comment on this point and how to best address this issue.

Because some information on Form 144 would no longer be provided if we were to adopt these amendments, we believe that additional disclosure in registration statements or periodic reports filed by the issuer of the securities may help to inform the market about the number of restricted securities available for resale. We solicit comment on a possible amendment to Item 701 of Regulations S-K and S-B that would require disclosure regarding: (1) whether the securities issued in unregistered transactions were restricted securities, as defined in Rule 144(a)(3); (2) if the securities were not restricted securities, the resale status of such securities under Rule 144; and (3) if the securities were restricted securities, the first date when such securities could be deemed to meet the holding period requirement in Rule 144(d).

Request for Comment

- Should we permit persons who are subject to Section 16 reporting obligations to provide the disclosure required by Form 144 on Form 4 instead? Is there any particular information currently disclosed on Form 144 that would otherwise not be disclosed on Form 4 which industry participants or security holders want or find material? If so, what is that information?
- Could relevant information be reported elsewhere? Should we revise Item 701 of Regulations S-K and S-B to require added disclosure in a

company's registration statement or periodic reports about the resale status of securities issued in unregistered transactions at the time when the company first sells the securities? What other types of disclosure regarding restricted securities (other than the resale status of the securities) would be useful to the market? Would disclosure regarding the securities at the time they were first issued be beneficial, or would such disclosure be premature and speculative?

- If we permit persons subject to Section 16 reporting obligations to file a Form 4 in lieu of a Form 144, is it appropriate to delay the filing deadline of Form 144 to two business days after the transaction is completed?¹⁶⁵ Is there a benefit to having this information at an earlier time, rather than two business days after the transaction is completed? How do market participants use the information in Form 144 today?
- If we expand Form 4 by adding requirements from Form 144, would Form 144 information contained in Form 4 be more difficult to find? Should we provide a means to allow persons searching on EDGAR to determine whether a Form 4 is being used to disclose Form 144 information (e.g., a checkbox on Form 4)?
- Should we mandate that Form 144 be filed electronically on EDGAR when the form relates to the securities of a reporting company?

¹⁶⁵ Such an amendment would also necessitate revising the rule to modify or delete the requirement in proposed Rule 144(h) that the security holder filing the notice shall have a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice.

- Should we expand Form 4 to add disclosure requirements from Form 144 for these purposes? If so, which disclosures from Form 144 should we retain? Should we modify Form 4 to incorporate them or should this information be provided as a supplement to Form 4? For example, should Form 144 information be in a new separate table? Would a combined Form 4/Form 144 be confusing to investors, other persons using the forms, or persons submitting the forms?
- Should we require only persons that seek to satisfy both their Rule 144 and Form 4 requirements with one form to fill out all of the questions on a combined Form 4/Form 144? If so, what mechanisms can we use to prevent confusion and assist filers in providing only the information that they are required to provide? For example, should we implement programming changes to EDGAR that would electronically filter out any filers not seeking to report information pursuant to Rule 144 on their Form 4 by withholding questions relevant to Rule 144 unless the filer indicates that he or she intends to provide such information on Form 4?
- Would combining the forms and delaying the Rule 144 filing date make it more difficult for brokers to perform the inquiries required in order to qualify the transaction as a “brokers’ transaction”? Do brokers and transfer agents need to see Form 144 information prior to executing the transaction? Is there a better way for these parties to obtain this information prior to executing the transaction other than a separate filing?

Should brokers be deemed to be aware of facts contained in Form 4 to the extent that the form is filed for Rule 144 purposes?

- Should we implement programming changes to EDGAR that would enable security holders to create two separate filings, one Form 4 and one Form 144, at the same time by completing only one submission to EDGAR? Would this lessen the probability of confusion that would result if items on Form 144 were transferred to Form 4?

IV. General Request for Comments

We request and encourage any interested person to submit comments regarding:

- The proposed rule changes that are the subject of this release;
- Additional or different changes; or
- Other matters that may have an effect on the proposals contained in this release.

We request comment from the point of view of registrants, investors and other users of information about the resale of restricted securities and securities owned by affiliates of the issuer.

V. Paperwork Reduction Act

A. Background

Our proposals contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).¹⁶⁶ We are submitting the proposed revisions to Form 144 to the Office of Management and Budget (OMB) for

¹⁶⁶ 44 U.S.C. 3501 *et seq.*

review in accordance with the PRA.¹⁶⁷ The title for the information collection is “Notice of Proposed Sale of Securities Pursuant to Rule 144 under the Securities Act of 1933” (OMB Control No. 3235-0101). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a current valid control number.

B. Summary of Proposed Amendments

The proposed amendments would eliminate the need for non-affiliates of the issuer to file Form 144. In addition, the proposal would raise the filing threshold for Form 144 to 1,000 shares or \$50,000 worth of securities during a three-month period. Currently, the Form 144 filing threshold is 500 shares and \$10,000. Form 144 may be filed in paper or electronically using the EDGAR filing system. The proposed amendments also include two limited changes to Form 144.¹⁶⁸ The primary purpose of this collection of information is the disclosure of a proposed sale of securities by security holders deemed not to be engaged in the distribution of the securities. The filings are publicly available. Persons reselling securities in reliance on Rule 144 are the respondents to the information required by Form 144. The information collection requirements imposed by Form 144 are mandatory.

Currently, an estimated 60,500 notices on Form 144 are filed annually for a total burden of 121,000 hours.¹⁶⁹ If adopted, the amendments would eliminate the need for non-affiliates to ever file a Form 144. We currently estimate that approximately 45%, or

¹⁶⁷ See 44 U.S.C. 3507 and 5 CFR 1320.11.

¹⁶⁸ We propose to amend Form 144 to include information regarding security holders' hedging activities and to allow security holders to represent that they do not know of material adverse information about the company as of the date they adopt a plan under Exchange Act Rule 10b5-1.

¹⁶⁹ This reflects current OMB estimates.

27,127, of the total 60,500 filings are filed by non-affiliates.¹⁷⁰ Under the proposals, these filings would no longer be required. In addition, we estimate that increasing the Form 144 filing thresholds from 500 shares or \$10,000 to 1,000 shares or \$50,000 would reduce the number of filings by affiliates by approximately 5%, or 3,025 filings.¹⁷¹ We estimate that each notice on Form 144 imposes a burden for purposes of the Paperwork Reduction Act of two hours.¹⁷² Therefore, we estimate that the proposals would reduce the burden on selling security holders by approximately 60,300 burden hours.¹⁷³

C. Solicitation of Comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comments to (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) evaluate the accuracy of our estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and

¹⁷⁰ The Office of Economic Analysis obtained data from the Thomson Financial Wharton Research Database. The estimate is based on information contained in notices on Form 144 filed in 2005.

¹⁷¹ This estimate is based on information contained in notices on Form 144 filed in 2005.

¹⁷² This is the same as the current OMB estimate.

¹⁷³ $(27,127 \text{ filings} + 3,025 \text{ filings}) * 2 \text{ hours/filing} = 60,304 \text{ hours.}$

Regulatory Affairs, Washington, DC 20503, and should send a copy to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303, with reference to File No. S7-11-07. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-11-07, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. Cost-Benefit Analysis

A. Background

Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. Specifically, a selling shareholder is deemed not an underwriter under Section 2(a)(11), and therefore may take advantage of the Section 4(1) exemption and need not register its sale of securities, if the sale complies with the provisions of the rule. Rule 145 requires Securities Act registration of certain types of business combination transactions. Rule 145 contains a safe harbor provision similar to Rule 144 for presumed underwriters who receive securities in such a business combination transaction. Form 144 is required to be filed by persons intending to sell securities in reliance on Rule 144 if the amount of securities to be sold in any three-month period exceeds 500 shares or other units or the aggregate sales price exceeds \$10,000. The primary purpose of the form is to publicly

disclose the proposed sale of securities by persons not deemed to be engaged in the distribution of the securities.

B. Description of Proposal

We are proposing amendments to Rule 144, Rule 145, and Form 144 that would accomplish the following:

- Simplify the Preliminary Note to Rule 144 and text of Rule 144, using plain English principles;
- Reduce the Rule 144(d) holding period for restricted securities of reporting companies to six months for both affiliates and non-affiliates;
- Significantly reduce requirements applicable to non-affiliates of reporting and non-reporting companies so that:
 - Non-affiliates of reporting companies would be subject only to the current public information requirement after meeting the six-month (or more depending on hedging activities) holding period and up until one year since the date they acquired their securities; and
 - Non-affiliates of non-reporting companies would be able to resell freely after the one-year holding period;
- Require that security holders toll the holding period during the time they enter into certain hedging transactions, but in no event would the holding period extend beyond one year;
- Eliminate the “manner of sale” limitations with respect to debt securities;
- Increase the thresholds that would trigger a Form 144 filing requirement;

- Codify the staff's positions, as they relate to Rule 144, concerning the following issues:
 - Inclusion of securities acquired in a transaction under Section 4(6) of the Securities Act in the definition of "restricted securities,"
 - The effect that creation of a holding company structure has on a security holder's holding period,
 - Holding periods for conversions and exchanges of securities,
 - Holding periods for cashless exercise of options and warrants,
 - Aggregation of a pledgee's resales with resales by other pledgees of the same security for the purpose of determining the amount of securities sold,
 - The extent to which securities issued by reporting and non-reporting shell companies are eligible for resale under Rule 144, and
 - Representations required from security holders relying on Rule 10b5-1(c); and
- Eliminate the presumptive underwriter status in Securities Act Rule 145, except for transactions involving a shell company, and harmonize the resale requirements in that rule with the proposed resale requirements for securities of shell companies in Rule 144.

We also solicit comment on how best to coordinate the Form 144 filing deadline with the Form 4 filing deadline and permit persons who are subject to Section 16 to meet their Form 144 filing requirement by filing a Form 4.

C. Benefits

If adopted, the proposed amendments should reduce the cost of complying with Rules 144 and 145. We have examined the Forms 144 that have been filed with the Commission since 1997.¹⁷⁴ In 2006, the volume of transactions filed under Rule 144 exceeded \$71 billion, and more than 50% of U.S. public companies, large and small alike, have reported every year at least one transaction on Form 144. Reducing the burden associated with these transactions can reduce the cost of capital to these companies.

One item on Form 144 requires security holders to provide information on the nature of the acquisition transaction. Some Form 144 filers acquire their securities from the company as a private investment, while others receive the securities as part of their employee awards, or as a form of payment for services to the company. Reducing the burden associated with selling these securities not only can reduce the cost of raising capital, but also may increase the value of these securities in non-cash transactions and reduce the cost of services and employment.

For the most part, transactions that were filed on Form 144 have been small. In 2006, about 90% of the transactions had a market value of less than \$2 million and 99% of these transactions had a market value of less than \$20 million. More than half of the investors report total annual transactions of a market value of less than \$240,000 with any specific company. Thus, reducing the costs associated with filing Form 144 and raising the thresholds that trigger a Form 144 filing requirement are likely to affect many small investors.

¹⁷⁴ These filings were obtained through Thomson Financial's Wharton Research Database which includes Forms 144 filed from 1996 through 2007.

We expect that the increase in the value of these securities would come from several sources under the proposed rule. The first is the increase in the liquidity of the securities. Investors, suppliers, or employees who are restricted from selling securities and who cannot hedge their positions are generally exposed to more risk than those who are not subject to such limitations, and generally require higher compensation (or a larger discount) for this risk.¹⁷⁵ We should also expect that the longer the non-trading period, the higher the premium that investors charge for their lack of liquidity.¹⁷⁶ Thus, reducing the time limit for selling these securities in the market is likely to reduce the discount that investors will charge for these securities, or the amount of securities that the company will need to provide for services. The actual reduction in this cost of capital will depend on the extent to which the six-month limit has a binding impact on security holders' decisions to resell their securities, and the extent to which investors, employees, or service providers can protect themselves against such exposure.

¹⁷⁵ There is also evidence that the non-trading period is associated with the premium that investors charge for lack of liquidity. See, for example, Silber, W.L., Discounts on restricted stock: The impact of illiquidity on stock prices, *Financial Analysts Journal*, 47, 60-64 (1991). Several studies have attempted to separate the discount associated with the non-transferability of the shares from other factors that affect the discount. See, for example, Wruck, K. H., Equity Ownership Concentration and Firm Value, Evidence from Private Equity Financings, *Journal of Financial Economics*, 23, 3-28 (1989); Hertz, M., and R. L. Smith, Market Discounts and Shareholder Gains for Placing Equity Privately, *Journal of Finance*, 459-485 (1993); Bajaj, M., Denis, D., Ferris, S.P., and A. Sarin, Firm Value and Marketability Discounts, *Journal of Corporate Law*, 27, 89-115 (2001); Finnerty, J.D., The Impact of Transfer Restrictions on Stock Prices (Fordham U. Working Paper, 2002). The average discounts attributed to lack of transferability across these studies is estimated between 7% and 20%. Other factors that could affect the discount are the amount of resources that private investors need to expend to assess the quality of the issuing firm or to monitor the firm, the ability of the investors to diversify the risk associated with the investment, whether the investors are cash constrained, the financial situation of the firm, etc.

¹⁷⁶ We are not aware of any empirical work that examines the effect of shortening the holding period in Rule 144 on the discount. Longstaff (1995) calculates an upper bound for percentage discounts for lack of marketability. According to his model, drops in a restriction from two years to one year and from one year to 180 days are associated each with a 30% drop in the discount. Longstaff, F. A., How Much Can Marketability Affect Security Values? *Journal of Finance*, 50, 1767-1774 (1995).

Also, resale transactional costs for non-affiliate selling security holders should decrease as a result of the removal of all conditions other than the holding period and the current public information condition applicable to non-affiliates. Reducing restrictions on resales by non-affiliates would streamline the rule and reduce the complexity of the rule. This and other simplifications of the rule and Preliminary Note to Rule 144 should make it easier to understand and follow, reducing the time that investors must spend analyzing whether or not they can rely on the rule as a safe harbor from the requirement to register the resale of their securities. However, because we are proposing to shorten the holding period only with respect to securities of reporting companies, the proposals would add some additional complexity that would diminish the effect of simplifying the other aspects of the rule.

If the proposals are adopted, non-affiliates would no longer have to file a Form 144. Therefore, they would save the cost of preparing and filing this form, as well as the transactional costs related to Rule 144's manner of sale requirements and volume of sale limitations. The increase in the Form 144 filing thresholds should further reduce the number of transactions for which a Form 144 needs to be filed for affiliates of the issuer. This would eliminate the cost of filing the form for transactions that fall below the thresholds.

The elimination of the manner of sale limitations would reduce costs for debt security holders. It is difficult to estimate the amount of reduction. Among the Forms 144 filed in 2005, we found at least 200 filings covering a sale of debt securities, although we believe the actual number of debt securities resales relying on Rule 144 may

be higher than this.¹⁷⁷ The elimination of the manner of sale limitation may also reduce brokers' fees, and therefore result in a reduction of revenue for brokers.

The codification of existing staff positions should create no added cost to companies or investors because, substantively, there is no expected change in practice. However, these codifications should provide substantial benefit to the investing community by clarifying and better publicizing the staff's positions. Greater clarity and transparency of our rules should reduce security holders' transactional costs by eliminating uncertainty and reducing the need for legal analysis.

The proposed amendments to Rule 145 remove what we preliminarily believe are unnecessary restraints on the resale of securities by parties or their affiliates to a merger, recapitalization, or other transaction listed in Rule 145(a). The proposed amendments to Rule 145 would reduce costs incurred by companies, parties to the transaction, and their affiliates to comply with the resale and other restrictions of the rule. Retaining the presumptive underwriter provision for transactions involving shell companies is intended to afford investors with additional protection against manipulative practices or abusive sales by parties to the transaction and their affiliates after the completion of the Rule 145 transaction.

The primary benefit of permitting an affiliate to satisfy a Form 144 filing requirement by timely filing a Form 4 reporting the sale of securities would be to reduce duplicative paperwork costs incurred by these individuals. We solicit comment on a number of alternatives to address this point, including which items on Form 144 could be transferred to Form 4 in order to ascertain which items on Form 144 are more important

¹⁷⁷ We base the estimate on number of filings that indicated that the securities were debt securities in the section of the Form 144 that requests information on the nature of the acquisition transaction.

to the market and should therefore be preserved. While the market would receive the information later if the Form 144 filing deadline were to be revised to coincide with the Form 4 filing deadline, the information that would have been contained on Form 144 may be more easily accessible to users of the information, if transferred to Form 4, which is filed electronically.

D. Costs

The proposal to reintroduce a provision that tolls the holding period if the shareholder had entered into a transaction that hedges the economic risk of ownership of the securities may increase the cost of a private offering. The proposal provides that regardless of the presence of such hedging, the holding period would not extend beyond one year, which is the current holding period before security holders may begin to sell their restricted securities. After one year, affiliates would be able to trade subject to the conditions to which they are subject under the current rules. However, the tolling provision may add a layer of complexity to calculating whether the holding period requirement has been met between the six-month and one-year marks because subsequent purchasers must determine whether previous owners of the securities have entered into such hedging transactions. We seek to minimize the burden on security holders of making this determination by providing, under the proposed rules, that the holding period need not be suspended if the security holder reasonably believes that the previous owner has not engaged in hedging transactions. We also believe that the ceiling on the proposed tolling provision minimizes burdens. For example, a security holder who wishes to rely on proposed Rule 144 but is unable to determine the previous owner's hedging activities would be able to omit the period in which the previous owner held the securities in the

calculation of the holding period or be subject to a maximum one-year holding period, as under the current rule, and a non-affiliate security holder would be permitted to resell the securities after one-year, regardless of any hedging activities in connection with the securities. Also, as provided under the proposed revision to Note (ii) of Rule 144(g)(3), brokers would also be required to inquire into security holders' hedging transaction which may increase some costs for them, although we preliminarily believe such costs would not be significant.

Under the proposed amendments, after one year, non-affiliates would be permitted to sell their restricted securities freely without being subject to any other condition. One concern is whether, in cases of the securities of a non-reporting company, relieving non-affiliates from compliance with Rule 144's existing conditions, including the current public information condition requiring that there be adequate available current information with respect to the issuer of the securities, would lead to abuse.

Reducing the requirements under Rule 144 might also cause a substitution effect, where companies might choose to rely more on private transactions than on public transactions to raise capital. There is also the risk that the market would not be informed about the nature of these transactions, given that these transactions would not need to be registered and given the changes to the Form 144 filing requirements. The market may also be less informed, given that restricted securities of reporting companies could be resold by non-affiliates earlier without complying with the condition that current information on the issuer of the securities be publicly available, and restricted securities of non-reporting companies could be resold by non-affiliates without ever complying with the current public information condition. This, in return, could lead to a less

efficient price formation. Direct negotiated deals with companies could also lead to informational advantage of some investors. Reducing the requirements could also lead to movement of certain investors from public transactions to private transactions. The effect of the proposed rule on these movements and their effect on investor wealth are thus subject to many factors.

While these are potential costs, we believe that they are justified by the potential benefits of the proposal and may not be significant in the aggregate. First, there is some evidence that, on average, the announcement of resales under Rule 144 by security holders has no adverse effect on stock prices, suggesting that the market does not attribute an information advantage to these security holders at the time of selling.¹⁷⁸ Second, the rule provides several barriers to selling restricted securities by affiliated investors to alleviate these concerns. Third, to the extent that privately negotiated deals give private investors lucrative terms at the expense of public investors, public investors may avoid such companies, and these companies may eventually be worse off. We solicit comment as to whether information regarding the resale status of an issuer's securities should be provided by other means such as pursuant to Item 701 of Regulation S-K or Regulation S-B.

As noted above, the proposed amendments to Rule 145 would reduce costs incurred by companies, parties to the transaction, and their affiliates to comply with the resale and other restrictions of the presumed underwriter provision. The magnitude of such reduction may vary.

¹⁷⁸ Osborne, Alfred E., Rule 144 Volume Limitations and the Sale of Restricted Securities in the Over-The-Counter Market, *Journal of Finance*, 37,505-523 (1982).

E. Request for Comments

We seek comments and empirical data on all aspects of this Cost-Benefit

Analysis. Specifically, we ask the following:

- What would be the effect on the liquidity discount for privately issued securities of reducing the holding period for securities of reporting companies to six months? Would this effect significantly increase a company's ability to raise capital in private securities transactions? Would the reduced holding period have an impact, in particular, on the ability of smaller businesses to raise capital?
- Would shortening the holding period to six months for reporting companies increase the frequency of abusive transactions where the security holder has not taken a sufficient economic risk of investment? What if the holding period for non-reporting companies is shortened to six months as well?
- What is the impact of eliminating the conditions to which non-affiliates are currently subject for a period of time prior to free public resale (i.e., the current public information requirement, the volume limitations, the manner of sale limitations, and the notice requirement)? Do any of the current conditions to which non-affiliates are subject provide a measurable benefit to the market? For example, would buyers of restricted securities of non-reporting companies be disadvantaged because sellers relying on Rule 144 are no longer subject to the condition requiring that current information of the issuer be publicly available?

- Who uses the information filed on Form 144? Would the proposed elimination of the requirement to file a Form 144 by non-affiliates and the proposed filing thresholds result in a loss of important information for these individuals?
- What would be the effect of reintroducing the tolling concept to Rule 144? How would it affect a company's ability to raise capital? Would the tolling provision impose undue costs on brokers and security holders due to the additional duties relating to tracking the security holders' or previous owners' hedging transactions? Would the tolling provision impose costs on transfer agents?
- What would be the impact of the proposed elimination of the limitations on the manner of sale for debt securities? How much would debt security holders save in fees that they would no longer incur under the proposed amendments? What impact would the elimination have on brokers? Would this proposal increase the burden on transfer agents?
- What are the benefits and costs of codifying the staff's existing interpretations under Rule 144?
- What is the effect of the elimination of the presumptive underwriter provision in Rule 145 for all transactions except those involving a shell company?

VII. Consideration of Burden of Competition and Promotion of Efficiency, Competition and Capital Formation

Securities Act Section 2(b)¹⁷⁹ requires us when engaging in rulemaking that requires us 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.

The proposed amendments are intended to reduce regulatory requirements for the resale of securities and simplify the process of reselling such securities. Currently, a shareholder owning restricted securities must wait until at least one year after the securities are last sold by the issuer or an affiliate before that shareholder can rely on Rule 144 safe harbor to resell those securities. The amendments would reduce this holding period to as little as six months for restricted securities of Exchange Act reporting companies if the security holder did not engage in hedging transactions with respect to the securities. The holding period would extend past six months to the extent the security holder engaged in hedging transactions, but in no event would the holding period extend beyond one year. Restricted securities of non-reporting companies would continue to be subject to a one-year holding period. A shorter holding period for restricted securities of reporting companies may increase the liquidity of securities sold in private transactions. This could result in increased efficiency in securities offerings because companies will be able to sell securities in private offerings at prices closer to prices that they may obtain in public markets, without the need to register those securities, and otherwise obtain better terms in private offerings. We also believe that this would promote capital formation, particularly for smaller companies, because the

¹⁷⁹ 15 U.S.C. 77b(b).

proposals would increase the liquidity of securities sold in private transactions. The amendments should increase a company's ability to raise capital in private securities transactions, which may improve the competitiveness of those companies, particularly smaller businesses that do not have ready access to public markets.

We do not believe that the proposed tolling provision that suspends the holding period while a security holder is engaged in hedging transactions places an undue burden on competition. The proposed tolling provision also may decrease efficiency somewhat by discouraging security holders from engaging in hedging with respect to their securities, however this effect should not be significant, as the proposed tolling provision would apply only for up to six months.

The other proposed amendments to Rule 144 generally should increase efficiency and assist in capital formation. We believe that the proposed elimination of most of the Rule 144 conditions applicable to non-affiliates may further increase the liquidity of privately sold securities. We anticipate that the proposed elimination of the manner of sale limitations for debt securities would provide security holders with greater flexibility in the resale of their securities, thereby increasing efficiency. Raising the Form 144 filing thresholds, as proposed, should also improve efficiency by reducing security holders' paperwork burden.

Under the proposed amendment to Rule 145, individuals and small entities owning stock in companies that engage in transactions specified in Rule 145(a) would no longer be subject to the presumptive underwriter provision, except in the case of transactions involving a shell company. These proposed amendments should improve

competitiveness of many small entities by permitting them to resell securities without the restrictions imposed by the current rule.

We request comment on whether the proposals, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views, if possible.

Section 23(a)(2) of the Exchange Act¹⁸⁰ requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. We do not believe that the proposed coordination of the Form 144 filing requirements with Form 4 filing requirements, if implemented, would cause a burden on competition. We request comment on whether such amendments would have competitively harmful effects, and how we can minimize those effects.

VIII. Initial Regulatory Flexibility Analysis

We have prepared this Initial Regulatory Flexibility Analysis in accordance with Section 603 of the Regulatory Flexibility Act.¹⁸¹ This analysis relates to the proposed amendments to Rules 144 and 145 and Form 144 under the Securities Act.

A. Reasons for, and Objectives of, Proposed Action

Rule 144 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. If a selling security holder satisfies its conditions, that selling security holder may resell his or her securities publicly without registration and without being deemed an underwriter.

¹⁸⁰ 15 U.S.C. 78w(a)(2).

Rule 145 governs the offer and sale of certain securities received in connection with reclassifications, mergers, consolidations and asset transfers. It imposes restrictions similar to Rule 144 on a party to such transactions and to persons who are affiliates of that party at the time the transaction is submitted for vote or consent, with regard to securities acquired in that transaction. Rule 145 contains holding period requirements similar to those in Rule 144.

Form 144 is required to be filed by persons intending to sell securities in reliance on Rule 144 if the amount of securities to be sold in any three-month period exceeds 500 shares or other units or the aggregate sales price exceeds \$10,000. The primary purpose of the form is to publicly disclose the proposed sale of securities by persons deemed not to be engaged in the distribution of the securities.

We are proposing amendments that would make Rule 144 easier to understand and apply. We propose to streamline both the Preliminary Note to Rule 144 and the rule. In addition to codifying several staff interpretive positions, the proposals would reduce the Rule 144 holding period and substantially reduce requirements for non-affiliates. The proposals would reintroduce a provision tolling the holding period but only up to one year after the acquisition of the securities from the issuer or an affiliate of the issuer, which is the holding period under the current rules.

The reduction of the Rule 144 holding periods for restricted securities of reporting companies for affiliates and non-affiliates should increase the liquidity of privately issued securities, enabling companies to raise private capital more efficiently. An increase in the Form 144 filing threshold would take into account the effects of inflation since the

¹⁸¹ 5 U.S.C. 603.

last amendment to that provision in 1972. Although the codification of several staff interpretive positions is not intended to substantively change the rules, they should simplify analyses under Rule 144 by compiling these interpretations in one readily accessible location. The objectives of the proposed amendments are to simplify Rule 144, to reduce its burdens on investors where consistent with investor protection, and to facilitate capital formation.

The release solicits comment on how best to coordinate the Form 144 filing deadline with the Form 4 filing deadline and permit a person who is subject to Section 16 of the Exchange Act to meet a Form 144 filing requirement with a Form 4 filing, to the extent possible. Such amendments could simplify filing requirements for Section 16 persons even further by allowing them to file only one form to meet the requirements of both Rule 144 and Form 4.

B. Legal Basis

The amendments are proposed pursuant to Sections 2(a)(11), 4(1), 4(4), 7, 10, 19(a) and 28 of the Securities Act, as amended.

C. Small Entities Subject to Rule

The proposed rules would affect both small entities that issue securities and small entities that hold such securities. An issuer, other than an investment company, is considered a “small business” for purposes of the Regulatory Flexibility Act if that issuer:

- Has assets of \$5 million or less on the last day of its most recent fiscal year, and

- Is engaged or proposing to engage in a small business financing.¹⁸²

An issuer is considered to be engaged in a small business financing if it is conducting or proposes to conduct an offering of securities that does not exceed the dollar limitation prescribed by Section 3(b)¹⁸³ of the Securities Act. This dollar amount is currently \$5 million. When used with reference to an issuer or person, other than an investment company, Exchange Act Rule 0-10¹⁸⁴ defines small entity to mean an issuer or person that, on the last day of its most recent fiscal year, had total assets of \$5 million or less.

We are aware of approximately 1,100 Exchange Act reporting companies that currently satisfy the definition of “small business” and may be affected by the proposed amendments as issuers.¹⁸⁵ The proposed amendments also may affect companies that are small businesses, but that are not subject to Exchange Act reporting requirements. As noted above, we currently estimate that approximately 60,500 notices on Form 144 are filed annually.¹⁸⁶ The Commission does not collect information about the size of private companies about which a Form 144 is filed, but some of these non-reporting issuers may be “small.” The proposed tolling provision and the proposals to eliminate the manner of sale limitations may also affect brokers that qualify as small entities. We estimate that 910 broker-dealers registered with the Commission are small entities for the purposes of

¹⁸² 17 CFR 230.157. See 5 U.S.C. 601((2).

¹⁸³ 15 U.S.C. 77c(b).

¹⁸⁴ 17 CFR 240.0-10.

¹⁸⁵ The estimated number of reporting small entities is based on 2007 data including the Commission’s EDGAR database and Thomson Financial’s Worldscope database. This represents an update from the number of reporting small entities estimated in prior rulemakings. See, for example, Executive Compensation and Related Disclosure, Release No. 33-8732A (Aug. 29, 2006) [71 FR 53158] (in which the Commission estimated a total of 2,500 small entities, other than investment companies).

¹⁸⁶ This reflects current OMB estimates.

the Regulatory Flexibility Act.¹⁸⁷ We ask for comments regarding an estimate of the number of small entities that may be affected if the proposed amendments are adopted.

D. Reporting, Recordkeeping and Other Compliance Requirements

We expect several of the proposed amendments to reduce the number of Form 144 filings made to the SEC by selling security holders. These proposed amendments are:

- Elimination of all Rule 144 requirements, other than the holding period and the current public information requirement for six months, for non-affiliates; and
- Increased share number and dollar amount thresholds for filing Form 144.

As a result of the elimination of all requirements for non-affiliate security holders, other than the holding period and the current public information requirement, non-affiliates no longer would have to file a Form 144, regardless of the amount of securities sold. We estimate that 45% of the Form 144 filings that we currently receive are from non-affiliates. Therefore, this particular amendment should result in a corresponding reduction in Form 144 filings.

The increase in the filing threshold for Form 144 should decrease the number of Form 144 filings filed by affiliates. Based on studies by the Commission's Office of Economic Analysis, we expect the number of Form 144 filings to decrease by approximately 5%, or 3,025 filings, if the thresholds are increased to 1,000 shares or \$50,000 in sales price.

¹⁸⁷ For purposes of the Regulatory Flexibility Act, a broker or dealer is small entity if it (i) had total capital of less than \$500,000 on the date in its prior fiscal year as of which its audited financial statements were prepared or, if not required to file audited financial statements, on the last

Clerical skills are necessary to complete Form 144.

Also, because the proposed amendments would significantly reduce the conditions in Rule 144 to which non-affiliates are subject, non-affiliates would also no longer be required to keep track of compliance with those conditions. Non-affiliates with securities of both reporting companies and non-reporting companies would no longer be required to comply with the manner of sale limitations and volume limitations. Non-affiliates of non-reporting companies would no longer be required to comply with the requirement that there be current information regarding the issuer that is publicly available.

The reintroduction of the tolling provision would require the security holder and brokers to determine whether the security holder or a previous owner had engaged in hedging transactions with respect to the securities, which may require them to maintain some additional documentation. However, the holding period need not be suspended if the security holder reasonably believes that the previous owner had not engaged in hedging transactions in the securities. Also, a determination regarding hedging activities would only need to be made where the issuer of the securities is a reporting company and the securities are sold before a year has passed since the date the securities were acquired from the issuer or affiliate.

The proposal to eliminate the manner of sale limitation for debt securities would also obviate the need for security holders to determine whether such condition has been met in the resale of their debt securities. The amendments to Rule 145 eliminate the need for parties to a Rule 145(a) transaction or their affiliates to determine whether they have

business day of its prior fiscal year, and (ii) is not affiliated with any person that is not a small entity and is not affiliated with any person that is not a small entity. 17 CFR 240.0-1.

met the resale provisions of Rule 145, except when the transaction involves a shell company.

E. Overlapping or Conflicting Federal Rules

No current federal rules duplicate, overlap or conflict with the rules and forms that we are proposing, except that persons subject to the reporting requirements under Section 16 of the Securities Exchange Act of 1934 may need to file reports on Form 4 as well as Form 144 under certain circumstances. However, the class of Form 144 filers is different than that for Form 4 filers because affiliates of companies not subject to the Exchange Act reporting requirements must file Form 144, but not Form 4. Further, persons who may be deemed affiliates under Rule 144 may not necessarily be the same persons who also are subject to Section 16. Also, Form 144 is required to be filed earlier than Form 4 and Form 144 contains some information that is not required to be included on Form 4. As noted above, the release also solicits comment on whether Form 4 and Form 144 filing requirements should be coordinated to delay the Form 144 filing deadline to match the Form 4 filing deadline and so that persons subject to Section 16 could be exempt from filing a Form 144 regarding a particular transaction if they have already filed a Form 4 with respect to that transaction.

F. Significant Alternatives

We considered different compliance standards for small entities that would be affected by the proposed amendments. In the 1997 proposing release, we solicited comment regarding the possibility of different standards for small entities. However, we believe that such differences would be inconsistent with the purposes of the rules. Commenters on this issue in the 1997 proposing release unanimously agreed that

different standards would not be feasible and would only add to the complexity and difficulty of applying the rules.

We also considered the other types of alternatives set forth in the Regulatory Flexibility Act to minimize the economic impact of the amendments on small entities.

These included the following:

- the clarification, consolidation, or simplification of compliance and reporting requirements for small entities;
- the use of performance rather than design standards; and
- an exemption from some or all of the proposed amendments for small entities.

Because the proposed amendments would benefit all companies and holders of restricted securities, differing compliance timetables or standards for small entities would not be appropriate. In addition, the proposed holding period would likely have a favorable impact on small entities by increasing a company's ability to raise capital in private securities transactions, which may improve the competitiveness of those companies, particularly smaller businesses that do not have ready access to public markets. The amendments which clarify and streamline Rule 144 should benefit all companies, including small entities. We continue to believe that further changes such as the use of performance standards or other exemptions with regard to small entities would overly complicate the rule, which would be contrary to our stated purpose. The proposed hedging provision seeks to ensure that any security holder relying on Rule 144 has taken sufficient economic risk of investment in the securities and the prohibition against

security holders of reporting and non-reporting shell companies protect against abuses relating to the resale of privately issued securities.

The proposed changes to Rule 145 would eliminate presumptive underwriter provision and resale restrictions on parties to a transaction specified in Rule 145(a) and their affiliates, including small entities and their affiliates, except when the transaction involves a shell company. We believe that retaining the presumptive underwriter provision when the transaction involves a shell company is necessary, given the potential for abuse relating to such transactions.

G. Solicitation of Comments

We encourage you to submit written comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we seek comment on: (a) the number of small entities that would be affected by the proposed rule; (b) the expected impact on small entities of the proposals as discussed above; and (c) a reliable means to quantify the number of small entities that would be affected by the proposed rules and the rules' impact on small entities.

We ask commenters to describe the nature of any impact and provide empirical data supporting the extent of the impact. We will consider comments when we prepare the Final Regulatory Flexibility Analysis if the proposed revisions are adopted. Persons wishing to submit written comments should file them with: Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. All comments received will be available for public inspection and copying at the SEC's Public Reference Room at the same address.

IX. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,¹⁸⁸ a rule is “major” if it has resulted, or is likely to result in:

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

We request comment on whether our proposals would be a “major rule” for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment or innovation.

X. Statutory Basis and Text of Proposed Amendments

We are proposing to adopt the amendments pursuant to Sections 2(a)(11), 4(1), 4(4), 7, 10, 19(a) and 28 of the Securities Act, as amended.

List of Subjects

17 CFR Part 230

Advertising, Reporting and recordkeeping requirements, Securities.

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

¹⁸⁸ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

For the reasons set out above, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 -- GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. Revise the authority citation for Part 230 to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78w, 78ll(d), 78mm, 78t, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Amend §230.144 by:
 - a. Revising the preliminary note;
 - b. Revising paragraphs (a)(3)(vi) and (a)(3)(vii), and adding paragraph (a)(3)(viii);
 - c. Revising paragraphs (b), (c), (d)(1), (d)(3)(i), (d)(3)(ii), and (d)(3)(viii);
 - d. Adding paragraphs (d)(3)(ix) through paragraphs (d)(3)(xii);
 - e. Revising the heading and the introductory text to paragraphs (e) and (e)(1);
 - f. Removing paragraphs (e)(2), (j) and (k);
 - g. Redesignating existing paragraph (e)(3) as paragraph (e)(2);
 - h. Revising newly redesignated paragraph (e)(2); and
 - i. Revising paragraphs (f), the notes to paragraph (g)(3), paragraph (h) and paragraph (i).

The revisions and additions read as follows:

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

PRELIMINARY NOTE

Rule 144 creates a safe harbor from the definition of the term “underwriter” found in Section 2(a)(11) of the Securities Act. If a sale of securities complies with all of the applicable provisions of Rule 144:

1. Any person who sells restricted securities will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction;
2. An affiliate or any person who sells restricted or other securities on behalf of an affiliate of the issuer will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction; and
3. The purchaser will receive securities that are not restricted securities.

This means that someone entitled to claim the safe harbor would be able to sell his or her securities under Section 4(1) of the Act.

Rule 144 is not an exclusive safe harbor. This means that a person who does not meet all the requirements of Rule 144 still may claim any other available exemption for resales under the Act. The Rule 144 safe harbor is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.

(a) * * *

(3) * * *

(vi) Securities acquired in a transaction made under §230.801 to the same extent and proportion that the securities held by the security holder of the class with

respect to which the rights offering was made were, as of the record date for the rights offering, “restricted securities” within the meaning of this paragraph (a)(3);

(vii) Securities acquired in a transaction made under §230.802 to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were “restricted securities” within the meaning of this paragraph (a)(3); and

(viii) Securities acquired from the issuer in a transaction subject to an exemption under section 4(6) (15 U.S.C. 77d(6)) of the Act.

(b) Conditions to be met. Subject to paragraph (i) of this section, the following conditions must be met:

(1) Non-Affiliates.

(i) If the issuer of the securities is, and has been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, any person who is not an affiliate of the issuer, and has not been an affiliate during the preceding three months, who sells restricted securities of an issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of paragraphs (c)(1) and (d) of this section are met. The requirements of paragraph (c)(1) of this section shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of one year has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer.

(ii) If the issuer of the securities is not, or has not been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, any person who is not an affiliate of the issuer, and has not been an affiliate during the preceding three months, who sells restricted securities of an issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if the condition of paragraph (d) of this section is met.

(2) Affiliates. Any affiliate who sells restricted securities or any other securities of an issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of this section are met.

(3) Persons selling on behalf of affiliates. Any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of this section are met.

(c) Current public information. Adequate current public information with respect to the issuer of the securities must be available. Such information will be deemed to be available only if at least one of the following conditions is met:

(1) Reporting Issuers. The issuer is, and has been for at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and has filed all required reports under section 13 or 15(d) during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports), other than Form 8-K reports (§249.308 of this chapter); or

(2) Non-reporting Issuers. If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, there is publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of §240.15c2-11 of this chapter, or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of the Exchange Act (15 U.S.C. 78j(g)(2)(G)(i)).

Note to §230.144(c). With respect to paragraph (c)(1), the person can rely upon:

1. A statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required under section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the issuer was required to file such reports), other than Form 8-K reports (§249.308 of this chapter), and has been subject to such filing requirements for the past 90 days; or
2. A written statement from the issuer that it has complied with such reporting requirements.
3. Neither type of statement may be relied upon, however, if the person knows or has reason to believe that the issuer has not complied with such requirements.

(d) * * *

(1) General rule.

(i) If the issuer of the securities is, and has been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, a minimum of six months must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and

any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(ii) If the issuer of the securities is not, or has not been for at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(iii) If the acquiror takes the securities by purchase, the holding period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer.

* * * * *

(3) * * *

(i) Stock dividends, splits and recapitalizations. Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization shall be deemed to have been acquired at the same time as the securities on which the dividend or, if more than one, the initial dividend was paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitalization.

(ii) Conversions and exchanges. If the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.

Note to §230.144(d)(3)(ii). If the surrendered securities originally did not provide for cashless conversion or exchange by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the surrendered securities to permit cashless conversion or exchange, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the surrendered securities, so long as the conversion or exchange itself meets the conditions of this section.

* * * * *

(viii) Rule 145(a) transactions. The holding period for securities acquired in a transaction specified in §230.145(a) shall be deemed to commence on the date the securities were acquired by the purchaser in such transaction, except as otherwise provided in paragraphs (d)(3)(ii) and (ix) of this section.

(ix) Holding company formations. Securities acquired from the issuer in a transaction effected solely for the purpose of forming a holding company shall be deemed to have been acquired at the same time as the securities of the predecessor issuer exchanged in the holding company formation where:

(A) The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;

(B) Holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and

(C) Immediately following the transaction, the holding company has no significant assets other than securities of the predecessor company and its existing subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.

(x) Cashless exercise of options and warrants. If the securities sold were acquired from the issuer solely upon cashless exercise of options or warrants issued by the issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the exercised options or warrants, even if the options or warrants exercised originally did not provide for cashless exercise by their terms.

Notes to §230.144(d)(3)(x).

Note 1 to §230.144(d)(3)(x). If the options or warrants originally did not provide for cashless exercise by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the options or warrants to permit cashless exercise, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the options or warrants.

Note 2 to §230.144(d)(3)(x). If the options or warrants are not purchased for cash or property and do not create any investment risk to the holder, as in the case of employee stock options, the newly acquired securities shall be deemed to have been acquired at the time the options or warrants are exercised, so long as the conditions of Rule 144(d)(1) and Rule 144(d)(2) are met at the time of exercise.

(xi) Short sales and hedging transactions. In computing the six-month holding period the following periods shall be excluded:

(A) If the securities sold are equity securities, as defined in §230.405, there shall be excluded any period during which the person for whose account they are sold had a short position, or had entered into a “put equivalent position” (as defined in §240.16a-1(h) of this chapter), with respect to any equity securities of the same class or any securities convertible into securities of such class; and

(B) If the securities sold are nonconvertible debt securities, there shall be excluded any period during which the person for whose account they are sold had a short position, or had entered into a “put equivalent position” (as defined in §240.16a-1(h) of this chapter), with respect to any nonconvertible debt securities of the same issuer.

(C) If the holding period is based on a period that a previous owner has held the securities, there shall be excluded any period during which the previous owner had a short position or had entered into a “put equivalent position” (as defined in §240.16a-1(h) of this chapter), with respect to any equity securities of the same class or any securities convertible into securities of such class, if the securities sold are equity securities, or with respect to any nonconvertible debt securities of the same issuer, if the securities sold are nonconvertible debt securities, unless the person for whose account the securities are sold reasonably believes that no such position was held by a previous owner.

Note to §230.144(d)(3)(xi).

This paragraph shall not apply if the holding period computed under paragraph (d) of this rule (excluding this paragraph) has been twelve months or more.

(xii) Securities sold under paragraph (i)(2). For the purposes of computing the holding period of securities sold under paragraph (i)(2) of this rule, securities of an issuer that has ceased to be an issuer described in paragraph (i)(1)(i) shall be deemed to have

been acquired at the time the securities were acquired from the issuer, at the time they were acquired from an affiliate of the issuer, or at the time the "Form 10 information" regarding the issuer is filed with the Commission, whichever is the latest date.

(e) Limitation on amount of securities sold by or for affiliates. Except as hereinafter provided, the amount of securities which may be sold by or for affiliates in reliance upon this rule shall be determined as follows:

(1) If any securities are sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, the amount of securities sold, together with all sales of securities of the same class sold for the account of such person within the preceding three months, shall not exceed the greatest of:

* * * * *

(2) Determination of amount. For the purpose of determining the amount of securities specified in paragraph (e)(1) of this section, the following provisions shall apply:

(i) Where both convertible securities and securities of the class into which they are convertible are sold, the amount of convertible securities sold shall be deemed to be the amount of securities of the class into which they are convertible for the purpose of determining the aggregate amount of securities of both classes sold;

(ii) The amount of securities sold for the account of a pledgee of those securities, or for the account of a purchaser of the pledged securities, during any period of three months within six months after a default in the obligation secured by the pledge, and the amount of securities sold during the same three-month period for the account of

the pledgor shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) of this section;

Note to §230.144(e)(2)(ii): Sales by a pledgee of securities pledged by a borrower will not be aggregated under paragraph (e)(2)(ii) with sales of the securities of the same issuer by other pledgees of such borrower in the absence of concerted action by such pledgees.

(iii) The amount of securities sold for the account of a donee of those securities during any three-month period within six months after the donation, and the amount of securities sold during the same three-month period for the account of the donor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) of this section;

(iv) Where securities were acquired by a trust from the settlor of the trust, the amount of such securities sold for the account of the trust during any three-month period within six months after the acquisition of the securities by the trust, and the amount of securities sold during the same three-month period for the account of the settlor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) of this section;

(v) The amount of securities sold for the account of the estate of a deceased person, or for the account of a beneficiary of such estate, during any three-month period and the amount of securities sold during the same three-month period for the account of the deceased person prior to his death shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) of this section; provided, that no limitation on amount shall apply if the estate or beneficiary of the estate is not an affiliate of the issuer;

(vi) When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the

account of all such persons during any period of three months shall be aggregated for the purpose of determining the limitation on the amount of securities sold;

(vii) The following sales of securities need not be included in determining the amount of securities sold in reliance upon this rule:

(A) Securities sold pursuant to an effective registration statement under the Act;

(B) Securities sold pursuant to an exemption provided by Regulation A (§230.251 through §230.263) under the Act;

(C) Securities sold in a transaction exempt pursuant to section 4 of the Act (15 U.S.C. 77d) and not involving any public offering; and

(D) Securities sold offshore pursuant to Regulation S (§230.901 through §230.905, and Preliminary Notes) under the Act.

(f) Manner of sale.

(1) The securities shall be sold in brokers' transactions within the meaning of section 4(4) of the Act or in transactions directly with a market maker, as that term is defined in section 3(a)(38) of the Exchange Act, and the person selling the securities shall not:

(i) Solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transaction, or

(ii) Make any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities.

(2) Paragraph (f)(1) shall not apply to:

(i) Securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate provided the estate or estate beneficiary is not an affiliate of the issuer; or

(ii) Debt securities.

Note to §230.144(f)(2)

For the purposes of paragraph (f)(2), "debt securities" is defined to mean:

1. Any security other than an equity security as defined in §230.405;
2. Non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer; and
3. Asset-backed securities, as defined in §229.1101 of this section.

(g) * * *

(3) * * *

Notes to §230.144(g)(3).

Note 1 to paragraph (g)(3). The broker, for his own protection, should obtain and retain in his files a copy of the notice required by paragraph (h) of this section.

Note 2 to paragraph (g)(3). The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

1. The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should include physical inspection of the securities;

2. If the securities have been held for less than one year, the existence and character of any short position or put equivalent position with regard to the securities held by the person for whose account they are to be sold and whether such person has made inquiries about the existence and character of any short position or put equivalent position with regard to the securities held by the previous owner of the securities and the results of such person's inquiries;

3. The nature of the transaction in which the securities were acquired by such person;

4. The amount of securities of the same class sold during the past 3 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

5. Whether such person intends to sell additional securities of the same class through any other means;

6. Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

7. Whether such person has made any payment to any other person in connection with the proposed sale of the securities; and

8. The number of shares or other units of the class outstanding, or the relevant trading volume.

(h) Notice of proposed sale.

(1) If the amount of securities to be sold in reliance upon this rule during any period of three months exceeds 1,000 shares or other units or has an aggregate sale price in excess of \$50,000, three copies of a notice on Form 144 (§239.144 of this chapter)

shall be filed with the Commission at its principal office in Washington, DC. If such securities trade on any national securities exchange, one copy of such notice also shall be transmitted to the principal exchange on which such securities are traded.

(2) The Form 144 shall be signed by the person for whose account the securities are to be sold and shall be transmitted for filing concurrently with either the placing with a broker of an order to execute a sale of securities in reliance upon this rule or the execution directly with a market maker of such a sale. Neither the filing of such notice nor the failure of the Commission to comment on such filing shall be deemed to preclude the Commission from taking any action that it deems necessary or appropriate with respect to the sale of the securities referred to in such notice. The person filing the notice required by this paragraph shall have a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice.

(i) Inapplicability to issuers with no or nominal operations and no or nominal non-cash assets.

(1) A selling security holder may not rely on this section to resell securities if the issuer of the securities is:

(i) An issuer, other than a business combination related shell company, as defined in §230.405, or an asset-backed issuer, as defined in Item 1101(b) of Regulation AB (§229.1101(b) of this chapter), that has:

(A) No or nominal operations; and

(B) Either:

(1) No or nominal assets;

(2) Assets consisting solely of cash and cash equivalents; or

(3) Assets consisting of any amount of cash and cash equivalents and nominal other assets; or

(ii) An issuer that has been at any time previously an issuer described in paragraph (i)(1)(i).

(2) Notwithstanding paragraph (i)(1), if the issuer of the securities previously had been an issuer described in paragraph (i)(1)(i) but has ceased to be an issuer described in paragraph (i)(1)(i); is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act; has filed all reports and other materials required to be filed by such requirements during the preceding 12 months (or for such shorter period that the registrant was required to file such reports and materials); and has filed current "Form 10 information" with the Commission reflecting its status as an entity that is no longer an issuer described in paragraph (i)(1)(i), then a security holder may resell those securities subject to the requirements of this rule 90 days after the "Form 10 information" is filed.

(3) The term "Form 10 information" means the information that is required by Form 10, Form 10-SB, or Form 20-F (§249.210, §249.210b, or §249.220f of this chapter), as applicable to the issuer of the securities, to register under the Securities Exchange Act of 1934 each class of securities being sold under this rule. The issuer may provide the Form 10 information in any issuer filing with the Commission.

3. Remove the authority citation following §230.144.

4. Amend §230.145 by revising paragraphs (c), (d) and (e) to read as follows:

§230.145 Reclassification of securities, mergers, consolidations and acquisitions of assets.

* * * * *

(c) Persons and parties deemed to be underwriters. For purposes of this section, if any party to a transaction specified in paragraph (a) of this section is a shell company, other than a business combination related shell company, as those terms are defined in §230.405, any party to that transaction, other than the issuer, or any person who is an affiliate of such party at the time such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(a)(11) of the Act.

(d) Resale provisions for persons and parties deemed underwriters. Notwithstanding the provisions of paragraph (c), a person or party specified in that paragraph shall not be deemed to be engaged in a distribution and therefore not to be an underwriter of securities acquired in a transaction specified in paragraph (a) that was registered under the Act if:

- (1) Any shell company specified in paragraph (c) is no longer a shell company; and
- (2) One of the following three conditions is met:
 - (i) Such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f), and (g) of §230.144 and at least 90 days have elapsed since the date the securities were acquired from the issuer in such transaction; or
 - (ii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and a period of at least six months, as determined in accordance

with paragraph (d) of §230.144, have elapsed since the date the securities were acquired from the issuer in such transaction, and the issuer meets the requirements of paragraph (c) of §230.144; or

(iii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and a period of at least one year, as determined in accordance with paragraph (d) of §230.144, has elapsed since the date the securities were acquired from the issuer in such transaction.

Note to paragraphs (c) and (d)

Paragraphs (c) and (d) are not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.

(e) Definitions.

(1) The term affiliate as used in paragraphs (c) and (d) of this section shall have the same meaning as the definition of that term in §230.405.

(2) The term party as used in paragraphs (c) and (d) of this section shall mean the corporations, business entities, or other person, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph (a).

(3) The term person as used in paragraphs (c) and (d) of this section, when used in reference to a person for whose account securities are to be sold, shall have the same meaning as the definition of that term in paragraph (a)(2) of §230.144.

5. Remove the authority citation following §230.145.
6. Amend §230.190 by:
 - a. Revising paragraphs (a)(2) and (a)(3); and
 - b. Adding paragraph (a)(4).

The revisions and addition read as follows:

§230.190 Registration of underlying securities in asset-backed securities transactions.

(a) * * *

(1) * * *

(2) Neither the issuer of the underlying securities nor any of its affiliates is an affiliate of the sponsor, depositor, issuing entity or underwriter of the asset-backed securities transaction;

(3) If the underlying securities are restricted securities, as defined in §230.144(a)(3), §230.144 must be available for the sale of the securities, provided however, that notwithstanding any other provision of §230.144, §230.144 shall only be so available if at least two years have elapsed since the later of the date the securities were acquired from the issuer of the underlying securities or from an affiliate of the issuer of the underlying securities; and

(4) The depositor would be free to publicly resell the underlying securities without registration under the Act. For example, the offering of the asset-backed security does not constitute part of a distribution of the underlying securities. An offering of asset-backed securities with an asset pool containing underlying securities that at the time of the purchase for the asset pool are part of a subscription or unsold allotment would be a distribution of the underlying securities. For purposes of this section, in an offering of

asset-backed securities involving a sponsor, depositor or underwriter that was an underwriter or an affiliate of an underwriter in a registered offering of the underlying securities, the distribution of the asset-backed securities will not constitute part of a distribution of the underlying securities if the underlying securities were purchased at arm's length in the secondary market at least three months after the last sale of any unsold allotment or subscription by the affiliated underwriter that participated in the registered offering of the underlying securities.

7. Amend §230.701, paragraph (g)(3), to revise the phrase "without compliance with paragraphs (c), (d), (e), and (h) of §230.144" to read "without compliance with paragraphs (c) and (d) of §230.144".

PART 239--FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

8. The authority citation for part 239 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-24, 80a-29, 80a-30 and 80a-37, unless otherwise noted.

* * * * *

9. Amend §239.144 by revising paragraph (b) to read as follows:

§239.144 Form 144, for notice of proposed sale of securities pursuant to §230.144 of this chapter.

* * * * *

(b) This form need not be filed if the amount of securities to be sold during any period of three months does not exceed 1,000 shares or other units and the aggregate

sale price does not exceed \$50,000.

* * * * *

10. Form 144 (referenced in §239.144) is revised as set forth in the Appendix.

By the Commission.



Nancy M. Morris
Secretary

June 22, 2007

Note: This Appendix to the Preamble will not appear in the Code of Federal Regulations.

Appendix

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 144
NOTICE OF PROPOSED SALE OF SECURITIES
PURSUANT TO RULE 144 UNDER THE SECURITIES ACT OF 1933

OMB APPROVAL
OMB Number: 3235-0101
Expires: December 31, 2009
Estimated average burden
hours per response 2.00

SEC USE ONLY
DOCUMENT SEQUENCE NO.

CUSIP NUMBER

WORK LOCATION

(e) TELEPHONE NO.
AREA CODE NUMBER

ATTENTION: *Transmit for filing 3 copies of this form concurrently with either placing an order with a broker to execute sale or executing a sale directly with a market maker.*

1 (a) NAME OF ISSUER (Please type or print)		(b) IRS IDENT. NO.	(c) S.E.C. FILE NO.
1 (d) ADDRESS OF ISSUER		STREET	CITY STATE ZIP CODE
2 (a) NAME OF PERSON FOR WHOSE ACCOUNT THE SECURITIES ARE TO BE SOLD		(b) IRS IDENT. NO.	(c) RELATIONSHIP TO ISSUER
		(d) ADDRESS STREET	CITY STATE ZIP CODE

INSTRUCTION: *The person filing this notice should contact the issuer to obtain the I.R.S. Identification Number and the S.E.C. File Number.*

3 (a) Title of the Class of Securities To Be Sold	(b) Name and Address of Each Broker Through Whom the Securities are to be Offered or Each Market Maker who is Acquiring the Securities	SEC USE ONLY	(c) Number of Shares or Other Units To Be Sold <i>(See instr. 3(c))</i>	(d) Aggregate Market Value <i>(See instr. 3(d))</i>	(e) Number of Shares or Other Units Outstanding <i>(See instr. 3(e))</i>	(f) Approximate Date of Sale <i>(See instr. 3(f))</i> (MO. DAY YR.)	(g) Name of Each Securities Exchange <i>(See instr. 3(g))</i>
		Broker-Dealer File Number					

INSTRUCTIONS:

- | | |
|--|---|
| <p>1. (a) Name of issuer
(b) Issuer's I.R.S. Identification Number
(c) Issuer's S.E.C. file number, if any
(d) Issuer's address, including zip code
(e) Issuer's telephone number, including area code</p> <p>2. (a) Name of person for whose account the securities are to be sold
(b) Such person's I.R.S. identification number, if such person is an entity
(c) Such person's relationship to the issuer (e.g., officer, director, 10% stockholder, or member of immediate family of any of the foregoing)
(d) Such person's address, including zip code</p> | <p>3. (a) Title of the class of securities to be sold
(b) Name and address of each broker through whom the securities are intended to be sold
(c) Number of shares or other units to be sold (if debt securities, give the aggregate face amount)
(d) Aggregate market value of the securities to be sold as of a specified date within 10 days prior to filing of this notice
(e) Number of shares or other units of the class outstanding, or if debt securities the face amount thereof outstanding, as shown by the most recent report or statement published by the issuer
(f) Approximate date on which the securities are to be sold
(g) Name of each securities exchange, if any, on which the securities are intended to be sold</p> |
|--|---|

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

TABLE I — SECURITIES TO BE SOLD

Furnish the following information with respect to the acquisition of the securities to be sold and with respect to the payment of all or any part of the purchase price or other consideration therefor:

Title of the Class	Date you Acquired	Nature of Acquisition Transaction	Name of Person from Whom Acquired <i>(If gift, also give date donor acquired)</i>	Amount of Securities Acquired	Date of Payment	Nature of Payment

INSTRUCTIONS: (1) If the securities were purchased and full payment therefor was not made in cash at the time of purchase, explain in the table or in a note thereto the nature of the consideration given. If the consideration consisted of any note or other obligation, or if payment was made in installments describe the arrangement and state when the note or other obligation was discharged in full or the last installment paid. (2) If the person for whose account the securities are to be sold has held the securities for less than a year and has entered into a short position or a put equivalent position (as defined in Exchange Act Rule 16a-1(h)) with respect to the same class of securities, provide a description of that position, including the dates during which such position was held. Information regarding a short position or put equivalent position held by any previous owner should be provided to the extent known.

TABLE II — SECURITIES SOLD DURING THE PAST 3 MONTHS

Furnish the following information as to all securities of the issuer sold during the past 3 months by the person for whose account the securities are to be sold.

Name and Address of Seller	Title of Securities Sold	Date of Sale	Amount of Securities Sold	Gross Proceeds

REMARKS:

INSTRUCTIONS:

See the definition of "person" in paragraph (a) of Rule 144. Information is to be given not only as to the person for whose account the securities are to be sold but also as to all other persons included in that definition. In addition, information shall be given as to sales by all persons whose sales are required by paragraph (e) of Rule 144 to be aggregated with sales for the account of the person filing this notice.

ATTENTION:

The person for whose account the securities to which this notice relates are to be sold hereby represents by signing this notice that he does not know any material adverse information in regard to the current and prospective operations of the Issuer of the securities to be sold which has not been publicly disclosed. If such person has adopted a written trading plan or given trading instructions to satisfy Rule 10b5-1 under the Exchange Act, by signing the form and indicating the date that the plan was adopted or the instruction given, that person makes such representation as of the plan adoption or instruction date.

DATE OF NOTICE

DATE OF PLAN ADOPTION OR GIVING OF INSTRUCTION,
IF RELYING ON RULE 10B5-1

(SIGNATURE)

The notice shall be signed by the person for whose account the securities are to be sold. At least one copy of the notice shall be manually signed. Any copies not manually signed shall bear typed or printed signatures.

ATTENTION: Intentional misstatements or omission of facts constitute Federal Criminal Violations (See 18 U.S.C. 1001)

*Commissioner Campos
Not Participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55946 / June 25, 2007

INVESTMENT ADVISERS ACT OF 1940
Release No. 2610 / June 25, 2007

INVESTMENT COMPANY ACT OF 1940
Release No. 27872 / June 25, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12664

In the Matter of

John Hancock Investment
Management Services, LLC,
John Hancock Distributors
LLC, John Hancock Advisers,
LLC, and John Hancock
Funds, LLC,

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER PURSUANT TO
SECTION 15(b) OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTIONS 203(e)
AND 203(k) OF THE INVESTMENT
ADVISERS ACT OF 1940, 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 against: (1) John Hancock Investment Management Services, LLC, pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act"); (2) John Hancock Distributors LLC pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e) and 203(k) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act; (3) John Hancock Advisers, LLC pursuant to Sections 203(e) and 203(k) of the Advisers Act,

Document 30 of 46

and Sections 9(b) and 9(f) of the Investment Company Act and (4) John Hancock Funds, LLC, pursuant to Section 15(b) of the Exchange Act, Sections 203(e) and 203(k) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 15(b) the Securities Exchange Act of 1934, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 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 Offers, the Commission finds¹ that:

Summary

1. From at least 2001 until as late as 2004 (the "relevant period"), certain investment advisers and broker-dealers owned by Manulife Financial Corporation ("Manulife Financial") and John Hancock Financial Services, Inc. ("John Hancock"), which Manulife Financial acquired in 2004 in a stock-for-stock merger, violated the federal securities laws when the investment adviser respondents failed to disclose their use of brokerage commissions to pay for their affiliated distributors' marketing expenses concerning the sale of mutual fund and variable annuity products offered by related Manulife Financial and John Hancock entities.

2. Respondents John Hancock Investment Management Services, LLC ("John Hancock Management") (known during the relevant period as Manufacturers Securities Services, LLC) and John Hancock Advisers, LLC ("John Hancock Advisers"), advisers respectively to the Manulife Financial variable annuity trust portfolios and the John Hancock retail mutual funds, directed brokerage commissions from transactions in the trust portfolios and retail mutual funds they advised to pay for marketing expenses their affiliated distributors incurred under the distributors' own marketing arrangements with broker-dealers. These marketing arrangements are known as "revenue sharing" arrangements. The commissions were trust portfolio and retail mutual fund assets, and

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

were in addition to the distribution-related expenses that the variable series trust and mutual fund boards had authorized, but the investment adviser respondents did not disclose to the trust or retail mutual fund boards the use of these assets to pay their affiliates' revenue sharing obligations, in breach of their fiduciary duty to the trust and retail mutual funds. John Hancock Distributors LLC ("John Hancock Distributors") (known during the relevant period as Manulife Financial Services, LLC) and John Hancock Funds, LLC ("John Hancock Funds"), the broker-dealer affiliates that distributed the Manulife Financial variable annuity products and John Hancock's retail mutual funds, negotiated and were obligated under the marketing arrangements. They knew or should have known that John Hancock Management and John Hancock Advisers failed to disclose to the trust and retail mutual fund boards the use of brokerage commissions to pay for these revenue sharing obligations.

Respondents

3. John Hancock Management is a Delaware corporation with its headquarters in Boston, Massachusetts. During the relevant period, John Hancock Management was called Manufacturers Securities Services, LLC ("MSS") and was owned and controlled by Manulife Financial. John Hancock Management is the investment adviser to the series investment company containing the investment options for Manulife Financial's variable annuity products. John Hancock Management was registered with the Commission as an investment adviser throughout the relevant period and was registered as a broker-dealer during the relevant period until 2002. After Manulife Financial completed a stock-for-stock merger with John Hancock in April 2004, Manulife Financial changed MSS's name to John Hancock Investment Management Services, LLC.

4. John Hancock Distributors is a Delaware Corporation with its headquarters in Toronto, Canada and is registered with the Commission as a broker-dealer. During the relevant period John Hancock Distributors was called Manulife Financial Services, LLC ("Manulife Services"). John Hancock Distributors was the principal underwriter and distributor of the variable annuity products issued by Manulife Financial. Manulife Financial owned and controlled Manulife Services during the relevant period.

5. John Hancock Advisers is a Delaware corporation with its headquarters in Boston, Massachusetts and is registered with the Commission as an investment adviser. John Hancock Advisers is the investment adviser to John Hancock mutual funds. John Hancock owned and controlled John Hancock Advisers during the relevant period.

6. John Hancock Funds is a Delaware corporation with its headquarters in Boston, Massachusetts and is registered with the Commission as a broker-dealer. John Hancock Funds is the underwriter and distributor of the mutual fund products offered by John Hancock. John Hancock owned and controlled John Hancock Funds during the relevant period.

Other Relevant Entities

7. During the relevant period, John Hancock was a Delaware corporation with its headquarters in Boston, Massachusetts. Its common stock traded on the New York Stock Exchange. John Hancock owned and controlled John Hancock Funds and John Hancock Advisers. In April 2004 Manulife Financial, a Canadian corporation with its headquarters in Toronto, Canada acquired John Hancock in a stock-for-stock merger. Manulife Financial common stock trades on the New York Stock Exchange. Since the merger John Hancock has operated as a Manulife Financial subsidiary.

8. During the relevant period, Manulife Financial owned directly or indirectly John Hancock Management, then known as MSS, John Hancock Distributors, then known as Manulife Financial Services and John Hancock Trust, then known as Manufacturers Investment Trust.

9. John Hancock Trust is a Massachusetts business trust with its headquarters in Boston, Massachusetts. During the relevant period, John Hancock Trust was called Manufacturers Investment Trust ("MIT"). It was a series investment company containing the investment options for Manulife Financial's variable annuity products and was registered with the Commission as an investment company. After the Manulife Financial/John Hancock merger, MIT changed its name to John Hancock Trust.

John Hancock Management's and John Hancock Distributors' Directed Brokerage and Revenue Sharing

10. John Hancock Management provided investment advisory and portfolio management services to John Hancock Trust. This included oversight of the sub-advisers John Hancock Trust used to manage its assets. The sub-advisers made investment decisions and placed orders for them through broker-dealers, some of whom were selected by John Hancock Management. John Hancock Distributors distributed the variable annuity products issued by John Hancock Trust.

11. During the relevant period, John Hancock Distributors negotiated and was obligated under revenue sharing arrangements with certain broker-dealers to compensate these broker-dealers to promote the sale of John Hancock Trust products. Under these arrangements, the broker-dealers agreed to provide special marketing services, such as the opportunity for John Hancock Management and John Hancock Distributors to participate in conferences and meetings in which John Hancock Trust products were presented to selling brokers and providing preferred placement of John Hancock Trust products in marketing programs or other favorable marketing of John Hancock Trust products. The fees ranged from 4 to 35 basis points (or 0.04% to 0.35%) on sales and up to 10 basis points (or 0.00% to 0.10%) on assets. In some instances, these broker-dealers agreed to accept brokerage commissions as payments under these revenue sharing arrangements.

12. During the relevant period, John Hancock Management stated in its filings with the Commission and in materials provided to the trust board that it may consider a broker or dealer's sales in directing its brokerage commissions. For example, the Statement of Additional Information ("SAI") for the relevant period stated that

Sales Volume Considerations. Consistent with the foregoing considerations and the Rules of Fair Practice of the NASD, sales of insurance contracts which offer Trust portfolios may be considered as a factor in the selection of brokers or dealers.

13. Also, John Hancock Management stated in filings with the Commission and in materials provided to the trust board that John Hancock Distributors paid its own distribution costs. For example, a variable annuity prospectus for the relevant period said that John Hancock Distributors may

pay broker-dealers additional compensation or reimbursement for their efforts in selling contracts

14. However, John Hancock Management knew that a portion of John Hancock Distributors' revenue sharing expenses was satisfied when John Hancock Management directed brokerage commissions to the broker-dealers providing marketing services to John Hancock Distributors under the arrangements. The broker-dealers, John Hancock Management and John Hancock Distributors considered these commissions to be payments under the revenue sharing arrangements. John Hancock Management never disclosed this use of fund assets to the trust board.

15. Without knowledge of this use of trust brokerage commissions, the trust board was unaware of the conflict of interest it created and was unable adequately to evaluate the trust's overall marketing expenses.

16. As a fiduciary, John Hancock Management had a duty to disclose to the trust this use of trust portfolio assets. John Hancock Management made no such disclosure.

17. John Hancock Management was primarily responsible for ensuring that the trust's prospectuses and SAIs were in compliance with the requirements of Form N-1A in describing John Hancock Management's trading practices for the John Hancock Trust. The information the Commission requires investment companies to disclose in its prospectuses and SAIs is set forth in Form N-1A. Specifically, Item 16(c) of the Form N-1A required a description in the SAI of "how the Fund will select brokers to effect securities transactions" and required that "if the Fund will consider the receipt of products or services other than brokerage or research services in selecting brokers, [the Fund should] specify those products or services." During the relevant period, the SAIs disclosed that John Hancock Management may consider sales of shares of the Trust as a factor in selecting brokers or dealers, to execute the Trust's portfolio transactions. The SAIs did not make the distinction between directing commissions "in consideration of fund sales" and using brokerage commissions to reduce its affiliate's revenue sharing obligations. The SAIs failed to

disclose that John Hancock Management directed brokerage commissions to pay its affiliate's revenue sharing obligations.

18. John Hancock Distributors knew when it offered and sold trust products that the brokerage commissions John Hancock Management directed to revenue sharing broker-dealers offset John Hancock Distributor's own revenue sharing obligations and knew, or should have known, that John Hancock Management did not disclose this use of fund assets to the trust board.

19. John Hancock Management and John Hancock Distributors failed to ensure that the commissions were used only for the benefit of the funds that generated them. As a result, these commissions were used to pay revenue sharing obligations across the entire Manulife Financial complex.

20. John Hancock Management and John Hancock Distributors benefited from this use of trust portfolio assets. If the revenue sharing arrangements increased fund sales, John Hancock Management would benefit from an increase in its compensation, which was calculated as a percentage of net assets under management. John Hancock Distributors benefited from not having to pay for the marketing services provided under these arrangements from its own resources.

21. In total, John Hancock Management directed \$14,838,943.65 in brokerage commissions to 55 broker-dealers during the relevant period as payment for John Hancock Distributors' obligations under the revenue sharing arrangements.

John Hancock Advisers' and John Hancock Funds'
Directed Brokerage and Revenue Sharing

22. John Hancock Funds marketed and distributed John Hancock retail mutual funds through a number of broker-dealers. John Hancock Advisers provided investment advisory and portfolio management services to John Hancock's retail mutual funds. During the relevant period, John Hancock Funds entered into revenue sharing arrangements with certain broker-dealers pursuant to which John Hancock Funds agreed to compensate these broker-dealers to promote the sale of John Hancock retail mutual funds. For example, these broker-dealers placed John Hancock mutual funds on "preferred lists" of mutual funds and gave John Hancock Funds increased access to registered representatives and sales conferences. In return John Hancock Funds agreed to make payments to these broker-dealers equal to a set percentage of gross sales and/or assets under management. These fees ranged from 10 to 25 basis points (or 0.1% to 0.25%) on sales and from 5 to 10 basis points (or 0.05% to 0.10%) on assets. In some instances, these broker-dealers agreed to accept brokerage commissions as payments under the revenue sharing arrangements.

23. In calculating the amount of brokerage commissions used to reduce revenue sharing payments, in some instances, broker-dealers used a formula that required John Hancock Funds to spend a higher amount in brokerage commissions than it would have

paid in cash. In these instances, John Hancock Funds and the broker-dealers used a ratio to convert brokerage commission amounts into a cash equivalent amount.

24. During the relevant period, John Hancock Advisers stated in its filings with the Commission and materials provided to the mutual fund boards and shareholders that John Hancock Funds may have paid broker-dealers from its own resources for services they provided in connection with their sales of John Hancock mutual fund products. For example, the prospectus for the funds stated that:

[John Hancock Funds] may pay significant compensation out of its own resources to your broker-dealer.

Also, during the relevant period, the SAI for the funds stated that:

[John Hancock Funds], at its expense, and without additional cost to the Fund or its shareholders may provide significant additional compensation to Selling Firms in connection with their promotion of the Fund or sale of shares of the Fund.

25. However, John Hancock Advisers knew that a portion of John Hancock Funds' revenue sharing expenses was satisfied when John Hancock Advisers directed brokerage commissions for fund portfolio transactions to certain broker-dealers. John Hancock Advisers never disclosed to the retail mutual fund boards this use of fund assets.

26. As a fiduciary, John Hancock Advisers had a duty to disclose to the retail mutual funds this use of fund assets. John Hancock Advisers made no such disclosure.

27. John Hancock Advisers was primarily responsible for ensuring that the John Hancock retail mutual fund prospectuses and SAIs were in compliance with the requirements of Form N-1A in describing John Hancock Funds' trading practices for the John Hancock retail mutual funds. The information the Commission required investment companies to disclose in their prospectuses and SAIs is set forth in Form N-1A. Specifically, during the relevant period, Item 16(c) of the Form N-1A requires a description in the SAI of "how the Fund will select brokers to effect securities transactions" and required that "if the Fund will consider the receipt of products or services other than brokerage or research services in selecting brokers, [the Fund should] specify those products or services." During the relevant period, the SAIs disclosed that John Hancock Advisers may consider sales of shares of the Funds as a factor in selecting brokers or dealers to execute the Fund's portfolio transactions. The SAIs did not make the distinction between directing commissions "in consideration of fund sales" and using brokerage commissions to reduce revenue sharing obligations. The SAIs failed to disclose that John Hancock Advisers directed brokerage commissions to pay its affiliate's revenue sharing obligations.

28. John Hancock Funds knew when it offered and sold these products that the brokerage commissions John Hancock Advisers directed to revenue sharing broker-dealers

offset John Hancock Funds' own revenue sharing obligations and knew, or should have known, that John Hancock Advisers did not disclose this use of fund assets to the fund boards.

29. Nor did John Hancock Funds or John Hancock Advisers ensure that the commissions were used only in connection with revenue sharing expenses associated with the funds that generated them. As a result, commissions generated by particular funds were used to pay revenue sharing obligations relating to the marketing of other funds in the John Hancock mutual fund complex.

30. In total, John Hancock Advisers directed \$2,899,907 in brokerage commissions to 12 broker-dealers during the relevant period as payment for John Hancock Funds' payment obligations under the revenue sharing arrangements. Based on the application of ratios that converted brokerage commissions into cash, John Hancock Funds received credit against revenue sharing obligations of approximately \$2,087,477.46, which is the amount it benefited from the use of these commissions to satisfy its revenue sharing arrangements.

Violations

31. As a result of the conduct described above, Respondents John Hancock Advisers and John Hancock Management willfully² violated Section 206(2) of the Advisers Act in that they engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients. Specifically, John Hancock Advisers and John Hancock Management failed to disclose to the trust and retail mutual fund boards the conflict of interest created by the use of brokerage commissions, which were assets of the funds and trusts they advised, to pay revenue sharing expenses incurred by John Hancock Funds and John Hancock Distributors.

32. As a result of the conduct described above, John Hancock Distributors and John Hancock Funds willfully³ aided and abetted and caused violations of Sections 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser, when they offered products while knowing that brokerage commissions generated by John Hancock Management and John Hancock Advisers' transactions in the trust portfolios and retail mutual funds they advised were used to pay John Hancock Distributors' and John Hancock Funds' revenue sharing obligations and knew, or should have known, that John

² "Willfully" as used with respect to direct violations in this Order means intentionally committing the act which constitutes the violation. See *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that it is violating one of the Rules or Acts.

³ "Willfully" as used with respect to aiding and abetting violations in this Order means knowingly committing the act which constitutes the violation. See *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that it is violating one of the Rules or Acts.

Hancock Management and John Hancock Advisers failed to disclose this use of fund assets to the trust and retail mutual fund boards.

33. As a result of the conduct described above, John Hancock Management and John Hancock Advisers willfully violated Section 34(b) of the Investment Company Act in that they made untrue statements of material fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act, or omitted to state therein, any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

34. As a result of the conduct described above, John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder, which provide in pertinent part that it is unlawful for any "affiliated person of or principal underwriter for any registered investment company ..., acting as principal, [to] participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which any such registered company ... is a participant ... unless an application regarding such joint enterprise or profit-sharing plan has been filed with the Commission and has been granted by an order entered prior to the submission of such plan[.]"

Respondents' Cooperation

35. In determining to accept the Offers, the Commission considered the cooperation afforded the Commission staff by the Respondents.

Undertakings

36. The Respondents undertake the following:

a. **Written Compliance Policies and Procedures.** Each Respondent shall, within 90 days from the entry of the Order, require a senior level employee to implement and maintain the following written compliance policies and procedures:

i. Procedures designed to ensure that when Respondent's traders place trades with a broker-dealer that also sells Respondent's mutual fund or variable annuity products, the person responsible for selecting such broker-dealer is not informed of, and does not take into account, the broker-dealer's promotion or sale of fund shares or variable annuity products;

ii. Procedures requiring the documentation of all revenue sharing arrangements and requiring each Respondent to enter into written contracts memorializing revenue sharing arrangements between Respondent and the broker-dealer or other intermediary. The documentation of each revenue sharing

arrangement will set forth the payment schedule and the services that the broker-dealer or other intermediary will provide and include a provision preventing the broker-dealer or other intermediary from accepting compensation for promoting or selling Respondent's fund shares or variable annuity products in the form of commissions for brokerage transactions directed to it from a Respondent's portfolio transactions;

iii. All revenue sharing arrangements concerning the sale of John Hancock retail fund shares must be approved in writing by the Respondent's Chief Compliance Officer and the form of any such arrangements, or any material deviation therefrom, presented to the fund boards prior to implementation;

iv. All revenue sharing arrangements concerning the sale of variable annuities offered through John Hancock registered separate accounts that invest in the John Hancock Trust must be approved in writing by the Respondent's Chief Compliance Officer and the form of any such arrangements, or any material deviation therefrom, presented to the trust board no later than the next regularly scheduled meeting;

v. Each Respondent will supplement its compliance manual to establish guidelines for entering into revenue sharing arrangements which shall not be inconsistent with the terms of this order;

vi. Subject to the approval of the Respondents' boards, Respondents will prepare disclosures for the mutual funds and variable series trust portfolios to include in their prospectuses or SAIs information about payments made by Respondents to broker-dealers or other intermediaries in respect of the sale of fund shares in addition to dealer concessions, shareholder servicing payments, and payments for services that Respondents or an affiliate otherwise would provide, such as sub-accounting, and state that such payments are intended to compensate broker-dealers for various services, including without limitation, placement on the broker-dealer's preferred or recommended list, access to the broker-dealers' registered representatives, assistance in training and education of personnel, marketing support and other specified services;

vii. Respondents shall cause there to be a senior level employee whose responsibilities shall include compliance matters regarding conflicts of interest relating to the Respondents' businesses, as the case may be;

viii. Respondents shall develop policies and procedures to ensure that fund brokerage expenses are not used to finance distribution of funds;

ix. At least once per year, John Hancock Management and John Hancock Advisers will make a presentation to the boards, including an overview of their revenue sharing arrangements and policies, including any material changes to

such policies, the number and types of such arrangements, the types of services received, the identity of participating broker-dealers and the total dollar amounts paid. John Hancock Management and John Hancock Advisers will also provide the Boards with a summary quarterly report setting forth amounts paid by Respondent for revenue sharing arrangements and the broker-dealers that received such payments.

37. Certification. No later than twenty-four months after the entry date of the Order, the chief executive officer of each Respondent shall certify to the Commission in writing that the Respondent has fully adopted and complied in all material respects with the undertakings set forth in this section, or in the event of material non-adoption or non-compliance, shall describe such material non-adoption or non-compliance.

38. Recordkeeping. Respondents shall preserve for a period not less than six years from the end of the fiscal year last used, the first two years in an easily accessible place, any record of Respondents' compliance with the undertakings set forth in paragraph 36.

39. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 203(e) of the Advisers Act, Respondents John Hancock Advisers and John Hancock Management are hereby censured.

B. Pursuant to Section 15(b)(4) of the Exchange Act, Respondents John Hancock Funds and John Hancock Distributors are hereby censured.

C. Pursuant to Section 203(k) of the Advisers Act, and Section 9(f) of the Investment Company Act, Respondents John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds shall cease and desist from committing or causing any violations and any future violations of Sections 206(2) of the Advisers Act, Respondents John Hancock Management and John Hancock Advisers shall cease and desist from committing or causing any violations and any future violations of Section 34(b) of the Investment Company Act, and Respondents John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds shall cease and desist from committing or causing any violations and any future violations of Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder;

D. IT IS FURTHER ORDERED that:

1. John Hancock Management and John Hancock Distributors shall, within 30 days from the date of entry of the Order, on a joint and several basis, pay disgorgement of \$14,838,943.65 and prejudgment interest of \$2,001,999.21 to the John Hancock Trust portfolios,⁴ based upon the amount of cash payments that the Respondents avoided paying under revenue sharing arrangements by using portfolio brokerage commissions to pay for revenue sharing obligations. John Hancock Management and John Hancock Distributors shall also provide evidence of a wire transfer that is acceptable to the Securities and Exchange Commission staff as proof of such payment. The amounts that will be paid to each John Hancock Trust portfolio are detailed below:

Fund	Amount
All Cap Core	\$ 655,372.00
All Cap Growth	\$ 731,112.07
All Cap Value	\$ 176,133.60
Blue Chip Growth	\$ 708,820.67
Capital Appreciation	\$ 725,943.97
Dynamic Growth	\$ 146,759.93
Emerging Growth	\$ 13,181.32
Emerging Small Company	\$ 333,109.47
Equity-Income	\$ 417,364.61
Financial Services Trust	\$ 36,472.87
Fundamental Value	\$ 136,967.18
Global	\$ 806,885.41
Global Allocation	\$ 13,405.03
Health Sciences	\$ 70,129.00
Income & Value	\$ 441,367.45
International Core	\$ 355,158.90
International Equity Index A	\$ 55,798.31
International Small Cap	\$ 422,206.61
International Value	\$ 1,147,276.86
Large Cap Trust	\$ 2,789,923.76
Large Cap Value	\$ 185,990.04
Mid Cap Index	\$ 155,880.34
Mid Cap Stock	\$ 798,213.56
Mid Cap Value	\$ 459,569.65
Natural Resources	\$ 21,208.73
Quantitative All Cap	\$ 1,141.27
Quantitative Mid Cap	\$ 232,155.25
Real Estate Securities	\$ 161,839.32
Science & Technology	\$ 505,747.40
Small Cap Opportunities	\$ 187,019.04

⁴ The disgorgement and prejudgment interest amounts will be paid to the affected portfolios or their successors.

Small Company Value	\$	83,600.86
Special Value	\$	15,855.45
U.S. Core	\$	2,116,692.27
U.S. Global Leaders Growth	\$	293,517.27
U.S. Large Cap	\$	857,469.77
Utilities Trust	\$	69,129.97
Value	\$	512,523.65
Total	\$	16,840,942.86

2. John Hancock Advisers and John Hancock Funds shall, within 30 days from the date of entry of the Order, on a joint and several basis, pay disgorgement of \$2,087,477.46 and prejudgment interest of \$359,460.63 to the John Hancock mutual funds,⁵ based upon the amount of cash payments that the Respondents avoided paying under revenue sharing arrangements by using fund brokerage commission to pay for revenue sharing obligations. John Hancock Advisers and John Hancock Funds shall also provide evidence of a wire transfer that is acceptable to the Securities and Exchange Commission staff as proof of such payment. The amounts that will be paid to each fund are detailed below:

Fund / Account	Amount
Balanced	\$ 3,144.97
Bank & Thrift Opportunity	\$ 129,567.26
Classic Value	\$ 4,200.25
Financial Industries	\$ 442,273.26
Financial Trends	\$ 19,769.61
Focused Equity	\$ 1,867.79
Growth Trends	\$ 45,781.17
Health Sciences	\$ 31,056.08
High Yield	\$ 1,529.79
Institutional Accounts	\$ 99,623.67
JHT Blue Chip Growth ⁶	\$ 808.82
JHT Financial Services ⁶	\$ 16,180.36
JHT Growth & Income ⁶	\$ 20,949.10
JHT Mid Cap Stock ⁶	\$ 1,248.95
JHT Small Cap Growth ⁶	\$ 18,374.57
Large Cap Equity	\$ 614,955.42
Mid Cap Growth	\$ 172,696.75
Multi-Cap Growth	\$ 928.07
Patriot Global Dividend	\$ 2,512.96
Patriot Preferred Dividend	\$ 1,058.00
Patriot Premium Dividend I	\$ 1,913.63
Patriot Premium Dividend II	\$ 3,197.36

⁵ The disgorgement and prejudgment interest amounts will be paid to the affected portfolios or their successors.

⁶ This fund was formerly a John Hancock mutual fund, but has since merged into a portfolio of the John Hancock Trust. Thus, the payment will be made to the appropriate portfolio of the John Hancock Trust.

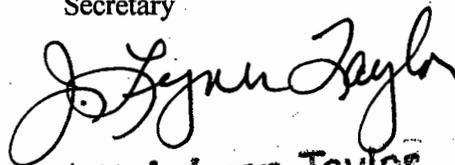
Patriot Select Dividend	\$	2,202.52
Preferred Income III	\$	1,050.07
Regional Bank	\$	221,684.29
Small Cap Equity	\$	229,809.55
Sovereign Investors	\$	68,817.75
Technology	\$	45,535.23
U.S. Global Leaders Growth	\$	244,200.86
Total	\$	2,446,938.09

3. Within 30 days from the date of the entry of the Order, John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds shall each pay a civil monetary penalty in the amount of \$500,000 to the United States Treasury. All such payments shall be made by United States postal money order(s), wire transfer, certified check(s), bank cashier's check(s) or bank money order(s); made payable to the Securities and Exchange Commission; 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 submitted under one or more cover letters that identify John Hancock Investment Management Services, LLC, John Hancock Distributors, LLC, John Hancock Funds, LLC and John Hancock Advisers, LLC as Respondents in these proceedings and the file number of these proceedings. A copy of the cover letter(s), wire transfer instructions, money order(s) or check(s) shall be sent to David Bergers, Director, Boston Regional Office, 23rd Floor, 33 Arch Street, Boston, MA 02110.

E. Respondents shall comply with the undertakings set forth in paragraph 36.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Commissioner Campos
Not Participating

SECURITIES ACT OF 1933
Release No. 8816 / June 25, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 55947 / June 25, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12664

In the Matter of

John Hancock Investment
Management Services, LLC, John
Hancock Distributors LLC, John
Hancock Advisers, LLC and John
Hancock Funds, LLC

Respondents.

**ORDER UNDER SECTION 27A(b) OF THE
SECURITIES ACT OF 1933 AND SECTION
21E(b) OF THE SECURITIES EXCHANGE
ACT OF 1934, GRANTING WAIVERS OF
THE DISQUALIFICATION PROVISIONS OF
SECTION 27A(b)(1)(A)(ii) OF THE
SECURITIES ACT OF 1933 AND SECTION
21E(b)(1)(A)(ii) OF THE SECURITIES
EXCHANGE ACT OF 1934**

John Hancock Investment Management Services, LLC ("John Hancock Management"), John Hancock Distributors LLC ("John Hancock Distributors"), John Hancock Advisers LLC ("John Hancock Advisers") and John Hancock Funds, LLC ("John Hancock Funds"), collectively, "Respondents", have submitted a letter, dated December 1, 2006, on behalf of themselves and their affiliate, Manulife Financial Corporation, whose stock is traded on the New York Stock Exchange, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from the Respondents' settlement of an administrative proceeding instituted by the Commission.

On June 25, 2007, pursuant to the Respondents' Offers of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) of the Exchange Act, Sections 203(e), and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order") against Respondents. Under the Order, the Commission found that:

1. As a result of the conduct described in the Order, John Hancock Advisers and John Hancock Management willfully violated Section 206(2) of the Investment Advisers Act of

Document 31 of 46

1940 ("Advisers Act") and Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act").

2. As a result of the conduct described in the Order, John Hancock Distributors and John Hancock Funds willfully aided and abetted and caused John Hancock Management and John Hancock Advisers' violations of Sections 206(2) of the Advisers Act.

3. As a result of the conduct described in the Order, John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder.

The Order requires, among other things:

1. Respondents to pay a total of approximately \$21,287,880.95 million in disgorgement, including pre-judgment interest and civil penalties; and

2. John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds to comply with certain undertakings concerning compliance oversight.

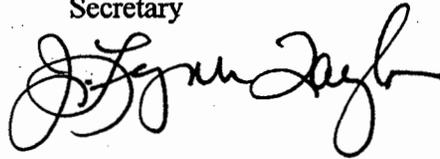
The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of an . . . administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in Respondents' request, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Order is appropriate and should be granted.

Accordingly, IT IS ORDERED, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to John Hancock Management, John Hancock Distributors, John Hancock Advisers, John Hancock Funds and Manulife Financial Corporation and their affiliates resulting from the entry of the Order is hereby granted.

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

*Commissioner Campos
Not Participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8816 / June 25, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 55947 / June 25, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12664

In the Matter of

John Hancock Investment
Management Services, LLC, John
Hancock Distributors LLC, John
Hancock Advisers, LLC and John
Hancock Funds, LLC

Respondents.

**ORDER UNDER SECTION 27A(b) OF THE
SECURITIES ACT OF 1933 AND SECTION
21E(b) OF THE SECURITIES EXCHANGE
ACT OF 1934, GRANTING WAIVERS OF
THE DISQUALIFICATION PROVISIONS OF
SECTION 27A(b)(1)(A)(ii) OF THE
SECURITIES ACT OF 1933 AND SECTION
21E(b)(1)(A)(ii) OF THE SECURITIES
EXCHANGE ACT OF 1934**

John Hancock Investment Management Services, LLC ("John Hancock Management"), John Hancock Distributors LLC ("John Hancock Distributors"), John Hancock Advisers LLC ("John Hancock Advisers") and John Hancock Funds, LLC ("John Hancock Funds"), collectively, "Respondents", have submitted a letter, dated December 1, 2006, on behalf of themselves and their affiliate, Manulife Financial Corporation, whose stock is traded on the New York Stock Exchange, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from the Respondents' settlement of an administrative proceeding instituted by the Commission.

On June 25, 2007, pursuant to the Respondents' Offers of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) of the Exchange Act, Sections 203(e), and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order") against Respondents. Under the Order, the Commission found that:

1. As a result of the conduct described in the Order, John Hancock Advisers and John Hancock Management willfully violated Section 206(2) of the Investment Advisers Act of

Document 32 of 46

1940 ("Advisers Act") and Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act").

2. As a result of the conduct described in the Order, John Hancock Distributors and John Hancock Funds willfully aided and abetted and caused John Hancock Management and John Hancock Advisers' violations of Sections 206(2) of the Advisers Act.

3. As a result of the conduct described in the Order, John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder.

The Order requires, among other things:

1. Respondents to pay a total of approximately \$21,287,880.95 million in disgorgement, including pre-judgment interest and civil penalties; and

2. John Hancock Management, John Hancock Distributors, John Hancock Advisers and John Hancock Funds to comply with certain undertakings concerning compliance oversight.

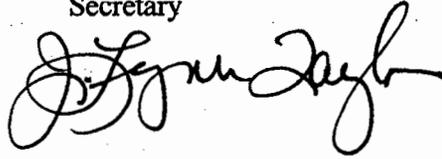
The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of an . . . administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in Respondents' request, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Order is appropriate and should be granted.

Accordingly, IT IS ORDERED, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to John Hancock Management, John Hancock Distributors, John Hancock Advisers, John Hancock Funds and Manulife Financial Corporation and their affiliates resulting from the entry of the Order is hereby granted.

By the Commission.

Nancy M. Morris
Secretary

A handwritten signature in black ink, appearing to read "J. Lynn Taylor". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

By: J. Lynn Taylor
Assistant Secretary

Commissioner Atkins
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Commissioner Campos
Not Participating

SECURITIES EXCHANGE ACT OF 1934
Release No. 55954 / June 25, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2623 / June 25, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12666

In the Matter of

INTERNATIONAL BUSINESS
MACHINES CORPORATION,

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 United States 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 International Business Machines Corporation ("IBM" 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.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. SUMMARY

In 2000 and 2001, IBM assisted Dollar General Corporation's commission of accounting fraud through a sham transaction. The transaction was conceived by an IBM Business Unit Executive (the "IBM BUE") and was designed to achieve a particular accounting result for Dollar General. In addition, IBM maintained inaccurate books and records in 2000 and 2001 that resulted from, among other things, revenue recognition errors by various IBM business units in a number of countries around the world that departed from Generally Accepted Accounting Principles ("GAAP").

In 1999, IBM and Dollar General agreed that Dollar General would lease new electronic cash registers from IBM to replace Dollar General's old Omron-brand cash registers. As originally planned, Dollar General would phase out the old registers and purchase the new IBM equipment over a multi-year period. In the second half of 2000, however, IBM, through the IBM BUE, suggested that Dollar General accelerate the roll-out of new IBM equipment by leasing for approximately \$10 million all of the new equipment by the end of 2000. This would have the result of increasing IBM's revenue for fiscal year 2000. Dollar General initially rejected the proposal, however, due to an accounting problem. Specifically, if Dollar General replaced all of the Omron equipment, it would be required to write off the book value of that equipment as an expense. This "book loss" problem, as it became known, in turn, would have a negative impact on Dollar General's earnings for its fiscal year 2000, which ended February 2, 2001.

IBM, through the IBM BUE, devised a way to solve Dollar General's "book loss" problem. Specifically, the IBM BUE proposed that IBM would purchase the old Omron equipment for approximately \$11 million. By selling the equipment at that price, Dollar General would avoid most of the negative consequences of having to write off the book value of the equipment that would have occurred if it simply replaced the old registers with the new IBM equipment. The proposed "purchase," however, was not a bona fide transaction because, among other reasons, IBM's purchase price for the Omron equipment was repaid to IBM by an offsetting increase in the amount that Dollar General was to pay for the new IBM equipment. In addition, although IBM agreed to buy the Omron equipment for more than Dollar General was going to pay for the new IBM registers, IBM knew that the Omron equipment was worthless, IBM intended to destroy it, and ultimately IBM never took possession of any of the sales registers. Nevertheless, the

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

“purchase” occurred and Dollar General removed the Omron equipment from its books and minimized the negative impact on its earnings in fiscal year 2000.

In addition, IBM in 2000 and 2001 maintained inaccurate books and records as a result of numerous discrete revenue recognition errors (many of which were errors with respect to the timing of recognition as between quarters and which were discovered and corrected by IBM) totaling approximately \$577 million in revenues over that two-year period.

B. RESPONDENT AND RELATED ENTITY

IBM, headquartered in Armonk, New York, and incorporated in New York, manufactures and sells computer services, hardware and software. IBM stock is registered under Section 12(b) of the Exchange Act and is listed on the New York Stock Exchange.

Dollar General Corporation, a Tennessee corporation headquartered in Goodlettsville, Tennessee, is a discount retailer of general merchandise. Dollar General’s common stock is registered under Section 12(b) of the Exchange Act and is listed on the New York Stock Exchange.²

C. THE OMRON TRANSACTION

1. IBM Proposal For An Accelerated Roll-Out Is Rejected

In 1999, Dollar General decided to lease new electronic cash registers from IBM’s Retail Store Solutions business unit to replace Dollar General’s old Omron-brand cash registers over a multi-year roll-out period. In November of 2000, IBM, through the IBM BUE, suggested that Dollar General accelerate the roll-out of the new electronic cash registers by leasing all the 4,224 remaining registers under the agreement before December 31, 2000. IBM offered to lease the new equipment to Dollar General for approximately \$10 million, which included a one million dollar discount to encourage Dollar General to agree to the deal. After receiving the proposal, Dollar General concluded that the negative impact on Dollar General’s earnings for its fiscal year 2000 from writing off the remaining book value for the Omron registers would outweigh the benefit of the transaction.

² On April 7, 2005, the SEC filed a settled enforcement action against Dollar General and certain of its former officers and employees in the United States District Court for the Middle District of Tennessee. Securities and Exchange Commission v. Dollar General Corp., et al., Civil Action No. 3:05-0283. Dollar General consented to the entry of a final judgment permanently enjoining it from violating the antifraud, internal controls, books and records, and periodic reporting provisions of the federal securities laws, specifically, Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-11, 13a-11, and 13a-13 thereunder. The Commission’s complaint included allegations relating to the Dollar General transaction with IBM that is one of the subjects of this Order.

Dollar General rejected IBM's offer on November 29, 2000, explaining to the IBM BUE that it was not worth it to Dollar General to acquire the new registers in 2000 because of the additional expense Dollar General would incur in writing off the remaining book value of the company's old equipment. Internal communications at IBM make clear that IBM understood Dollar General's accounting issue, specifically the write-off of the remaining book value, was a significant obstacle to completing the December 2000 roll-out of the IBM equipment.

2. IBM Proposes "Purchase" of Omron Registers To Solve Dollar General's Accounting Concern

On behalf of IBM, the IBM BUE devised and proposed a solution to, as he wrote in an e-mail, "help fix [Dollar General's] Omron book value issue." Specifically, IBM offered to "purchase" the Omron registers from Dollar General to accomplish the goal of helping Dollar General to minimize the impact of writing off the book value of Dollar General's Omron registers. On November 30, 2000, the IBM BUE contacted Dollar General's Treasurer and Dollar General's vice president of information services to discuss a proposal to address Dollar General's "accounting concerns." The proposal was that Dollar General lease, by December 31, 2000, all of the new equipment then currently scheduled to be leased in future years. If Dollar General agreed, IBM would "purchase" the Omron registers for a specified amount and would offset that purchase price by increasing the price Dollar General would pay to lease the new IBM registers by approximately the same amount. Initially, the proposal was that the Omron purchase price would be repaid immediately by Dollar General; ultimately, IBM agreed that its "purchase price" would be repaid over time by Dollar General as part of the financing arrangements for the new equipment.

At the same time that IBM agreed to "purchase" the Omron registers, the IBM BUE and various other IBM personnel knew that the Omron equipment was worthless. For example, an IBM Asset Manager had determined by December 5, 2000, that the Omron registers had no value to IBM and communicated this to an IBM Client Manager. The IBM Client Manager also understood that IBM was going to dispose of the Omron equipment it was planning to purchase from Dollar General. In addition, an IBM Business Operations Manager for the North American sales team for IBM's Retail Store Solutions checked with an IBM contractor to see if there was any market value for the Omron registers. The contractor told the IBM Business Operations Manager that there was no domestic resale value for the equipment. Finally, the IBM BUE ultimately told Dollar General that the Omron registers were worthless to IBM and that IBM intended to destroy them.

IBM allowed Dollar General to set the "purchase" price for the equipment. After considering the book value of the Omron registers, Dollar General determined that the best price

would be between \$10 million and \$11 million and communicated that to IBM. Thus, IBM was asked to pay as much or more for the worthless Omron registers as IBM had proposed Dollar General would pay for the new IBM equipment.

The IBM BUE and others at IBM also understood from the outset that the purchase price it proposed to pay for the older registers would not be at risk because it would be repaid by Dollar General in the form of an increased lease price for the new equipment. In effect, there was no "purchase" of Omron equipment; instead the amount was to be a loan from IBM to Dollar General. Internal IBM documents make clear the relationship between the Omron purchase price and the offsetting price increase for IBM equipment. For example, in a December 3, 2000, email, the IBM BUE described the new price for the IBM equipment as \$20,530,000 – over double the approximately \$10 million originally contemplated. The new purchase price now took into account the price of the Omron equipment, which, at that time, was specified in the email as \$10,030,000.

The entire transaction was to be financed by IBM. The financing terms for Dollar General were to involve "one payment of \$10,030,000 in February 2001, and the rest [of the \$20,530,000] deferred with a payment start date of August 2001." Under these terms, the portion of the purchase price attributed to the Omron equipment would be promptly reimbursed, while the amount Dollar General owed on the new IBM equipment would be financed over a longer period. Moreover, during the course of negotiations, there was a nexus between the price of the Omron equipment and the final price. For example, in a December 15, 2000 email written by the IBM BUE, he explained that since Dollar General was "now asking for the \$10,030,000 to go to \$11,030,000, we will need to do a similar analysis for \$19,620,480 + \$1,000,000 more in Omron for a new total of \$20,620,480 financed."

It was clear to certain IBM and Dollar General personnel that the only reason for the purported purchase of the Omron equipment was to solve Dollar General's accounting issues. The IBM BUE, for example, wrote in a December 3, 2000 email that "a buyback of the Omron equipment will erase the book loss issue, removing this as an obstacle to a more rapid roll-out." In the same email, the IBM BUE also stated that the proposed purchase should "significantly reduce or eliminate any negative P&L issues, and remove the lurking book loss issue." In turn, as Dollar General evaluated the offer, the company was seeking to determine whether the new proposal put Dollar General in a better position than it would have been if it held to the original roll-out schedule. In a December 5, 2000 email, the IBM BUE wrote: "The Customer is evaluating two things. Can we help fix their Omron book value issue (which we can and have already agreed to) and what is the comparative [net present value] of our best offer in December versus their current plan of acquiring [the equipment]"

In addition, completing the Omron "purchase" would increase IBM's earnings for the quarter by allowing it to close the accelerated roll-out transaction. The IBM BUE wrote in an email that "this would be quite a nice deal to put this much business this far forward at a time when IBM desperately needs to show revenue growth." In addition, the IBM BUE had a direct incentive to close the deal. His annual bonus was based in part on the total revenue from the sales "price" for the new IBM equipment (which was artificially inflated to offset the purchase price for the Omron transaction). Specifically, almost 50% of the IBM BUE's bonus for 2000 was attributable to the Dollar General transaction.

3. IBM and Dollar General Finalize Contract Terms

After negotiating the terms of the financing and other arrangements over the course of a few weeks, IBM and Dollar General finalized the two-part transaction by agreements dated December 22, 2000. Under one agreement, IBM agreed to purchase 14,070 Omron registers from Dollar General for \$11,098,672, with payment to be made to Dollar General no later than January 31, 2001 – just two days before the end of Dollar General's fiscal year 2000. On the same day, Dollar General signed a separate agreement committing the company to lease 4,224 new IBM registers for approximately \$21 million. That purchase price was to be financed by IBM Credit Corporation and would be repaid by Dollar General over five years, starting in January 2001.

4. IBM "Buys" the Omron Registers

IBM and the IBM BUE understood that Dollar General needed to receive the check for the sale of the Omron registers by the end of January 2001 to achieve the desired accounting result. The written agreement also required that IBM make the payment to Dollar General no later than January 31, 2001. On January 17, 2001, the IBM BUE sent an internal email to several IBM employees seeking to have the check for the Omron registers issued. In the email, he stated: "It is critical that this check gets cut ASAP to Dollar General for \$11,216,995. Their fiscal year ends 01/31/01 and this must be in house at DG."

Notably, the \$11.2 million amount referenced in the IBM BUE's email includes both the purchase price of \$11,098,672 and an additional \$118,323 that IBM was paying to cover the cost of disposal of the very equipment that it was purchasing. Although various IBM personnel saw the check request and one individual noted that the whole transaction seemed "a little peculiar and may be worth asking . . . questions [about]," the check request was approved and the check was issued to Dollar General shortly before January 31, 2001, two days before the end of Dollar General's fiscal year 2000.

Despite the purchase agreement, almost two years later in late 2002, none of the Omron registers purportedly purchased by IBM had left Dollar General's custody, nor were they destroyed. They were stored in Dollar General distribution centers awaiting disposal.

5. IBM and Dollar General's Respective Accounting for the Transaction

Dollar General received significant accounting benefits from the Omron transaction. Dollar General utilized the Omron purchase payment from IBM to improperly reduce certain expenses for its fiscal year 2000, thereby inflating its reported pre-tax income. Specifically, Dollar General improperly reduced the loss on Omron registers accounted for as having been removed from service in 2000.

The Omron transaction also served to enable Dollar General to avoid addressing an unrelated accounting issue pertaining to the Omron equipment – specifically, the fact that Dollar General had not sufficiently depreciated the Omron equipment during fiscal year 2000. At the time Dollar General entered into the multi-year agreement with IBM to replace the Omron equipment, Dollar General should have reassessed the remaining useful lives of the Omron equipment and accelerated the depreciation on that equipment consistent with the equipment removal and replacement schedule. In the fourth quarter 2000, at the time Dollar General entered into the Omron transaction with IBM, Dollar General had not depreciated the Omron equipment sufficiently (by approximately \$7.9 million) during fiscal year 2000. The Omron transaction, which removed the assets from the books, alleviated the need for Dollar General to face this problem. Utilizing the cash received from IBM for the Omron equipment, Dollar General instead minimized the loss on disposal of Omron registers and did not incur a substantial depreciation charge.

By improperly reducing expenses that Dollar General should have recognized, the net effect of Dollar General's accounting for the sham payment from IBM was to increase Dollar General's pretax income for fiscal 2000 by \$7.1 million, or 6.5% of Dollar General's restated pretax fiscal year 2000 income.

IBM, in contrast, ultimately accounted for the transaction by netting out the impact of the "purchase" of Omron equipment. IBM treated the purchase price for the Omron registers as a trade-in credit against the full purchase price of the new IBM equipment. IBM, however, did have to undertake unusual journal entries in order to accomplish this task because the transactions were separately documented. Consequently, as the IBM BUE wrote in a December 21, 2000 email, the "[l]edger amount to IBM Retail Store Solutions" was the net of the full purchase price, less the Omron price, for a total of approximately \$10.1 million. As structured, however, certain IBM employees received credit for the full \$21 million purchase price for purposes of bonus

calculations. Consequently, certain IBM employees, including the IBM BUE, received bonuses that were higher than they would have been but for the fraudulent Omron transaction.

D. IBM'S INACCURATE BOOKS AND RECORDS

As a result of numerous discrete incidents taking place in various IBM units, divisions, and wholly-owned subsidiaries in the United States, and in at least 23 other countries, IBM made at least \$200 million in revenue recognition errors in its fiscal year 2000, and at least \$377 million in revenue recognition errors in its fiscal year 2001.

At least \$281 million of this revenue involved the use of side letters, a substantial portion of which were side letters in which IBM granted rights of return. For example, in December 2000, several executives, managers, and employees of IBM Retail Store Solutions (the same unit involved in the Omron transaction) and Business Partner units caused IBM to improperly recognize \$9.3 million in revenue in connection with the sale of 22,680 printers to a business partner. Revenue recognition was improper at the time because, among other reasons, IBM Retail Store Solutions employees had granted a full right of return for the equipment in a side letter to the business partner.³ This \$9.3 million in improperly recognized revenue allowed the Retail Store Solutions unit to exceed its full-year sales target by \$2 million.

At least \$171 million of this revenue recognized in error for IBM's fiscal years 2000 and 2001 related to premature revenue recognition of product stored in warehouses not controlled by IBM's customers. At least \$100 million of this amount related to IBM's Retail Store Solutions unit and its use of IBM-controlled warehouses to store merchandise that had not been shipped to the end-customer but for which IBM nonetheless recognized revenue.⁴

³ The mere fact that a side letter was used to grant a right of return to a customer and that the right is termed a "full right" indicates a more-than-normal likelihood that the sale might be reversed and the product returned. In such a situation, the probability that the product will be returned and the amount of returns cannot be reasonably estimated, and thus the sale cannot be recognized. Financial Accounting Standard ("FAS") No. 48, Revenue Recognition When Right of Return Exists, includes, as a criterion for recognizing revenue when the right of return exists, that "the amount of future returns can be reasonably estimated."

⁴ SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, states, "The staff believes that revenue generally is realized or realizable and earned when . . . [among other criteria] delivery has occurred or services have been rendered." See also Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (stating that "if a sale or cash receipt (or both) precedes...delivery..., revenues may be recognized as earned by production and delivery"). Under the circumstances in this case, it was improper for IBM to recognize revenue at a time when it had not actually delivered the product.

The revenue recognition errors were, in many cases, errors with respect to the timing of recognition as between quarters. In most cases, the revenue recognition errors were discovered and corrected by IBM in advance of the Commission's investigation.

E. LEGAL DISCUSSION

1. IBM Caused Dollar General's Fraud

Section 21C of the Exchange Act provides that the Commission may order any person who is or was a cause of a violation of any provision of the Exchange Act, due to an act or omission the person knew or should have known would contribute to the violation, to cease and desist from causing such violations. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder proscribe a variety of fraudulent practices in connection with the purchase or sale of securities. Violations of Section 10(b) and Rule 10b-5 occur when an issuer makes material misstatements or omissions in periodic reports filed with the Commission, including financial statements, and trading thereafter occurs in the issuer's securities. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 860-862 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Great American Indus.*, 407 F.2d 453 (2d Cir.), *cert. denied*, 395 U.S. 920 (1968).

The Supreme Court, in interpreting the securities laws, has held that a fact is material if there is a "substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see also Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Information regarding the financial condition of a company is presumptively material. *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). Even financial misstatements that are not large in magnitude may be material if they are made intentionally to manage a company's income, hide a failure to meet analysts' expectations or sustain an earnings trend. *See Ganino v. Citizens Utility Co.*, 228 F.3d 154, 166 (2d Cir. 2000).

Dollar General violated Section 10(b) and Rule 10b-5 thereunder by fraudulently overstating its fiscal year 2000 income with the benefit of the Omron transaction. IBM was a cause of Dollar General's violations because IBM knew or should have known that its creation of and participation in the Omron transaction to solve Dollar General's "book loss" problem would contribute to Dollar General's securities fraud. IBM knew the Omron purchase transaction was not a bona fide sale because the Omron equipment was worthless, would be destroyed, and that the purchase "price" was really a loan from IBM to Dollar General that would be repaid through the inflated price for IBM's new equipment. In addition, IBM knew explicitly that it was an accounting impact on Dollar General's earnings that was the obstacle in completing the transaction – and IBM agreed to participate in a transaction that would solve that accounting problem. By engaging in the transaction with Dollar General, IBM was a cause of Dollar General's fraud.

2. IBM Caused Dollar General's Books and Records and Reporting Violations

Section 13(a) of the Exchange Act requires issuers with securities registered under Section 12 of the Exchange Act to file with the Commission such information and documents as required to keep reasonably current the information and documents required to be included in or filed with an application or registration statement. The requirement that issuers file such information and documents necessarily embodies the requirement that such reports be true and correct. *See Great Sweet Grass Oils, Ltd.*, 37 S.E.C. 683, 684 n.1 (1957), *aff'd*, 256 F.2d 893 (D.C. Cir. 1958); *see also SEC v. IMC Int'l*, 384 F. Supp. 889, 893 (N.D. Tex. 1974) ("The reporting provisions of the Exchange Act are clear and unequivocal, and they are satisfied only by the filing of complete, accurate, and timely reports."), *aff'd*, 505 F.2d 733 (5th Cir. 1974). Rule 13a-11 requires issuers to file current reports on Form 8-K. Rule 12b-20 further requires that such reports contain any further material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. Financial statements in Commission filings that do not comply with GAAP are presumed to be misleading. Regulation S-X, 17 C.F.R. § 210.4-01(a)(1). No showing of scienter is required to violate Section 13(a). *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998). A person may be a cause of a non-scienter based violation through negligent conduct that contributes to the violation. *See KPMG, LLP v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002).

Dollar General violated Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder by filing inaccurate Forms 8-K on January 23, 2001 and February 28, 2001 relating to Dollar General's fiscal 2000 earnings. These reports were inaccurate because they included overstated earnings as a result of the Omron transaction. IBM was a cause of Dollar General's violations because it knew or should have known that it was contributing to Dollar General's reporting of inaccurate financial statements by participating in the sham Omron transaction.

Section 13(b)(2)(A) of the Exchange Act requires Section 12 registrants 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." Dollar General violated Section 13(b)(2)(A) by failing to make and keep books, records, and accounts, which accurately and fairly reflected the Omron transaction in reasonable detail. IBM was a cause of Dollar General's violations of Section 13(b)(2)(A) because it knew or should have known that it was contributing to Dollar General's participation in and inaccurate recording of the Omron transaction.

3. IBM Violated the Books and Records Provisions of the Securities Laws

IBM violated Section 13(b)(2)(A) by failing to make and keep books, records, and accounts, which accurately and fairly reflected transactions in reasonable detail, in IBM's own books, records, and accounts for its fiscal year 2000 and fiscal year 2001, as described in section D above.

F. UNDERTAKING

IBM undertakes, within ten (10) business days of the date of the issuance of this Order, to pay \$7,000,000 to the Clerk of the United States District Court for the Middle District of Tennessee together with a cover letter specifying that this payment shall be deposited and joined to the funds currently held in *SEC v. Dollar General Corporation, et al.*, C.A. No. 3:05-0283. IBM has agreed to refer to this administrative proceeding in the cover letter and to transmit photocopies of such payment and letter to Kevin M. Loftus, Branch Chief, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549. IBM has agreed not to seek the return of any portion of its payment.

IV.

In determining to accept the Offer, the Commission considered the Undertaking in Section III. F. and remedial acts that were undertaken by Respondent.

V.

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

Accordingly, it is hereby ORDERED that Respondent IBM cease and desist from committing or causing any violations and any future violations of Sections 10(b), 13(a), and 13(b)(2)(A) of the Exchange Act, and Rules 10b-5, 12b-20 and 13a-11 thereunder.

By the Commission.

Nancy M. Morris
Secretary



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By: J. Lynn Taylor
Assistant Secretary

1011

Commissioner Campos
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2611 / June 26, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12669

In the Matter of

RAJEEV JOHAR,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Rajeev Johar ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

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

1. Johar was a principal in Entrust Capital Management, LLC ("Entrust"), an investment adviser not registered with the Commission, from at least October 2000 through April 2005. Johar is 34 years old and is a resident of West Monroe, Louisiana.

2. On June 4, 2007, a final judgment was entered by consent against the Respondent, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled, SEC v. Amit Mathur et al., Civil Action No. 05-CV-10729 (MLW) in the United States District Court for the District of Massachusetts.

3. The Commission's complaint alleged, among other things, that during the period starting in October 2000 through April 2005, Johar, his partner, and their investment advisory firm engaged in a scheme to defraud investors in a purported hedge fund they ran at Entrust. Johar and other defendants made material misrepresentations to clients and prospective clients concerning the number of Entrust's clients, its assets under management, and the returns that the hedge fund generated. Approximately twenty clients placed over \$16 million with Johar and the other defendants to fund investments in publicly traded securities. Johar and his partner, through Entrust, dissipated nearly all of their clients' assets through undisclosed trading losses in Entrust's brokerage accounts, unauthorized use of investor funds to support Entrust's operating expenses, and misappropriation of client funds for personal use. Johar misappropriated at least \$450,000 in investor funds for his own personal gain. Johar and the other participants in the fraud hid their wrongdoing from investors using a variety of schemes, misrepresentations, and fraudulent business practices.

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 203(f) of the Advisers Act, that Respondent Johar be, and hereby is barred from association with any investment adviser;

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

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

By the Commission.

Nancy M. Morris
Secretary

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

*Commissioner Camps
Not Participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55956 / June 26, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12667

In the Matter of

GLG PARTNERS, LP,

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 GLG Partners, LP ("GLG" 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 arising out of or related to these proceedings, 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 finds¹ that

Respondent

GLG is one of the largest hedge fund managers in Europe. GLG manages thirty hedge funds with total assets in excess of \$12 billion. GLG is headquartered in London, United Kingdom, and subject to regulation by the Financial Services Authority of the United Kingdom. Several of GLG's funds trade in securities through United States markets.

Summary

This matter involves multiple violations of Rule 105 of Regulation M under the Exchange Act by GLG. On sixteen occasions from July 2003 through May 2005, GLG violated Rule 105. During the period, GLG did not have any policies, procedures or training with respect to Rule 105.

With respect to each violation, GLG sold securities short during the five business days before the pricing of public offerings and then covered the short positions with securities purchased in the offerings. These transactions occurred in four of GLG's Funds: GLG Market Neutral Fund; GLG North American Opportunity Fund; GLG Technology Fund; and GLG European Long Short Fund (collectively, the "GLG Funds"). GLG made over \$2 million in profits for the GLG funds on these transactions.²

Violative Trades

Rule 105 of Regulation M, "Short Selling in Connection With a Public Offering," prohibits covering a short sale with securities obtained in a public offering if the short sale occurred within five business days before the pricing of the offering (the "Restricted Period"). The Commission adopted Rule 105 of Regulation M in an effort to prevent manipulative short selling prior to a public offering by short sellers who cover their short position by purchasing securities in the offering, thus largely avoiding exposure to market risk. Anti-manipulation Rules Concerning Securities Offerings, Release Nos. 33-7375, 34-38067 (Dec. 20, 1996). The Rule is prophylactic and prohibits the conduct irrespective of the short seller's intent in effecting the short sale. Short Sales, Final Rule, Release No. 34-50103 (July 28, 2004).

During the relevant period, GLG violated Rule 105 on sixteen occasions in fourteen different public offerings involving the following securities: ChipMos Technologies (Bermuda) Ltd. (Nasdaq: IMOS), Petco Animal Supplies, Inc. (Nasdaq: PETC), Nextel Partners, Inc. (Nasdaq: NXTP), Chicago Mercantile Exchange Holdings, Inc. (NYSE: CME), AU Optronics, Inc.

¹ The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

² In a related civil action, GLG consented to entry of a final judgment ordering it to pay a penalty. See SEC v. GLG Partners, L.P. (D.D.C. 2007).

(NYSE: AUO), Lipman Electronic Engineering Ltd. (Nasdaq: LPMA), Hewitt Associates, Inc. (NYSE: HEW), Spectrasite, Inc. (NYSE: SSI), Estee Lauder Cos., Inc. (NYSE: EL), Lubrizol Corp. (NYSE: LZ), Taiwan Semiconductor Manufacturing Company (NYSE: TSM) and CMS Energy Corp. (NYSE: CMS). Three examples of GLG's conduct are described in detail below.

Taiwan Semiconductor Manufacturing Co. Ltd. ("Taiwan")

On October 21, 2003, Taiwan announced a secondary offering of 100 million ADSs representing 500 million common stock shares. The underwriters priced the ADSs at \$10.77 after the market closed on November 10, 2003. Accordingly, the Restricted Period was Tuesday November 4, 2003 through Monday November 10, 2003.

During the Restricted Period, from November 5, 2003 through November 10, 2003, GLG, on behalf of GLG Market Neutral Fund, on nine occasions sold short a total of 2.548 million Taiwan ADSs. On November 10, 2003, GLG, on behalf of GLG Market Neutral Fund, purchased 7 million Taiwan ADSs in the secondary offering at a price of \$10.77. In violation of Rule 105, GLG used the ADSs purchased in the offering to cover the fund's outstanding short position in Taiwan, realizing profits for the fund of \$651,111.20.

Spectrasite, Inc. ("Spectrasite")

On April 23, 2004, Spectrasite announced a secondary offering of over 10 million shares of its common stock, which was subsequently amended to over 9 million shares. The underwriters priced the offering after the market closed on May 10, 2004. Accordingly, the Restricted Period was Tuesday May 4, 2004 through Monday May 10, 2004.

During the Restricted Period, from May 4, 2004 through May 7, 2004, GLG, on behalf of GLG North American Opportunity Fund, on six occasions sold short a total of 152,490 shares of Spectrasite. On May 10, 2004, GLG, on behalf of GLG North American Opportunity Fund, purchased 266,535 shares of Spectrasite in the secondary offering at a price of \$36.25. In violation of Rule 105, GLG used the shares purchased in the offering to cover the fund's outstanding short position in Spectrasite, realizing profits for the fund of \$217,871.78.

AU Optronics, Inc. ("AU Optronics")

On May 7, 2004, AU Optronics announced a secondary offering of 30 million ADSs representing 300 million shares of common stock. The ADSs in the offering would be temporary shares for seven business days, after which time they would automatically convert to ADSs exchangeable for common stock. The underwriters priced the offering after the market closed on June 17, 2004. Accordingly, the Restricted Period was Friday June 11, 2004 through Thursday June 17, 2004.

On June 17, 2004, within the Restricted Period, GLG, on behalf of GLG Market Neutral Fund, sold short 400,000 ADSs for \$16.8208 per share and 100,000 ADSs for \$16.90 per share. On June 18, 2004, GLG, on behalf of GLG Market Neutral Fund, purchased 9,000 AU Optronics ADSs in the market. On June 18, 2004, GLG, on behalf of GLG Market Neutral Fund, purchased

2,427,500 temporary AU Optronics ADSs in the secondary offering at a price of \$16. In violation of Rule 105, GLG used the ADSs purchased in the offering to cover the fund's outstanding short position in AU Optronics (491,000 ADSs) once the shares converted from temporary ADSs, realizing profits for the fund of \$418,979.70.

In each of the above trades related to the fourteen offerings, GLG sold securities short during the five business days before the pricing of public offerings and then covered the short positions with securities purchased in the offerings. GLG made a total of \$2,214,180 in profits for the GLG funds on these transactions.

As a result of the conduct described above, GLG violated Rule 105 of Regulation M under the Exchange Act which makes it "unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the . . . period beginning five business days before the pricing of the offered securities and ending with the pricing."

GLG's Remedial Efforts

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

Undertakings

GLG has undertaken to:

- a. adopt, implement and maintain written compliance policies and procedures reasonably designed to prevent violations of Rule 105 of Regulation M of the Exchange Act and, commencing in 2008, review those policies and procedures annually;
- b. provide training on Rule 105 of Regulation M to all new and existing employees of GLG who participate in or supervise trades or trading decisions, and all compliance and legal personnel;
- c. designate a senior level GLG employee with responsibility for overseeing GLG's compliance with Rule 105 and these undertakings; and
- d. certify in writing to the Commission no later than forty five (45) days after the entry of this Order that it has adopted the policies and procedures described in paragraph (a) above.

IV.

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

Accordingly, it is hereby ORDERED that:

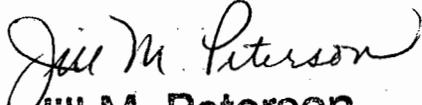
A. Pursuant to Section 21C of the Exchange Act, GLG cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M.

B. IT IS FURTHERED ORDERED that GLG shall, within 10 days of the entry of this Order, pay disgorgement of \$2,214,180 and prejudgment interest of \$489,455.94 for a total amount of \$2,703,635.94 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 GLG Partners, LP 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 Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-8549B.

C. GLG shall comply with the undertakings enumerated in Section III above.

By the Commission.

Nancy M. Morris
Secretary


By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8817; 34-55969

File No. 265-24]

SUBJECT: Advisory Committee on Improvements to Financial Reporting

AGENCY: Securities and Exchange Commission

ACTION: Notice of Federal Advisory Committee Establishment and Notice of Meeting

SUMMARY: The Chairman of the Securities and Exchange Commission ("Commission") intends to establish the Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting ("Committee").

The first meeting of the Committee will be held on August 2, 2007 in the Auditorium, Room L-002, at the Commission's main offices, 100 F Street, NE, Washington, DC beginning at 10:00 am. The meeting will be open to the public. The public is invited to submit written statements with the Committee.

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

Electronic Statements

- Use the Commission's Internet submission form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail message to rule-comments@sec.gov. Please include File Number 265-24 on the subject line; or

Paper Comments

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

All submissions should refer to File No. 265-24. 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 its Web site (<http://www.sec.gov/rules/other.shtml>). Comments also will be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: James L. Kroeker at (202) 551-5360 Deputy Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6561.

SUPPLEMENTARY INFORMATION: In accordance with the requirements of the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended, the Securities and Exchange Commission ("Commission") is publishing this notice that the Chairman of the Commission intends to establish the Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting (the "Committee"). The Committee's objective is to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors.

To achieve the Committee's goals, between 14 and 18 members will be appointed who can effectively represent the varied interests affected by the range of issues to be considered. The Committee's membership may include officers of public companies; board and audit committee members of public companies; accountants and securities lawyers who provide professional services to public companies; and investors, among others. The Committee's membership will be fairly balanced in terms of the points of view represented and the functions to be performed.

The Committee may be established 15 days after the publication of this notice by filing a charter for the Committee complying with the Federal Advisory Committee Act, with the Committee on Banking, Housing, and Urban Affairs of the United States Senate and with the Committee on Financial Services of the United States House of Representatives. A copy of the charter will be filed with the Chairman of the Commission, furnished to the Library of Congress, placed in the Public Reference Room at the Commission's headquarters, and posted on the Commission's Web site at www.sec.gov. The Committee's charter would direct it to consider the following areas:

- the current approach to setting financial accounting and reporting standards, including (a) principles-based vs. rules-based standards, (b) the inclusion within standards of exceptions, bright lines, and safe harbors, and (c) the processes for providing timely guidance on implementation issues and emerging issues;
- the current process of regulating compliance by registrants and financial professionals with accounting and reporting standards;

- the current systems for delivering financial information to investors and accessing that information;
- other environmental factors that may drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is a hesitance of professionals to exercise judgment in the absence of detailed rules;
- whether there are current accounting and reporting standards that do not result in useful information to investors, or impose costs that outweigh the resulting benefits (the Committee could use one or two existing accounting standards as a “test case,” both to assist in formulating recommendations and to test the application of proposed recommendations by commenting on the manner in which such standards could be improved); and
- whether the growing use of international accounting standards has an impact on the relevant issues relating to the complexity of U.S. accounting standards and the usefulness of the U.S. financial reporting system.

The Committee would be directed to conduct its work with a view to enhancing financial reporting for the benefit of investors, with an understanding that unnecessary

complexity in financial reporting can be harmful to investors by reducing transparency and increasing the cost of preparing and analyzing financial reports. Our expectation is that the advisory committee would provide specific recommendations and action steps that can be implemented both in the near term and the long term.

The Committee will operate for approximately 12 months from the date it is established, unless, before the expiration of that time period, its charter is extended or renewed in accordance with the Federal Advisory Committee Act or unless the Commission determines that the Committee's continuance is no longer in the public interest.

The Committee will meet at such intervals as are necessary to carry out its functions. The charter will provide that meetings of the full Committee are expected to occur no more frequently than twelve times per year. Meetings of subcommittees of the full Committee may occur more frequently.

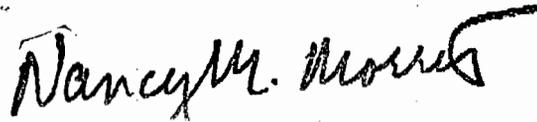
The charter will provide that the duties of the Committee are to be solely advisory. The Commission alone will make any determinations of action to be taken and policy to be expressed with respect to matters within the Commission's authority with respect to which the Committee provides advice or makes recommendations.

The Chairman of the Commission affirms that the establishment of the Committee is necessary and in the public interest.

Furthermore, upon establishment of the Committee, and in accordance with section 10(a) of the Federal Advisory Committee Act, 5 U.S.C. App. 10a, notice is hereby given that the first meeting of the Committee will be held on August 2, 2007 in the Auditorium, room L-002 at the Commission's main offices, 100 F Street, NE,

Washington, DC, beginning at 10:00 am. The meeting will be open to the public. The purpose of this meeting will be to discuss general organizational matters, to plan the progression of the Committee's work, and to begin discussions about the sources of unnecessary complexity and the barriers to investor transparency in the U.S. financial reporting system.

By the Commission

A handwritten signature in black ink that reads "Nancy M. Morris". The signature is written in a cursive style with a prominent flourish at the end of the name.

Nancy M. Morris
Committee Management Officer

Dated: June 27, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 240 and 242

[Release No. 34-55970; File No. S7-21-06]

RIN 3235-AJ76

Regulation SHO and Rule 10a-1

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (“Commission”) is amending the short sale price test under the Securities Exchange Act of 1934 (“Exchange Act”). The amendments are intended to provide a more consistent regulatory environment for short selling by removing restrictions on the execution prices of short sales (“price tests” or “price test restrictions”), as well as prohibiting any self-regulatory organization (“SRO”) from having a price test. In addition, the Commission is amending Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt,” if the seller is relying on an exception from a price test.

DATES: Effective Date: [Insert date of publication in the Federal Register].

Compliance Date: July 6, 2007.

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Lillian Hagen, Special Counsel, Victoria L. Crane, Special Counsel, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 551-5720, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is removing Rule 10a-1 [17 CFR 240.10a-1], amending Rule 200 of Regulation SHO [17 CFR 242.200], and adding Rule 201 of Regulation SHO [17 CFR 242.201] under the Exchange Act.

I. Introduction

A. Executive Summary

In December 2006, the Commission proposed amendments to remove the price test of Rule 10a-1 and add Rule 201 of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any security.¹ In addition, we proposed to prohibit any SRO from having a price test.² We also proposed to amend Rule 200(g) of Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt” if the seller is relying on an exception from a price test.³

The proposed amendments were designed to modernize and simplify short sale regulation and, at the same time, provide greater regulatory consistency by removing restrictions where they no longer appear effective or necessary.

We received twenty-seven comment letters in response to the proposed amendments. Commenters included individual investors, attorneys, an academic, individual traders, brokerage firms, the New York Stock Exchange LLC (“NYSE”), the International Association of Small Broker-Dealers and Advisors (“IASBDA”), the Securities Traders Association (“STA”), the Managed Funds Association (“MFA”), the

¹ See Exchange Act Release No. 54891 (Dec. 7, 2006), 71 FR 75068 (Dec. 13, 2006) (“Proposing Release”).

² See *id.*

³ See *id.*

Securities Industry and Financial Markets Association (“SIFMA”) and the American Stock Exchange LLC (“Amex”). While most commenters supported the Commission’s proposals, some expressed concerns regarding particular provisions.⁴ We discuss specific comments below in connection with the discussion of the amendments.

After carefully considering the comments, we are adopting the amendments as proposed. In particular, we are removing Rule 10a-1 and adding Rule 201 of Regulation SHO to provide that no price test, including any price test by any SRO, shall apply to short selling in any security. In addition, Rule 201, as adopted, will prohibit any SRO from having a price test.

Because we are adopting our proposal to remove all current price test restrictions, as well as prohibit any SRO from having its own price test, we are also amending Rule 200(g) of Regulation SHO⁵ to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt” if the seller is relying on an exception from the price test of Rule 10a-1, or any price test of any exchange or national securities association.⁶

⁴ A number of comment letters received in response to the proposed amendments discussed issues unrelated to the Proposing Release. We have included a summary of these comment letters in Section IV. Other Comments, below.

⁵ 17 CFR 242.200(g).

⁶ These amendments affect price tests and related marking requirements only. They do not relate to other provisions of Regulation SHO. We note, however, that on June 13, 2007, at an Open Commission Meeting, we approved amendments to eliminate the “grandfather” provision of Regulation SHO, and proposed amendments to eliminate the options market maker exception of Regulation SHO. These amendments do not alter the amendments to eliminate the grandfather provision, or the proposal to eliminate the options market maker exception.

B. Background

The Commission originally adopted Rule 10a-1 in 1938 to restrict short selling in a declining market.⁷ Paragraph (a) of Rule 10a-1 covers short sales in securities registered on, or admitted to unlisted trading privileges (“UTP”) on, a national securities exchange (“listed securities”), if trades of the security are reported pursuant to an “effective transaction reporting plan” and information regarding such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.⁸

Rule 10a-1(a)(1) provides that, subject to certain exceptions, a listed security may be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it is higher than the last different price (zero-plus tick).⁹ Short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions is commonly described as the “tick test.”

The core provisions of Rule 10a-1 have remained virtually unchanged since its adoption almost 70 years ago. Over the years, however, in response to changes in the securities markets, including changes in trading strategies and systems used in the marketplace, the Commission has added exceptions to Rule 10a-1 and granted numerous

⁷ See Exchange Act Release No. 1548 (Jan. 24, 1938), 3 FR 213 (Jan. 26, 1938).

⁸ Rule 10a-1 uses the term “effective transaction reporting plan” as defined in Rule 600 of Regulation NMS (17 CFR 242.600) under the Exchange Act. See 17 CFR 240.10a-1(a)(1)(i).

⁹ The last sale price is the price reported pursuant to an effective transaction reporting plan, *i.e.*, the consolidated tape, or to the last sale price reported in a particular marketplace. Under Rule 10a-1, the Commission gives market centers the choice of measuring the tick of the last trade based on executions solely on their own exchange rather than those reported to the consolidated tape. See 17 CFR 240.10a-1(a)(2).

written requests for relief from the rule's restrictions.¹⁰ These requests for exemptive relief have increased dramatically in recent years in response to significant developments in the securities markets, such as the increased use of matching systems that execute trades at independently derived prices during random times within specific time intervals and the spread of fully automated markets. Also, decimal pricing increments have substantially reduced the difficulty of short selling on an uptick. In addition, under current price test regulation, different price tests apply to different securities trading in different markets and apply generally only to large or more actively-traded securities.¹¹

In 2004, we adopted Rule 202T of Regulation SHO,¹² which established procedures for the Commission to temporarily suspend price tests so that the Commission could study the effectiveness of these tests.¹³ Pursuant to the process established in Rule 202T of Regulation SHO, we issued an order ("First Pilot Order") creating a one year

¹⁰ See Proposing Release, 71 FR at 75071-75072 (discussing exceptions to Rule 10a-1 added by the Commission and relief granted by the Commission from the rule's restrictions in recent years).

¹¹ Rule 10a-1's tick test is based on the last reported sale and applies to securities listed on a national securities exchange. The NASD's and Nasdaq's bid tests are based on the last bid rather than the last reported sale and apply only to short sales in Nasdaq Global Market securities. See NASD Rule 5100, [available at](http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159007939&element_id=1159006014&highlight=5100#r1159007939) http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159007939&element_id=1159006014&highlight=5100#r1159007939; Nasdaq Rule 3350, [available at](http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=16) http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=16. Thus, under the current market structure, Nasdaq Global Market securities traded on Nasdaq or the over-the-counter ("OTC") market and reported to an NASD facility are subject to Nasdaq's or the NASD's bid tests; other listed securities traded on an exchange, or otherwise, are subject to Rule 10a-1's tick test. Nasdaq-listed securities traded on exchanges other than Nasdaq are not subject to any short sale price test restrictions. In addition, smaller and more thinly-traded securities, such as Nasdaq Capital Market securities and securities quoted on the OTC bulletin board ("OTCBB") and pink sheets, are not subject to any price test restrictions wherever traded.

¹² 17 CFR 242.202T.

¹³ See *id.*; see also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48012-48013 (Aug. 6, 2004) ("Regulation SHO Adopting Release").

pilot (“Pilot”) temporarily suspending the provisions of Rule 10a-1(a) and any price test of any exchange or national securities association for short sales of certain securities.¹⁴

The Pilot was designed to assist the Commission in assessing whether changes to current short sale regulation are necessary in light of current market practices and the purposes underlying short sale regulation.¹⁵ The Commission stated in the Regulation SHO Adopting Release that conducting a pilot pursuant to Rule 202T would “allow us to obtain data on the impact of short selling in the absence of a price test to assist in determining, among other things, the extent to which a price test is necessary to further the objectives of short sale regulation, to study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity, and to obtain empirical data to help assess whether a price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities.”¹⁶ As noted in the Regulation SHO Adopting Release, the empirical data from the Pilot was to be obtained and analyzed “as part of [the Commission’s] assessment as to whether the price test

¹⁴ Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (Aug. 6, 2004). Specifically, the First Pilot Order suspended price tests for: (1) short sales in the securities identified in Appendix A to the First Pilot Order; (2) short sales in the securities included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the consolidated tape on the following day; and (3) short sales in any security not included in paragraphs (1) and (2) effected in the period between the close of the consolidated tape and the open of the consolidated tape on the following day. In addition, the First Pilot Order provided that the Pilot would commence on January 3, 2005 and terminate on December 31, 2005, and that the Commission might issue further orders affecting the operation of the First Pilot Order. *Id.* at 48033. On November 29, 2004, we issued an order resetting the Pilot to commence on May 2, 2005 and end on April 28, 2006 to give market participants additional time to make systems changes necessary to comply with the Pilot. Exchange Act Release No. 50747 (Nov. 29, 2004), 69 FR 70480 (Dec. 6, 2004). On April 20, 2006, we issued an order (“Third Pilot Order”) extending the termination date of the Pilot to August 6, 2007, the date on which temporary Rule 202T of Regulation SHO expires. Exchange Act Release No. 53684 (April 20, 2006), 71 FR 24765 (April 26, 2006). The purpose of the Third Pilot Order was to maintain the status quo with regard to price tests for Pilot securities while the staff completed its analysis of the Pilot data and the Commission conducted any additional short sale rulemaking.

¹⁵ 69 FR at 48032.

¹⁶ Regulation SHO Adopting Release, 69 FR at 48009.

should be removed or modified, in part or whole, for actively-traded securities or other securities.”¹⁷

Thus, the Commission’s Office of Economic Analysis (“OEA”) gathered the data made public during the Pilot, analyzed this data and provided the Commission with a summary report on the Pilot.¹⁸ The OEA Staff’s Summary Pilot Report examined several aspects of market quality including the overall effect of price tests on short selling, liquidity, volatility and price efficiency. The Pilot data was also designed to allow the Commission and members of the public to examine whether the effects of price tests are similar across stocks.¹⁹

In addition, the Commission encouraged outside researchers to examine the Pilot. In response to this request, the Commission received four completed studies (the

¹⁷ Id. at 69 FR at 48013. In the Regulation SHO Adopting Release we noted that “the purpose of the [P]ilot is to assist the Commission in considering alternatives, such as: (1) Eliminating a Commission-mandated price test for an appropriate group of securities, which may be all securities; (2) adopting a uniform bid test, and any exceptions, with the possibility of extending a uniform bid test to securities for which there is currently no price test; or (3) leaving in place the current price tests.” Id. at 69 FR at 48010.

¹⁸ See Office of Economic Analysis U.S. Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot (Feb. 6, 2007) (the “OEA Staff’s Summary Pilot Report”), available at <https://www.sec.gov/news/studies/2007/regshopilot020607.pdf>. See also Office of Economic Analysis U.S. Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot (Sept. 14, 2006) (the “OEA Staff’s Draft Summary Pilot Report”), available at http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf. Prior to the publication of the Proposing Release, OEA made available on the Commission’s Internet Web site, the OEA Staff’s Draft Summary Pilot Report. The conclusions reached in the OEA Staff’s Summary Pilot Report do not differ from those in the OEA Staff’s Draft Summary Pilot Report.

¹⁹ In the Regulation SHO Adopting Release, the Commission stated its expectation that data on trading during the Pilot would be made available to the public to encourage independent researchers to study the Pilot. See Regulation SHO Adopting Release, 69 FR at 48009, n.9. Accordingly, nine SROs began publicly releasing transactional short selling data on January 3, 2005. The nine SROs were the AMEX, ARCA, BSE, CHX, NASD, Nasdaq, National Stock Exchange, NYSE and Phlx. The SROs agreed to collect and make publicly available trading data on each executed short sale involving equity securities reported by the SRO to a securities information processor. The SROs publish the information on a monthly basis on their Internet Web sites.

“Academic Studies”) from outside researchers that specifically examine the Pilot data.²⁰

The Commission also held a public roundtable (the “Regulation SHO Roundtable”) that focused on the empirical evidence learned from the Pilot data (the OEA Staff’s Draft Summary Pilot Report, Academic Studies, and Regulation SHO Roundtable are referred to collectively herein as, the “Pilot Results”).²¹ The Pilot Results contained a variety of observations, which we considered in determining whether or not to propose removal of current price test restrictions and whether to adopt the amendments today. Generally, the Pilot Results supported removal of current price test restrictions.²²

Based on our review of the Pilot Results and of the status of current price test restrictions, we proposed to remove Rule 10a-1 and add Rule 201 of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. Rule 201 would also prohibit any SRO from having a price test. In addition, because we proposed to remove all current price test restrictions, and prohibit any price test by any SRO, we proposed to amend Rule 200(g) of Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt” if the seller is relying on an exception from the price test of Rule 10a-1, or any price test of any exchange or national securities association.

²⁰ See Karl Diether, Kuan Hui Lee and Ingrid M. Werner, It’s SHO Time! Short-Sale Price-Tests and Market Quality, June 20, 2006; Gordon J. Alexander and Mark A. Peterson, The Effect of Price Tests on Trader Behavior and Market Quality: An Analysis of Reg. SHO (forthcoming in Journal of Financial Markets); J. Julie Wu, Uptick Rule, short selling and price efficiency, August 14, 2006; Lynn Bai, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? 2006 (“Bai”).

²¹ A transcript from the roundtable (“Roundtable Transcript”) is available at <http://www.sec.gov/about/economic/shopilottrans091506.pdf>.

²² See Proposing Release, 71 FR at 75072-75075 (discussing the Pilot Results).

II. Removal of Price Test Restrictions

We proposed to remove Rule 10a-1 and add Rule 201 of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, we proposed to prohibit any SRO from having a price test. We are adopting the amendments, as proposed.

A. Comments Summary

The comments on the proposed amendments varied. Most commenters (including individual traders, academics, broker-dealers, MFA, STA, NYSE, and SIFMA) advocated removing all price test restrictions.²³ These commenters believe that price test restrictions are no longer necessary in today's markets, which are more transparent and where there is real-time regulatory surveillance that can easily monitor for and detect any short sale manipulation.²⁴ In addition, these commenters noted that market developments, such as technological innovations and decimalization, have transformed the trading landscape since Rule 10a-1 was first adopted and has changed the impact of price test restrictions.²⁵

²³ See, e.g., letter from Howard Teitelman, CSO, Trillium Trading (Feb. 6, 2007) ("Teitelman Letter"); letter from S. Kevin An, Deputy General Counsel, E*TRADE (Feb. 9, 2007) ("E*TRADE Letter"); letter from Carl Giannone (Feb. 11, 2007) ("Giannone Letter"); letter from David Schwarz (Feb. 12, 2007) ("Schwarz Letter"); letter from John G. Gaine, President, MFA (Feb. 12, 2007) ("MFA Letter"); letter from Lisa M. Utasi, Chairman of the Board and John C. Giese, President and CEO, STA (Feb. 12, 2007) ("STA Letter"); letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS (Feb. 14, 2007) ("UBS Letter"); letter from Mary Yeager, Assistant Secretary, NYSE (Feb. 14, 2007) ("NYSE Letter"); letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University (Feb. 14, 2007) ("Angel Letter"); letter from Ira D. Hammerman, SIFMA Managing Director and General Counsel (Feb. 16, 2007) ("SIFMA Letter").

²⁴ See, e.g., Giannone Letter, supra note 23; E*TRADE Letter, supra note 23; STA Letter, supra note 23; UBS Letter, supra note 23.

²⁵ See, e.g., MFA Letter, supra note 23.

In supporting the proposal, one commenter expressed its view that “short selling enhances market liquidity and contributes to stock pricing efficiency, and thus is an important part of our securities markets, and that the existing restrictions on the execution prices of short sales . . . inhibit the free-market price discovery mechanism of an efficient market.”²⁶ In addition, this commenter noted the significant financial, technology and human resources it expends on ensuring compliance with price test restrictions.²⁷ This commenter believes that the compliance costs and loss of market benefits created by short sales (such as, added liquidity and price efficiency) outweigh any potential or theoretical regulatory benefits of price tests.²⁸

In expressing its support for prohibiting SROs from having their own price tests, SIFMA noted that without this prohibition SROs “could feel pressured to maintain a price test as a marketing tool for attracting issuer listings. This would lead to an environment, as exists today, where there would be disparate price tests, or even no price test, depending on the market on which a security trades. Such a result imposes unnecessary compliance costs upon broker-dealers (without also providing real benefits to investors) and leads to regulatory arbitrage.”²⁹

²⁶ E*TRADE Letter, supra note 23. See also, MFA Letter, supra note 23 (stating that the MFA regards short selling as an essential method by which investors, including fiduciaries managing others’ assets, can manage risk, hedge their portfolios, and reflect their view that the current market price of a security is higher than it should be).

²⁷ See E*TRADE Letter, supra note 23.

²⁸ See id. See also, UBS Letter, supra note 23 (noting that there are substantial programming, implementation, and ongoing compliance costs associated with maintaining price test restrictions).

²⁹ SIFMA Letter, supra note 23. See also, E*TRADE Letter, supra note 23 (commenting that allowing SROs to have their own price tests would increase compliance and systems change costs to market participants, including broker-dealers executing customer short sales). In addition, in its letter, SIFMA commented that allowing SROs to have their own price tests could raise best execution concerns for broker-dealers determining how best to route short sale orders, i.e., in that a broker-dealer would need to

Similarly, the STA commented that eliminating price test restrictions and prohibiting SROs from implementing the same would eliminate regulatory arbitrage in short sale regulation and would allow marketplaces to compete with each other on the basis of execution quality, rather than on regulatory disparities, which it believes, would increase public investor confidence in the markets.³⁰ The NYSE stated its belief that all equity markets should be regulated equally, noting that “[i]t is inappropriate that the federal securities laws, through the application of Rule 10a-1, requires trading of NYSE-listed securities to be held to a different standard than those listed on other markets.”³¹ The NYSE further noted that it believes the “practical effect of the proposed amendments will be to level the playing field in the area of short sales and establish a more consistent and uniform regulatory regime across all markets.”³²

Two commenters (both individual investors) opposed the proposed amendments noting the need for price tests to prevent “bear raids.”³³ Other commenters (including individual traders and E*Trade), however, noted that sharp market declines, such as those induced by “bear raids,” are highly unlikely to occur in today’s markets which are

consider whether to route short sale orders received to a market that has a price test, as opposed to a market which does not and which could thus perhaps provide a faster execution. See SIFMA Letter, supra note 23.

³⁰ See STA Letter, supra note 23.

³¹ NYSE Letter, supra note 23.

³² Id.

³³ See, e.g., letter from Jim Ferguson (Dec. 19, 2006); letters from David Patch (Jan. 1, 2007; Jan. 12, 2007) (“Patch Letters”). A “bear raid” involves the active selling of a security short to drive down the security’s price in the hopes of convincing less informed investors of a negative material perception of the security, triggering sell orders. Falling prices could trigger margin calls and possibly forced liquidations of the security, depressing the price further. This unrestricted short selling could exacerbate a declining market in a security by eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security’s price is falling for fundamental reasons. At the time, many people blamed “bear raids” for the 1929 stock market crash and the market’s prolonged inability to recover from the crash. See 8 Louis Loss & Joel Seligman, Securities Regulations, § 8-B-3 (3d ed. 2006).

characterized by much smaller spreads, higher liquidity, and greater transparency than when the rule was adopted almost 70 years ago.³⁴

One commenter, although generally in support of removing all price test restrictions, believes that at some level unrestricted short selling should be collared.³⁵ This commenter supported having a 10% circuit breaker to prevent panic in the event there is a major market collapse.³⁶ The NYSE also noted its concern about unrestricted short selling during periods of unusually rapid and large market declines. This commenter stated that the effects of an unusually rapid and large market decline could not be measured or analyzed during the Pilot because such decline did not occur during the period studied. Accordingly, the NYSE commented that it believes SROs should be permitted to propose rules to be applied in such situations should they deem it appropriate.³⁷

As an alternative to removing all price test restrictions, one commenter suggested extending the Pilot to include more securities to better evaluate the benefits of completely eliminating current price test restrictions.³⁸ Another commenter, the IASBDA, noted that while it believes that the staff makes a compelling case for the removal of price test

³⁴ See, e.g., E*Trade Letter, supra note 23; Giannone Letter, supra note 23; Schwarz Letter, supra note 23. In addition, we note that panelists at the Regulation SHO Roundtable stated the belief that price test restrictions do not provide protection from bear raids. See Roundtable Transcript.

³⁵ See Giannone Letter, supra note 23.

³⁶ See id.

³⁷ See NYSE Letter, supra note 23. The NYSE also noted that it believes that SROs should be permitted to maintain existing rules consistent with this concept, such as NYSE Rule 80(A)(a) (requiring the entry of any index arbitrage order to sell any component stock of the S&P 500 Stock Price IndexSM with the instruction “sell plus” on any trading day when the NYSE Composite Index® declines below its closing value on the prior trading day by at least the “two-percent” value, as calculated according to the methodology found in NYSE Rule 80A.10). See id.

³⁸ See Teitelman Letter, supra note 23.

restrictions for the Russell 3000 securities, it fails to address whether the issuers of other securities should have some choice in whether they want their stock subject to a price test.³⁹ IASBDA commented that “[b]y insisting that it must be all or none the staff may unnecessarily force small issuers to accept an environment which is most unkind to their securities.”⁴⁰ Furthermore, IASBDA criticized the Pilot for not including OTCBB stocks and other small stocks.⁴¹ This commenter noted that “[t]he Russell 3000 is a broad based index in terms of capitalization but there are roughly 9000 stocks in the publicly reporting universe. The Russell 3000 Index offers investors access to the broad U.S. equity universe representing approximately 98% of the U.S. market, but roughly 33% of individual stocks. The SEC’s Advisory Committee Report on Small Public Companies Final report concluded there were 9,428 companies listed including the otcbb. Report at p.5.”⁴² Thus, IASBDA stated that there may be an argument for phasing in the elimination by starting with the larger stocks and concluding with the OTCBB and smaller segments of the market. IASBDA suggested that this methodology might allow the Commission to learn something from its observance of the large stocks without a tick test.⁴³

³⁹ See letter from Peter Chepucavage, General Counsel, Plexus Consulting, on behalf of International Association of Small Broker-Dealers and Advisors (Dec. 19, 2006) (“IASBDA Letter”).

⁴⁰ Id.

⁴¹ Id.

⁴² Id.

⁴³ See id.

Similarly, Amex believes that it is premature to remove price tests from smaller securities pending further analysis.⁴⁴ In its comment letter, Amex stated that it has “noted numerous statements in the Proposing Release, the OEA Staff’s Draft Summary Pilot Report, and the Roundtable Transcript that suggest that the impact of eliminating short sale price tests may differ between large capitalization and small capitalization securities. Such a differential impact would obviously be of great concern to the Amex, which has a large concentration of small capitalization issuers.”⁴⁵ Thus, Amex commented that while it is not suggesting that price test restrictions be extended to additional securities, nor is it adamantly opposing the ultimate removal of price test restrictions from small capitalization securities to which price tests currently apply, it is advocating additional study before such action is taken in connection with small capitalization securities.⁴⁶

We noted in the Proposing Release that in connection with the Pilot, nine reporting markets have been making public information about short selling transactions,⁴⁷ and we requested comment regarding whether it would be in the public interest to request that markets continue to release this information.⁴⁸ In response, the NYSE expressed its objection to the Commission continuing to require the markets to collect and make this

⁴⁴ See letter from Claire P. McGrath, Senior Vice President and General Counsel, Amex (Feb. 16, 2007) (“Amex Letter”).

⁴⁵ Id.

⁴⁶ See id.

⁴⁷ See Proposing Release, 71 FR at 75069; see also, supra note 19.

⁴⁸ See Proposing Release, 71 FR at 75077. Specifically, we sought comment regarding whether requesting the markets to continue to release such information would improve transparency of short selling. In addition, we asked whether it would help the Commission monitor the markets for potential abuses if the Commission were to approve the removal of price tests. We also asked for comment regarding how costly it would be for the markets to continue to produce the data and whether there are any less costly alternatives to the current information being released by the markets.

information publicly available, noting that collecting and producing such information has proven to be costly and time-consuming.⁴⁹ The MFA commented that it believes such information should only be made available to law enforcement authorities.⁵⁰ Another commenter, however, urged the Commission to work with the SROs to ensure that data similar to that made publicly available during the Pilot, continues to be available to researchers after the Pilot.⁵¹

In its letter, the NYSE stated that it believes that “the stated purpose for publicly releasing such data during the pilot – i.e., encouraging independent researchers to study the pilot’s effects – has already been successfully accomplished, as evidenced by the academic studies published and public roundtable held concerning the results of the pilot data.”⁵² The NYSE also did not believe that we should request that the SROs submit periodic reports regarding the effects of the removal of price test restrictions at regular intervals, such as on a semi-annual or annual basis, stating that such a requirement, in addition to collecting and making publicly available data on short sale transactions, would “greatly exacerbate costs.”⁵³

B. Response to Comments

We have carefully considered all the comments we received regarding the proposed amendments. In particular, we note the comments regarding the need for price

⁴⁹ See NYSE Letter, supra note 23.

⁵⁰ See MFA Letter, supra note 23. The MFA commented that it is “concerned that public transactional short selling data may fuel frivolous issuer lawsuits against market participants with a legitimate but different view of the value of an issuer’s securities.” Id.

⁵¹ See Angel Letter, supra note 23.

⁵² NYSE Letter, supra note 23.

⁵³ See id.

test restrictions to prevent the use of short selling to drive down the market in “bear raids.” One of the Commission’s stated objectives when it adopted Rule 10a-1 in 1938 was to prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.⁵⁴ In addition, in the Proposing Release, we noted that although short selling serves useful market purposes, such as increasing market liquidity and price efficiency, it also may be used to illegally manipulate stock prices.⁵⁵ Because of the Commission’s stated objective when it adopted Rule 10a-1 and our concerns about the potential use of short sales to manipulate stock prices, OEA examined the Pilot data for any indication that there is an association between extreme price movements and price test restrictions. OEA, however, did not find any such association.⁵⁶ We also note that although we are removing current price test restrictions, today’s markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of undetected manipulation and permit regulators to monitor for the types of activities that current price test restrictions are designed to prevent. In addition, we note that the general anti-fraud and anti-manipulation provisions of the federal securities laws continue to prohibit activity designed to improperly influence the price of a security.⁵⁷

In addition, with respect to comments regarding the Commission allowing SROs to adopt price test restrictions in the event of unusually rapid and large market declines,

⁵⁴ See Exchange Act Release No. 13091 (Dec. 21, 1976), 41 FR 56530 (Dec. 28, 1976).

⁵⁵ See Proposing Release, 71 FR at 75070.

⁵⁶ See OEA Staff’s Summary Pilot Report at 56, supra note 18.

⁵⁷ See, e.g., Securities Act of 1933 Section 17(a), Exchange Act Section 9(a), 10(b), and 15(c), and Rule 10b-5 thereunder.

we have determined not to take such action at this time.⁵⁸ We believe that allowing SROs to adopt price test restrictions under such circumstances could undermine a primary objective of the proposed amendments of achieving regulatory uniformity and simplicity.⁵⁹ For the same reasons, we do not believe that we should implement a circuit breaker for short sales at this time.

We note, however, that pursuant to Section 36 of the Exchange Act, in the future the Commission could determine that circumstances have arisen that justify the issuance of an exemption from the provisions of Rule 201.⁶⁰ Should an SRO request the Commission issue such an exemption in conjunction with the filing of an SRO proposed rule change to establish a price test restriction, when considering any such request, the Commission would consider, among other things, whether the proposed rule change is consistent with the objectives of today's amendments of providing regulatory simplicity and consistency. In addition, to issue an exemption pursuant to Section 36, the Commission would have to find that such an exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.⁶¹

⁵⁸ See NYSE Letter, *supra* note 23.

⁵⁹ We note, however, that Section 12(k)(2) of the Exchange Act provides that the Commission, "in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization under the securities laws, as the Commission determines is necessary in the public interest and for the protection of investors (i) to maintain or restore fair and orderly securities markets (other than markets in exempted securities); (ii) to ensure prompt, accurate, and safe clearance and settlement of transactions in securities (other than exempted securities); or (iii) to reduce, eliminate, or prevent the substantial disruption by the emergency of (I) securities markets (other than markets in exempted securities), investment companies, or any other significant portion or segment of such markets, or (II) the transmission or processing of securities transactions (other than transactions in exempted securities)." In addition, SROs may also continue to have rules consistent with the concept of circuit breakers.

⁶⁰ See 15 U.S.C. 78mm.

⁶¹ See *id.*

In response to IASBDA's comment regarding allowing issuers to have a choice as to whether or not they want their stock to be subject to a price test, we have determined not to take such action at this time. A primary goal of the amendments is to bring uniformity to, and simplify, short sale regulation. To allow issuers to have a choice as to whether or not their stock is subject to a price test would undermine this primary objective. In addition, we note that in the Proposing Release we specifically requested comment from issuers regarding their views of the impact of the proposed amendments on their securities.⁶² We did not, however, receive any comments from issuers.⁶³

In addition, with respect to IASBDA's comment regarding the universe of securities subject to the Pilot and, in particular, that the Pilot did not include securities quoted on the OTCBB, we note that the Pilot did not include this class of securities because securities quoted on the OTCBB are not currently subject to any price test restrictions.

Both the IASBDA and Amex suggested removing price tests from larger securities first to allow time to study the impact of the permanent removal of price test restrictions before such action is taken for smaller securities. We do not believe that such an approach would provide new results relevant to smaller securities.⁶⁴ As we noted in the Proposing Release, while there is some evidence supporting the application of price test restrictions to smaller securities, the evidence is not strong enough to warrant the

⁶² See Proposing Release, 71 FR at 75076.

⁶³ We note that the IASBDA is an advocacy group for small broker-dealers and advisers (including lawyers and hedge funds).

⁶⁴ See IASBDA Letter, *supra* note 39; Amex Letter, *supra* note 44. We note that many smaller or thinly-traded securities, such as Nasdaq Capital Market securities and securities quoted on the OTCBB and pink sheets, are not currently subject to any price test restrictions.

continuation of current price test restrictions to any subset of securities.⁶⁵ Such continuation would also undermine a primary goal of these amendments of providing greater uniformity and simplicity to short sale regulation.

In connection with whether we should request that SROs continue to make public information regarding short sale transactions similar to that obtained during the Pilot, we note that the SROs have provided such information during the Pilot at our request so that researchers could provide the Commission with their own empirical analyses of the Pilot.⁶⁶ We have determined at this time not to propose to require the SROs to make information similar to that obtained during the Pilot publicly available on a regular basis.

With respect to whether the SROs should submit periodic reports regarding the effects of the removal of price tests, and in response to commenters concerns that traders may have been on “good behavior” during the Pilot,⁶⁷ we note that while we believe that current price test restrictions are no longer effective or necessary, we intend to closely monitor for potentially abusive trading activities. We expect that the markets will similarly continue to surveil for trading abuses. To the extent we obtain evidence of

⁶⁵ See Proposing Release, 71 FR at 75076. In addition, we note that academics have previously examined short selling in a matched sample of Nasdaq National Market stocks, which were subject to price test restrictions, and Nasdaq SmallCap stocks, which were not, during a period of high volatility and rapidly declining stock prices (September 2000 to August 2001). In this study’s sample of 2,275 observations, the study found no significant differences in the overall level of short selling, or the frequency of days with abnormally negative returns and abnormally high short selling. See Michael G. Ferri, Stephen E. Christophe, and James J. Angel, A short look at bear raids: Testing the bid test, 2004.

⁶⁶ See Regulation SHO Adopting Release, 69 FR at 48009.

⁶⁷ For example, in its letter, Amex noted a comment by OEA in the OEA Staff’s Draft Summary Pilot Report that it is possible that traders might behave differently if a rule were permanently and completely removed than if it is only temporarily and incompletely removed, and that traders with manipulative intentions might be on good behavior if they believe that heightened scrutiny during the Pilot increases their chances of getting caught. See Amex Letter, supra note 44.

possible violations of the federal securities laws, we will pursue investigations and law enforcement actions as warranted.

We have carefully considered the comments and continue to believe that the amendments are appropriate in light of market developments that have occurred in the securities industry since the Commission adopted Rule 10a-1 in 1938, such as decimalization, the increased use of matching systems that execute trades at independently derived prices during random times within specific time intervals, and, most recently, the spread of fully automated markets. We believe the amendments will bring increased uniformity to short sale regulation, level the playing field for market participants, and remove an opportunity for regulatory arbitrage.

In addition, we note that only one commenter questioned the economic evidence supporting the amendments, but we believe that the critique is inapplicable.⁶⁸ The Pilot was designed to assist the Commission in assessing whether changes to current short sale regulation are necessary in light of current market practices and the purposes underlying price test regulation.⁶⁹ During the comment period, we received one additional study examining the results of the Pilot.⁷⁰ This study found results that are consistent with

⁶⁸ One commenter expressed concern about the methodologies used in the Pilot studies. See Patch Letters, supra note 33 (stating that “the methods in which the OEA conducted their analysis (specifically the duration of time) is flawed. Bear raids do not last for months but over days or weeks and such analysis by the OEA, looking over large windows of time without looking at micro trading, is a flawed approach”). But see, OEA Staff’s Summary Pilot Report at 9, supra note 18 (stating that OEA focused its investigation on price patterns that might indicate manipulative behavior at a daily or intraday frequency). In addition, we note that panelists from the Regulation SHO Roundtable were asked to critique the studies and all panelists generally agreed with the results. See Roundtable Transcript at 49-57, 72-80, supra note 21.

⁶⁹ 69 FR at 48032. See also, Proposing Release, 71 FR at 75068-75069, 75072-75073 (discussing the Pilot and the Pilot Results).

⁷⁰ See Bai, supra note 20. See also, OEA Staff’s Summary Pilot Report at 85, supra note 18.

other Pilot studies previously submitted to, and discussed by, the Commission, which generally found that current price test restrictions do not enhance market quality.⁷¹

Thus, after carefully considering the comments received, we are adopting the amendments, as proposed.

III. Removal of “Short Exempt” Marking Requirement

Because we proposed to remove Rule 10a-1 and prohibit any SRO from having a price test, we also proposed to amend Rule 200(g) of Regulation SHO⁷² to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt” if the seller is relying on an exception from the tick test of Rule 10a-1, or any price test of any exchange or national securities association.⁷³ We are adopting the amendment as proposed.

Rule 200(g) of Regulation SHO provides that a broker-dealer must mark all sell orders of any security as “long,” “short,” or “short exempt.”⁷⁴ Further, Rule 200(g)(2) of Regulation SHO provides that a short sale order must be marked “short exempt” if the seller is “relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association.”⁷⁵ The “short exempt” marking requirement provides a record that short sellers are availing themselves of the

⁷¹ Bai found that the Pilot had no effect on stock price reactions to negative earnings shocks. See Bai, *supra* note 20. See also, Proposing Release, 71 FR at 75072-75075 (discussing the Pilot Results).

⁷² 17 CFR 242.200(g).

⁷³ Broker-dealers would, however, continue to be required to mark sell orders as either “long” or “short” in compliance with Rule 200(g).

⁷⁴ See 17 CFR 242.200(g).

⁷⁵ See *id.* at 242.200(g)(2).

various exceptions to, or exemptions from, the application of the restrictions of Rule 10a-1 or of any price test of any exchange or national securities association.

A. Comments Summary

We received five comment letters, from the MFA, STA, UBS, NYSE, and SIFMA in response to the proposed amendment.⁷⁶ Generally, the commenters supported the Commission's proposal to remove the "short exempt" marking requirement.⁷⁷

Although the STA stated that it supports the proposal to remove the "short exempt" marking requirement in Regulation SHO, the STA commented that it believes that securities currently marked "short exempt" pursuant to Rule 203(b)(2)(ii) of Regulation SHO⁷⁸ should be marked "long" rather than "short" because marking such orders "short" "does not accurately describe the customer's ownership of the same and could cause confusion and anger from public investors when they receive confirmation of the sale of a security they understood they owned."⁷⁹ Similarly, SIFMA commented that

⁷⁶ See MFA Letter, supra note 23; STA Letter, supra note 23; UBS Letter, supra note 23; NYSE Letter, supra note 23; SIFMA Letter, supra note 23.

⁷⁷ See MFA Letter, supra note 23; STA Letter, supra note 23; UBS Letter, supra note 23. In its letter, the MFA noted that it believes broker-dealers are in the best position to raise compliance issues related to their systems and the "short exempt" marking requirement. Thus, the MFA urged the Commission to carefully consider any compliance concerns raised by broker-dealers in considering this proposal. See MFA Letter, supra note 23.

⁷⁸ 17 CFR 242.203(b)(2)(ii). Rule 203(b)(2)(ii) of Regulation SHO excepts from the locate requirement of Regulation SHO any sale of a security that a person is deemed to own pursuant to Rule 200 of Regulation SHO, provided that the broker-dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. If the person has not delivered such security within 35 days after the trade date, the broker-dealer that effected the sale must borrow securities or close out the short position by purchasing securities of like kind and quantity. Such circumstances could include the situation where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date. Another situation could be where a customer owns stock that was formerly restricted, but pursuant to Rule 144 under the Securities Act of 1933, the security may be sold without restriction. In connection with the sale of such security, the security may not be capable of being delivered on settlement date due to processing to remove the restricted legend.

⁷⁹ STA Letter, supra note 23.

its member firms would encourage the Commission to amend the definition of a “long” sale to include these types of sales “to avoid unintended consequences and mistaken perceptions by issuers and others as to the nature of the sale.”⁸⁰

In addition, SIFMA commented that rather than removing the “short exempt” marking requirement, SIFMA firms generally would prefer that the Commission preserve the “short exempt” marking requirement, specifically amending Regulation SHO to indicate that a sale should be marked “short exempt” if effected in reliance on an exception from the “locate” requirement, pursuant to Rule 203(b)(2) of Regulation SHO.⁸¹ According to SIFMA, firms “generally are of the view that preserving “short exempt” marking for such situations should assist their compliance efforts by identifying short sales for which a locate is not required to be obtained.”⁸²

The MFA and NYSE responded to our request for comment in the Proposing Release regarding whether, in the absence of price test restrictions, the marking of sell

⁸⁰ SIFMA Letter, supra note 23.

⁸¹ Id. Rule 203(b)(2) provides an exception from the locate requirement of Rule 203(b)(1) for: “(i) A broker or dealer that has accepted a short sale order from another registered broker or dealer that is required to comply with paragraph (b)(1) of this section, unless the broker or dealer relying on this exception contractually undertook responsibility for compliance with paragraph (b)(1) of this section; (ii) Any sale of a security that a person is deemed to own pursuant to §242.200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. If the person has not delivered such security within 35 days after the trade date, the broker-dealer that effected the sale must borrow securities or close out the short position by purchasing securities of like kind and quantity; (iii) Short sales effected by a market maker in connection with bona-fide market making activities in the security for which this exception is claimed; and (iv) Transactions in security futures.”

⁸² SIFMA Letter, supra note 23. SIFMA noted in its letter that, if the Commission decides not to amend the definition of a “long” sale in Rule 200(g) as suggested by SIFMA, it would strongly urge the Commission to continue to allow firms to mark sales “short exempt,” in reliance on the exception from the Regulation SHO “locate” requirement in Rule 203(b)(2)(ii) of Regulation SHO. Id. UBS also commented that we should retain the “short exempt” marking requirement to “identify certain short sale transactions as exempt from the affirmative determination requirements for regulatory and compliance requirements.” UBS Letter, supra note 23.

orders would continue to need to be transparent to market makers and specialists.⁸³

Currently, to facilitate the application of price test restrictions, market makers and specialists receive information allowing them to distinguish short sales from other sales.

In its comment letter, the MFA stated that “[i]n protecting the confidentiality of customer orders and maintaining a level playing field for all market participants, MFA supports the idea of availing order marking information only to brokers preparing order tickets.”⁸⁴ The MFA believes that the “best safeguard for maintaining the integrity of order information is by limiting order marking information to those necessary in carrying out compliance functions.”⁸⁵

NYSE, on the other hand, expressed its belief that it is “necessary that the overall short interest in a security, as well as information on whether a particular sell order introduced to the Exchange is long or short, continue to be transparent intra-day to specialists in the securities in which they are registered.”⁸⁶ NYSE noted that “[f]or a specialist, making the correct determination regarding the necessity of a dealer transaction at any given moment includes an understanding of the general market conditions in a particular security, including the actual or reasonably anticipated needs of the market. The intra-day short interest position in a security as well as whether

⁸³ See Proposing Release, 71 FR at 75078. Specifically, in the Proposing Release we stated that: “To facilitate the application of Rule 10a-1, NASD Rule 5100, and Nasdaq Rule 3350, market makers and specialists receive information allowing them to distinguish short sales from other sales. In other words, the information on whether an order is marked “long,” “short,” or “short exempt” is made transparent to market makers and specialists but not to other market participants or the public. In the absence of price test restrictions, would the marking of sell orders need to be transparent to market makers and specialists? Would there be any systems or market quality costs/benefits associated with not revealing this information to specialists and market makers?”

⁸⁴ MFA Letter, supra note 23.

⁸⁵ Id.

⁸⁶ NYSE Letter, supra note 23.

particular orders are long or short are critical pieces of information in the overall mix of factors that combine to form the “market” in that security.⁸⁷ The NYSE believes that the absence of such information would result in poorer overall market quality.⁸⁸

B. Response to Comments

We have carefully considered all the comments we received. In response to the STA’s and SIFMA’s comments regarding revising the definition of when an order should be marked “long” to include sales of securities excepted from the locate requirement pursuant to Rule 203(b)(2)(ii) of Regulation SHO, we have determined not to take such action at this time. Although these are sales of securities that a person is “deemed to own” pursuant to Rule 200 of Regulation SHO,⁸⁹ the securities will not be delivered in time for settlement of the transaction and, therefore, we believe that such sales are more appropriately marked as “short” rather than “long” sales.⁹⁰

In addition, in response to STA’s comment that the marking of these orders as “short” does not accurately describe the customer’s ownership of the same and could cause confusion and anger from public investors when they receive confirmation of the sale of a security they understood they owned, we note that the order marking requirements are to facilitate the surveillance and monitoring of compliance with other provisions of Regulation SHO, such as the borrowing and delivery requirements for long

⁸⁷ Id.

⁸⁸ See id.

⁸⁹ 17 CFR 242.200(a)-(f).

⁹⁰ Regulation SHO provides that an order can only be marked “long” if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of Rule 200 of Regulation SHO and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) It is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than settlement of the transaction. See 17 CFR 242.200(g). Thus, Regulation SHO contemplates that only those sell orders that will be available for delivery on settlement date can be marked “long.”

sales under Rule 203(a),⁹¹ and the locate requirements for short sales under Rule 203(b).⁹² Regulation SHO does not require that a broker-dealer reveal an order marking to its customer. Nor do we believe at this time that it is necessary for a customer to receive such information.

In addition, we have determined not to retain the “short exempt” marking requirement or revise the definition of when an order should be marked “short exempt” to include those circumstances in which a short sale is excepted from the locate requirements of Rule 203(b)(2) of Regulation SHO.⁹³ The “short exempt” marking requirement has only ever applied if the seller is relying on an exception from a price test. It has never applied to sales that do not have to comply with the locate requirement of Regulation SHO.⁹⁴ Today’s amendment to remove the “short exempt” marking requirement is necessitated by the fact that we are removing current price test restrictions and prohibiting any SRO from having a price test. Thus, we do not believe that it is appropriate at this time to re-define the order marking requirements of Regulation SHO as suggested by commenters. We will, however, consider separately whether further action in this area is necessary or warranted.

With respect to the MFA’s and NYSE’s comments regarding the transparency of order markings to market participants other than those broker-dealers with responsibility for compliance with the marking requirements of Regulation SHO, we have determined at this time to not take any action to limit the transparency of order markings in this

⁹¹ 17 CFR 242.203(a).

⁹² 17 CFR 242.203(b).

⁹³ 17 CFR 242.203(b)(2).

⁹⁴ See id.

way.⁹⁵ We will continue, however, to review whether further action by the Commission on this matter is necessary or warranted.

After carefully considering the comments received, we are adopting the proposed amendment without modification.

IV. Other Comments

We received eight comment letters from individual investors discussing other provisions of Regulation SHO,⁹⁶ most notably the grandfather provision of that rule.⁹⁷ In addition, these commenters expressed concerns about naked short selling. This release discusses amendments that will affect price tests and related marking requirements only. They do not relate to other provisions of Regulation SHO or naked short selling, which are the subject of other Commission rulemaking.⁹⁸

V. Paperwork Reduction Act

The adopted amendments to Regulation SHO impose a “collection of information” within the meaning of the Paperwork Reduction Act of 1995,⁹⁹ however, the collection of information is covered by the approved collection for Exchange Act

⁹⁵ Currently, which market participants are able to see the marking for a sell order is established by SRO rule and varies among the SROs.

⁹⁶ See 17 CFR 242.200 *et seq.*

⁹⁷ See letter from Joan O'Leary (Jan. 22, 2007); letter from Candice Grant (Jan. 21, 2007); letter from Roland L. Pitts (Dec. 28, 2006); letter from Charles P. Bennett, M.D. (Jan. 18, 2007); letter from Carlos Molina (Jan. 17, 2007); letter from Lars D. Roose (Feb. 11, 2007); letter from Hillary Thomas (Feb. 11, 2007); letter from H. Glenn Bagwell, Jr. (Feb. 12, 2007). These comment letters relate to File No. S7-12-06 regarding proposed amendments to Regulation SHO and were considered in connection with that rulemaking.

⁹⁸ See Regulation SHO Amendments Proposing Release, 71 FR 41710; *see also*, *supra* n.[6].

⁹⁹ 44 U.S.C. 3501 *et seq.*

Rule 19b-4.¹⁰⁰ Rule 201(a) of Regulation SHO provides that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, Rule 201(b) of Regulation SHO prohibits any SRO from having a price test. Thus, to the extent that any SRO currently has a price test, that SRO is required to amend its rules to comply with these amendments to Regulation SHO. Any such amendments will need to be filed with the Commission as proposed rule changes, pursuant to Section 19(b) of the Exchange Act¹⁰¹ and Rule 19b-4 thereunder. This collection of information, however, will be collected pursuant to Exchange Act Rule 19b-4 and, therefore, will not be a new collection of information for purposes of the amendments.

VI. Consideration of Costs and Benefits of Proposed Amendments to Rule 10a-1 and Regulation SHO

The Commission is sensitive to the costs and benefits that result from our rules. Thus, in the Proposing Release, we solicited comments related to the costs and benefits associated with the proposed amendments.¹⁰² We explicitly requested that commenters provide supporting empirical data for any positions advanced. In addition, we specifically requested comment regarding the costs and benefits of unrestricted short selling activity and any costs associated with complying with the proposed amendments, if the Commission were to adopt the proposed amendments. We also requested comment regarding any costs relating to the removal of price test restrictions adopted by the SROs. In addition, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering,

¹⁰⁰ 17 CFR 240.19b-4.

¹⁰¹ 15 U.S.C. 78s(b).

¹⁰² See Proposing Release, 71 FR at 75078-75079.

management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants.

Four commenters, the STA, UBS, SIFMA, and Amex provided comments related to the costs and benefits of the proposed rule amendments.¹⁰³ We discuss these comment letters below.

A. Removal of Price Test Restrictions

1. Benefits

In the Proposing Release, we solicited comment on any benefits that could be realized if the Commission adopts the proposed amendments, including both short-term and long-term benefits. In addition, we solicited comment regarding benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection. Only the STA submitted comments noting benefits of the proposed amendments.¹⁰⁴

In its comment letter, the STA noted that it does not believe that the proposed amendments would result in higher trading costs or wider spreads.¹⁰⁵ In addition, the STA stated that it believes the proposed amendments would lead to a reduction in surveillance and compliance costs.¹⁰⁶

We believe that this is an appropriate time to remove existing price test restrictions because current price test regulation is inconsistent across markets, potentially creates an unlevel playing field, allows for regulatory arbitrage and has not

¹⁰³ See STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23; Amex Letter, supra note 44.

¹⁰⁴ See STA Letter, supra note 23.

¹⁰⁵ See id.

¹⁰⁶ See id.

kept pace with the types of trading systems and strategies currently used in the marketplace. In addition, today's markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of undetected manipulation and permit regulators to monitor for the types of activities that Rule 10a-1 and other price tests are designed to prevent.

We believe that the removal of current price test restrictions will benefit market participants by providing market participants with the ability to execute short sales in all securities in all market centers without regard to price test restrictions. In addition, market centers will be competing for executions on a level playing field because they will not be affected by the existence or non-existence of price test restrictions.

We also believe that removing all current price test restrictions is preferable to applying different tests in different markets, which can require market participants to apply different rules to different securities depending on which market the trade is executed. Thus, we believe that the amendments will reduce confusion and compliance difficulties for market participants.

We also believe that the amendments will benefit exchanges and other market centers because market participants will no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The amendments will remove a competitive disadvantage purportedly experienced by some market centers because market participants will no longer route orders to avoid application of a market center's price test. Nor will market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test.

In addition, the amendments will result in benefits associated with systems and surveillance mechanisms because these systems and mechanisms will no longer need to be programmed to account for price test restrictions based on last sale and last bid information. We also note that in the absence of price test restrictions, new staff (compliance personnel, associated persons, etc.) will no longer need to be trained regarding rules relating to price tests. Over the long run, we believe this will likely lead to decreased training and compliance costs for market participants.

We also believe that the amendments will lead to a reduction in costs because market participants and their lawyers, both in-house and outside counsel, will no longer need to make either informal (phone calls) or formal (letters) requests for exemptions from Rule 10a-1.

In addition, we anticipate that the removal of price test restrictions may result in increased price efficiency because prices will be determined by buy and sell interest, without any artificial restraints on short selling.

2. Costs

We recognize that the amendments may result in some costs to market participants. As an aid to evaluating the costs of the proposed amendments, we solicited comment in the Proposing Release. In particular, we sought comment regarding the costs of the proposed amendments to market participants, including broker-dealers and SROs, related to systems changes to computer hardware and software, reprogramming costs, and surveillance and compliance costs, including whether these costs would be incurred on a

one-time or ongoing basis.¹⁰⁷ Four commenters, the STA, UBS, SIFMA and Amex submitted comments regarding costs associated with the proposed amendments.¹⁰⁸

In their comment letters, the STA, UBS and SIFMA noted potential reprogramming costs that market participants may incur if the Commission does not act on the proposed amendments prior to market participants reprogramming their systems in response to the new regulatory framework created by Regulation NMS¹⁰⁹ and the desire of investors and other market participants for more automated and efficient trading services.¹¹⁰ On January 24, 2007, we extended the date for all automated trading centers (both SRO trading facilities and Alternative Display Facility participants) to have fully operational Regulation NMS-compliant trading systems to July 9, 2007 (the “Regulation NMS Compliance Date”).¹¹¹ In meeting the Regulation NMS Compliance Date, market participants have been developing new systems or modifying existing systems to be Regulation NMS-compliant.

In their comment letters, STA, UBS, and SIFMA urged the Commission to act on the proposed amendments prior to the Regulation NMS Compliance Date.¹¹² In its letter, STA noted that “[i]f the SEC’s proposal is implemented subsequent to the operation of Regulation NMS to certain securities, it will require industry-wide reprogramming of Regulation NMS compliance systems during the infancy of the Rules implementation, a

¹⁰⁷ See Proposing Release, 71 FR at 75079-75080.

¹⁰⁸ See STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23; Amex Letter, supra note 44.

¹⁰⁹ See Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005).

¹¹⁰ See STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23.

¹¹¹ See Exchange Act Release No. 55160 (Jan. 24, 2007), 72 FR 4202 (Jan. 30, 2007).

¹¹² See STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23.

most sensitive time period. As a result, the immediate success of Regulation NMS could be compromised.”¹¹³ As discussed in Section IX below, these amendments will be effective immediately upon publication in the Federal Register. Thus, market participants will have notice and time prior to the Regulation NMS Compliance Date to reprogram their systems without regard to current price test restrictions.

In its comment letter, Amex stated that “[w]hile it is difficult to predict future trading activities and the resultant need for new or different regulatory programs, [its] best estimate is that there would probably be no material impact on [its] regulatory costs.”¹¹⁴ Amex noted that although staff time and technology resources would no longer be required to monitor compliance with price tests, surveillance by Amex staff of order marking violations would still be required. In addition, Amex commented that “the absence of a tick test to discourage potential “bear raids” and other manipulative activities could result in the need to devote additional resources to such regulatory programs than is currently the case.”¹¹⁵

We believe that costs associated with the amendments will be minimal because the infrastructure necessary to comply with the amendments are, for the most part, already be in place. Market participants have needed to establish or modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from all

¹¹³ STA Letter, supra note 23. In addition, in its comment letter, SIFMA urged the Commission to take steps to eliminate price test restrictions prior to the Regulation NMS Compliance Date to alleviate the necessity for firms to, in the course of instituting programming changes to meet the new requirements of Regulation NMS, program systems to comply with price test restrictions, only to be required to reverse such programming costs shortly thereafter. SIFMA stated that cost estimates for firms to program for such changes varied, from as low as approximately \$200,000 for some firms to as high as \$2 million for others. See SIFMA Letter, supra note 23.

¹¹⁴ Amex Letter, supra note 44.

¹¹⁵ Id.

price test restrictions.¹¹⁶ In addition, any further changes to systems and surveillance mechanisms or procedures will be relatively minor because the amendments will remove all price test restrictions rather than, for example, impose a modified price test. We also believe that market participants will not need to incur costs to purchase new systems, or increase staffing based solely on the implementation of the amendments.

Although we recognize that market participants may incur costs to modify, establish or implement existing or new supervisory and compliance procedures due to the amendments, these costs will be minimal because market participants already have in place supervisory or compliance procedures to monitor for trading activity that current price test restrictions are designed to deter.

We recognize that SROs that have adopted price tests will incur costs associated with removing such price tests. For example, the NASD and Nasdaq have their own bid tests that, under the amendments, will no longer be applicable.¹¹⁷ In addition, some exchanges have adopted rules in conformity with the provisions of Rule 10a-1, which will no longer be applicable. SROs may incur costs associated with the processes to remove such rules, including filing rule changes with the Commission, as well as reprogramming systems designed to enforce these rules. Although we requested

¹¹⁶ The Pilot exempts a select group of securities from price test restrictions during regular trading hours. Between the close of the consolidated tape and the open of the consolidated tape on the following day, however, all equity securities are exempted from price test restrictions. See 69 FR at 48033.

¹¹⁷ See NASD Rule 5100, available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159007939&element_id=1159006014&highlight=5100#r1159007939; Nasdaq Rule 3350, available at http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=16.

comment regarding these costs, including costs relating to preparing and filing any necessary rule changes with the Commission,¹¹⁸ we did not receive any comments.

We also recognize that the amendments may increase transaction costs, decrease quoted depth, and increase intraday price volatility, particularly in small stocks. The Pilot results suggest, however, that these changes are small in magnitude and would not significantly increase costs or reduce liquidity.¹¹⁹

B. Removal of “Short Exempt” Marking Requirement

1. Benefits

We are amending Rule 200(g) of Regulation SHO to remove the “short exempt” marking requirement.¹²⁰ Rule 200(g)(2) of Regulation SHO provides that a short sale order must be marked “short exempt” if the seller is “relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association.”¹²¹ Thus, because we are removing all current price test restrictions, as well as prohibiting any SRO from having a price test, the “short exempt” marking requirement will no longer be applicable. In addition, we note that removing the “short exempt” marking requirement will promote regulatory simplification because the marking requirement will no longer be applicable.

2. Costs

Although we sought public comment on costs, we did not receive any such comments relating to this proposed amendment. We recognize, however, that there may

¹¹⁸ See Proposing Release, 71 FR at 75079-75080.

¹¹⁹ See *id.* at 75072-75075 (discussing the results of the Pilot).

¹²⁰ 17 CFR 242.200(g).

¹²¹ See *id.* at § 242.200(g)(2).

be some costs associated with removing the “short exempt” marking requirement. Some market participants, including broker-dealers and SROs, may have to reprogram systems and update supervisory procedures due to the removal of the “short exempt” marking requirement. Sales of securities previously marked “short exempt,” however, will continue to be marked either “long” or “short.” Thus, we believe that such costs will be minor.

VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.¹²² In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.¹²³ Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

In the Proposing Release, we solicited comment on the proposed amendments’ effects on efficiency, competition, and capital formation. In addition, we requested, but did not receive, comments regarding the impact of the proposed amendments on the

¹²² 15 U.S.C. 78c(f).

¹²³ 15 U.S.C. 78w(a)(2).

economy generally pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996.¹²⁴

We have considered the proposed amendments to Rule 10a-1 and Regulation SHO in light of the standards of Section 23(a)(2) of the Exchange Act and believe the adopted amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act.

The amendments will remove the price test restrictions of Rule 10a-1¹²⁵ and provide that no price test, including any price test of any SRO, shall apply to short sales in any security. The amendments will also prohibit any SRO from having a price test. In addition, the amendments will remove the “short exempt” marking requirement of Rule 200(g) of Regulation SHO because this marking requirement applies only if the seller is relying on an exception from the tick test of Rule 10a-1 or any short sale price test of any exchange or national securities association.

Current short sale regulation is inconsistent. For example, Rule 10a-1 applies only to short sale transactions in listed securities. The NASD’s and Nasdaq’s bid tests apply only to Nasdaq Global Market securities. No price tests apply to short sales in Nasdaq Capital Market securities or securities quoted on the OTCBB or pink sheets. In addition, no price test applies to short sales of Nasdaq Global Market securities executed on exchanges trading Nasdaq securities on a UTP basis, unless the market on which the securities are being traded has adopted its own price test. Moreover, the current exceptions to, and exemptions from, the price tests for a wide range of short selling activities have limited the applicability of the restrictions contained in these rules. The

¹²⁴ Pub. L. 104-121, tit. II, 110 Stat. 857 (1996).

¹²⁵ 17 CFR 242.10a-1.

end result is inconsistent short sale regulation of securities, depending on the market where the securities are trading, and the type of short selling activity. Thus, the amendments are intended to promote regulatory simplification and uniformity by no longer permitting the current price test restrictions on short selling.

We believe that the amendments will not harm efficiency because the empirical evidence from the Pilot Results shows that the Pilot did not adversely impact price efficiency. Further, market participants will no longer have to apply different price tests to securities trading in different markets.

In addition, we believe that the amendments will not have an adverse impact on capital formation because the empirical evidence from the Pilot Results shows that the price tests have very little impact on overall market quality and, particularly in large securities, may be harmful to overall market quality.

We believe that the amendments will promote competition among exchanges and other market centers because market participants will no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The amendments will remove a purported competitive disadvantage experienced by some market centers because market participants will no longer route orders to avoid application of a market center's price test. Nor will market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test. Moreover, the amendments will level the playing field for all market participants by requiring that no price test shall apply to any short sale in any security in any market.¹²⁶

¹²⁶ Although we recognize there could conceivably be a need in the future for SROs to propose new price test restrictions, in considering whether to approve any such proposals, the Commission would, among

VIII. Final Regulatory Flexibility Analysis

The Commission has prepared the Final Regulatory Flexibility Analysis (“FRFA”), in accordance with the provisions of the Regulatory Flexibility Act (“RFA”),¹²⁷ regarding the proposed amendments to Rule 10a-1 and Regulation SHO, Rules 200 and 201, under the Exchange Act.

A. Need for the Amendments

Based on the Pilot Results as well as our review of the status of short sale regulation in the context of the current application of Rule 10a-1 and other price tests, including the exceptions to the current rules and grants of relief from Rule 10a-1 by the Commission for a wide range of short selling activities, we believe it is necessary to remove Rule 10a-1 and to amend Regulation SHO to provide that no price test, including any price test by any SRO, shall apply to short selling in any security. In addition, the amendments will prohibit any SRO from having a price test. These amendments are designed to modernize and simplify short sale regulation in light of current short selling systems and strategies used in the marketplace, while providing greater regulatory consistency to short selling. We are also removing the “short exempt” marking requirement of Regulation SHO because this requirement only applies if a seller is relying on an exception to a price test.

other things, determine whether or not such proposals are consistent with the objectives of today’s amendments. Additionally, in order for an SRO to adopt new price test restrictions pursuant to Section 19(b) of the Exchange Act, an exemption from the provisions of Rule 201 pursuant to Section 36 of the Exchange Act would be necessary.

¹²⁷ 5 U.S.C. 604.

B. Significant Issues Raised by Public Comment

The Initial Regulatory Flexibility Analysis (“IRFA”) appeared in the Proposing Release.¹²⁸ We requested comment in the IRFA on the impact the proposed amendments would have on small entities and how to quantify the impact. We received two comment letters generally discussing the impact of the proposed amendments to remove price test restrictions on small issuers,¹²⁹ which we discuss below.

C. Small Entities Subject to the Rule

The entities covered by the amendment will include small broker-dealers, small businesses, and any investor who effects a short sale that qualifies as a small entity. Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10 under the Exchange Act¹³⁰ states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to §240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. In the IRFA in the Proposing Release, we estimated that as of 2005, there were approximately

¹²⁸ See Proposing Release, 71 FR at 75081-75082.

¹²⁹ See IASBDA Letter, *supra* note 39; Amex Letter, *supra* note 44. IASBDA expressed concern that the proposed amendments might “unnecessarily force small issuers to accept an environment which is most unkind to their securities.” See IASBDA Letter, *supra* note 39. In its letter, Amex advocated for additional study of the effects of price test restrictions on small capitalization securities before the Commission removes such restrictions on these securities. See Amex Letter, *supra* note 44.

¹³⁰ 17 CFR 240.0-10(c)(1).

910 broker-dealers that qualified as small entities as defined above.¹³¹ Presently, we estimate that as of 2006 there are approximately 894 broker-dealers that qualify as small entities, as defined above.¹³²

Paragraph (e) of Rule 0-10 under the Exchange Act¹³³ states that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10. No national securities exchanges are small entities because none meets these criteria. There is one national securities association (NASD) that is subject to these amendments. NASD is not a small entity as defined by 13 CFR 121.201.

Any business, however, regardless of industry, will be subject to the amendments if it effects a short sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the amendments is not feasible.

D. Reporting, Recordkeeping, and other Compliance Requirements

We recognize that the amendments may impose some new or additional reporting, recordkeeping, or compliance costs on any affected party, including broker-dealers, that are small entities.

¹³¹ These numbers are based on OEA's review of 2005 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

¹³² These numbers are based on OEA's review of 2006 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent in their FOCUS Report filings.

¹³³ 17 CFR 240.0-10(e).

As discussed above, three commenters noted potential reprogramming costs that market participants may incur if the Commission does not act on the proposed amendments prior to the Regulation NMS Compliance Date. In meeting the Regulation NMS Compliance Date, market participants have been developing new systems or modifying existing systems to be Regulation NMS-compliant. In their comment letters, STA, UBS, and SIFMA urged the Commission to act on the proposed amendments prior to the Regulation NMS Compliance Date.¹³⁴ In its letter, STA noted that “[i]f the SEC’s proposal is implemented subsequent to the operation of Regulation NMS to certain securities, it will require industry-wide re-programming of Regulation NMS compliance systems during the infancy of the Rules implementation, a most sensitive time period. As a result, the immediate success of Regulation NMS could be compromised.”¹³⁵ As discussed in Section IX below, these amendments will be effective immediately upon publication in the Federal Register. Thus, market participants will have notice and time prior to the Regulation NMS Compliance Date to reprogram their systems without regard to current price test restrictions.

In order to comply with the Pilot when it became effective on May 2, 2005, small entities needed to modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from current price test restrictions. Thus, the systems and surveillance mechanisms required to comply with the amendments are already be in place. We believe that any necessary additional systems and surveillance changes will be small because, due to the Pilot, systems are currently programmed to exempt many

¹³⁴ See STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23.

¹³⁵ STA Letter, supra note 23.

securities from price test restrictions prior to the close of the consolidated tape and exempt all securities from price test restrictions between the close of the consolidated tape and the open of the consolidated tape on the following day.

We believe that any reprogramming costs or updating of surveillance mechanisms associated with the removal of the “short exempt” marking requirement will be minimal because sales of securities will continue to be required to be marked either “long” or “short.” The amendments will merely remove an alternative marking requirement.

E. Agency Action to Minimize the Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that will accomplish the stated objective, while minimizing any significant adverse impact on small entities. Pursuant to Section 3(a) of the RFA,¹³⁶ the Commission considered the following types of alternatives in connection with the amendments: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The amendments are intended to modernize and simplify price test regulation by removing restrictions on the execution prices of short sales contained in current price tests, such as Rule 10a-1. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the goal of the amendments. In

¹³⁶ 5 U.S.C. 603(c).

particular, the request by IASBDA and Amex for a gradual phase-in of the amendments to permit price test restrictions to continue for small securities pending further study, would cause considerable uncertainty, such as how to treat securities that episodically move between the definition of small and large capitalization. Moreover, we do not believe that such an approach would provide new results relevant to smaller securities. As we noted in the Proposing Release, while there is some evidence supporting the application of price test restrictions to smaller securities, the evidence is not strong enough to warrant its continuation in any subset of securities.¹³⁷ In addition, we note that many smaller or thinly-traded securities, such as Nasdaq Capital Market securities, and securities quoted on the OTCBB and pink sheets, are not currently subject to any price test restrictions.

Thus, we have concluded that it would be inconsistent with the goal of the amendments to phase-in small capitalization securities or to further clarify, consolidate, or simplify the amendments for small entities. Finally, the amendments will impose performance standards rather than design standards.

IX. Administrative Procedure Act

Section 553(d) of the Administrative Procedure Act (“APA”) generally provides that a substantive rule may not be made effective less than 30 days after notice is published in the Federal Register.¹³⁸ Two exceptions to the 30-day requirement, among

¹³⁷ See Proposing Release, 71 FR at 75076. See also, *supra*, note 65 (discussing a prior study by academics of price test restrictions on smaller securities).

¹³⁸ 5 U.S.C. 553(d).

others, are (i) for a substantive rule that relieves a restriction, and (ii) an agency's finding of good cause for providing a shorter effective date.¹³⁹

The amendments will remove all current restrictions on the price at which a security can be sold short. Because the amendments relieve a restriction on short selling, these amendments may be made effective less than 30 days after notice is published in the Federal Register.

In addition, we note that a number of commenters to the proposed amendments discussed potential reprogramming costs that market participants may incur if the proposed amendments are not effective prior to the Regulation NMS Compliance Date.¹⁴⁰ In meeting the Regulation NMS Compliance Date, market participants have been developing new systems or modifying existing systems to be Regulation NMS-compliant. Immediate effectiveness of these amendments is necessary to provide market participants with sufficient notice and time prior to the Regulation NMS Compliance Date to reprogram their systems without regard to current price test restrictions.

Specifically, immediate effectiveness of the amendments is expected to alleviate any necessity for market participants to, in the course of instituting programming changes to meet the requirements of Regulation NMS, program systems to comply with price test restrictions, only to be required to reverse such programming shortly thereafter. Absent immediate effectiveness, market participants may expend unnecessary time and resources programming systems to comply with price test restrictions that are being removed. Thus, the Commission finds that there is good cause

¹³⁹ See id. at 553(d)(1), 553(d)(3).

¹⁴⁰ See, e.g., STA Letter, supra note 23; UBS Letter, supra note 23; SIFMA Letter, supra note 23.

for making the amendments effective immediately upon publication in the Federal Register.

X. Statutory Authority and Text of the Amendments

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(a), 10(a), 11A, 15, 15A, 17, 17A, 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(a), 78j(a), 78k-1, 78o, 78o-3, 78q, 78q-1, 78w(a), the Commission is removing Rule 10a-1, § 240.10a-1, and amending Regulation SHO, §§ 242.200 and 201.

Text of the Amendments to Rule 10a-1 and Regulation SHO

List of Subjects in 17 CFR Parts 240 and 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.10a-1 is removed and reserved and the undesignated heading preceding the section is removed.

PART 242 — REGULATIONS M, SHO, ATS, AC AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

4. Section 242.200 is amended by revising the introductory text of paragraph (g) and removing and reserving paragraph (g)(2) to read as follows:

§ 242.200 Definition of “short sale” and marking requirements.

* * * * *

(g) A broker or dealer must mark all sell orders of any equity security as “long” or “short.”

* * * * *

5. Section 242.201 is added to read as follows:

§ 242.201 Price test.

(a) No short sale price test, including any short sale price test of any self-regulatory organization, shall apply to short sales in any security.

(b) No self-regulatory organization shall have any rule that is not in conformity with, or conflicts with, paragraph (a) of this section.

By the Commission.

Nancy M. Morris
Secretary

Dated: June 28, 2007


By: J. Lynn Taylor
Assistant Secretary

Commissioner Casey
Not Participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55978 / June 28, 2007

Admin. Proc. File No. 3-12482

In the Matter of the Application of

FLORENCE SARAH POLLARD
c/o McColloch & Campitiello, LLP
5900 LaPlace Court, Suite 100
Carlsbad, California 92008

For Review of Disciplinary Action Taken by

NASD

ORDER DISMISSING APPEAL

Florence Sarah Pollard, formerly a registered representative at Equitrade Securities Corporation ("Equitrade"), has appealed from an NASD Hearing Panel decision fining her \$5,000 and suspending her for six months in a principal capacity.

In December 2005, NASD's National Adjudicatory Council ("NAC") issued an opinion reversing an earlier Hearing Panel decision in favor of Pollard. The NAC found that Pollard had violated NASD Conduct Rules 2460 and 2110 ^{1/} by procuring payments for Equitrade from issuers in exchange for making markets in the issuer's stock (the "December 2005 Decision"). The NAC remanded the case to the Hearing Panel to determine the appropriate sanction.

In September 2006, the Hearing Panel issued its decision imposing the sanctions set forth above (the "Remand Decision"). The transmittal letter accompanying service of the Remand

^{1/} NASD Conduct Rule 2460 provides, in relevant part, that "[n]o . . . person associated with a member shall accept any payment or other consideration, directly or indirectly, from an issuer of a security . . . for publishing a quotation, acting as market maker in a security, or submitting an application in connection therewith."

NASD Conduct Rule 2110 provides that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

Decision on Pollard informed her that she could "appeal to the NAC if [she] disagree[d] with this Remand Decision by filing a Notice of Appeal within 25 calendar days after service of the Remand Decision upon [her] [in accordance with the procedures] set forth in Conduct Rule 9311." ^{2/} NASD further advised Pollard that the Hearing Panel decision would "become the final decision of NASD 45 days after service of the Remand Decision upon [her] unless . . . [she] appeal[ed] to the . . . NAC, or the NAC calls the Remand Decision for review." ^{3/} Instead, Pollard applied for Commission review of the Remand Decision on November 14, 2006.

Pollard's appeal must be dismissed because she failed to exhaust her administrative remedies by not first appealing the Hearing Panel's sanction determination to the NAC. Under NASD Rule 9311(a), Pollard had twenty-five days after service of the Remand Decision to appeal its sanction determination to the NAC. Pollard was informed by NASD of her right to appeal to the NAC. She was further informed that the Remand Decision would "become the final decision of NASD . . . unless . . . [she] appeal[ed] to the . . . NAC." Pollard chose not to appeal the Hearing Panel's sanction determination to the NAC.

The precedent on this issue is well settled: "It is clearly proper to require that a statutory right to review be exercised in an orderly fashion, and to specify procedural steps which must be observed as a condition to securing the review." ^{4/} NASD's rules are designed to provide for a timely reexamination by the NAC of decisions of various hearing panels before NASD's action can be brought before us for review. To allow the bypassing of the NAC in cases such as that presented here, "would tend to destroy the effectiveness of these procedures." ^{5/}

^{2/} NASD Rule 9311(a) provides, in relevant part, that a respondent "may file a written notice of appeal within 25 days after service of a decision issued" by an NASD Hearing Panel." Rule 9311(b) directs that this appeal be made to the NAC.

^{3/} Evidence submitted by NASD, including copies of a fax receipt and a Federal Express airbill, establishes that NASD sent copies of the Remand Decision to Pollard's attorney on September 18, 2006. Pollard does not dispute this.

^{4/} Royal Secs. Corp., 36 S.E.C. 275, 277 (1955). See also Jeffrey A. King, Securities Exchange Act Rel. No. 52,571 (Oct. 7, 2005), 86 SEC Docket 1439, 1443 (emphasizing that we "will not consider an application for review if the applicant failed to follow NASD procedures"); David I. Cassuto, 56 S.E.C. 565 (2003) (same); Gary A. Fox, 55 S.E.C. 1147 (2002) (same); see also Calvin David Fox, Exchange Act Rel No. 54,840 (Nov. 30, 2006), 89 SEC Docket 1282, 1284 (appeal dismissed for failing to exhaust New York Stock Exchange remedies); MFS Secs. Corp., 56 S.E.C. 380 (2003), aff'd, 380 F.3d 611 (2d Cir. 2004) (same).

^{5/} Royal Secs. Corp., 36 S.E.C. at 277.

Pollard states that she is not seeking review of the Hearing Panel's sanction determination but, rather, the December 2005 Decision finding liability. Pollard argues, however, that, "[s]ince no party has appealed the sanction award within the applicable appeal period, the decision on remand constitutes a final disciplinary sanction in this action . . . [and, therefore,] [t]his matter is subject to review by the Securities and Exchange Commission pursuant to NASD Rule 9370 6/ and SEC Rule 420." 7/

Pollard misconstrues the scope of our jurisdiction. Exchange Act Section 19(d)(1) authorizes us to hear appeals of "final disciplinary sanctions" imposed by self-regulatory organizations, including NASD, on its members or associated persons. 8/ Exchange Act Rule 19d-3 9/ directs that "[a]pplications to the Commission for review of any final disciplinary sanction . . . shall be made pursuant to Rule 420 of the Commission's Rules of Practice." Rule of Practice 420(a)(I) provides that "[a]n application for review by the Commission may be filed by any person who is aggrieved by a determination of a self-regulatory organization with respect to any . . . final disciplinary sanction." The December 2005 Decision did not impose a final disciplinary sanction but merely made findings that Pollard had violated NASD rules. As Pollard concedes, the Remand Decision imposed the final disciplinary sanction against her, not the December 2005 Decision. Before filing her appeal with the Commission, Pollard was required to appeal the Remand Decision to the NAC.

Pollard argues, however, that NASD Rule 9370(a) permits a respondent to apply for review to the Commission if he or she was aggrieved by "final disciplinary action pursuant to the Rule 9200 Series [Hearing Panel actions] or the Rule 9300 Series [NAC review proceedings]" (emphasis added). Pollard notes that the "Rule 9200 Series" refers to hearing panel disciplinary proceedings, and that the "Rule 9300 Series" applies to NAC reviews of hearing panel decisions. Because Rule 9370(a) is written in the disjunctive, Pollard argues, a party may apply to the Commission for review when aggrieved by a final decision issued pursuant to either set of rules. Since the Remand Decision became final once she failed to appeal it, and the NAC failed to call it for review within the requisite time period, Pollard reasons, she had the option under Rule 9370 of appealing directly to the Commission.

6/ NASD Procedural Rule 9370(a) states, in relevant part, that "[a] Respondent aggrieved by final disciplinary action pursuant to the Rule 9200 Series [Hearing Panel actions] or the Rule 9300 Series [NAC actions] may apply for review by the Commission pursuant to Section 19(d)(2) of the Act."

7/ Rule of Practice 420, 17 C.F.R. § 201.420, sets out the procedures for appealing a self-regulatory organization decision to the Commission.

8/ 15 U.S.C. § 78s(d)(1).

9/ 17 C.F.R. § 240.19d-3.

Such a reading of Rule 9370 would fly in the face of the long-standing Commission precedent discussed above. It is also an unnecessary reading. The use of the disjunctive in Rule 9370 clarifies that a party may appeal to the Commission whether they were aggrieved by a decision in the Rule 9200 Series (because a hearing panel found against such party and the party's appeal to the NAC was unsuccessful) or by the Rule 9300 Series (because, although the party prevailed before the hearing panel and therefore was not aggrieved during the Rule 9200 Series proceeding, Enforcement appealed the decision to the NAC or the NAC called it for review and the party was aggrieved by a subsequent decision pursuant to the Rule 9300 Series).

We decline to construe NASD rules in a way that would disturb the long-settled and well-justified policy of requiring people to exhaust the full administrative process at NASD. Prior to any appeal here, Pollard was required to appeal the Remand Decision to the NAC. If she had then decided to appeal the NAC's ruling to us, she could have, at that time, raised any issue raised in the course of the proceeding, including her challenge to the December 2005 Decision. As NASD correctly pointed out in its motion to dismiss Pollard's appeal, Pollard's failure to follow this established procedure frustrates "an essential goal of an orderly appeal process: allowing the lower body to articulate its rationale or correct mistakes."

Accordingly, IT IS ORDERED that the appeal by Florence Sarah Pollard be, and it hereby is, dismissed.

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

Nancy M. Morris
Secretary


By: Florence E. Harmon
Deputy Secretary

Commissioner Casey
Not Participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55989 / June 29, 2007

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2613 / June 29, 2007

INVESTMENT COMPANY ACT OF 1940
Rel. No. 27880 / June 29, 2007

Admin. Proc. File No. 3-12559

In the Matter of

TRAUTMAN WASSERMAN & COMPANY, INC.,
GREGORY O. TRAUTMAN,
SAMUEL M. WASSERMAN,
MARK BARBERA,
JAMES A. WILSON, JR.,
JEROME SNYDER,
and
FORDE H. PRIGOT

ORDER DENYING
PETITION FOR
INTERLOCUTORY REVIEW

I.

Pending before an administrative law judge are proceedings against Trautman Wasserman & Company, Inc., Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder, and Forde H. Prigot (together, "Respondents"). We issued an interim stay on April 17, 2007 to preserve the status quo ante of the matter while we considered the merits of three motions filed before the Commission. ^{1/} Having granted the first two motions in

^{1/} See Trautman Wasserman & Co., Inc., Order Granting Interim Stay, Admin. Proc. File No. 3-12559 (April 17, 2007).

in separate orders, 2/ we now consider respondent Barbera's interlocutory request to dismiss the proceedings against him.

II.

The Order Instituting Proceedings ("OIP") in this case was issued on February 5, 2007 and alleged that Respondents engaged in late trading and deceptive market timing that resulted in numerous violations of the securities laws. The OIP authorized public administrative proceedings against Respondents pursuant to Section 15(b) of the Securities Exchange Act of 1934, Section 9(b) of the Investment Company Act of 1940, and Section 203(f) of the Investment Advisers Act of 1940. 3/ Cease-and-desist proceedings against Respondents under Section 8A of the Securities Act of 1933, Section 21C of the Exchange Act, and Section 9(f) of the Investment Company Act were also authorized. 4/

On March 13, 2007, the law judge granted an earlier application by the New York Attorney General ("NYAG"), made pursuant to Rule of Practice 210(c)(3), 5/ to stay the proceeding until the conclusion of parallel criminal proceedings against Scott A. Christian, who is expected to appear as a witness in this administrative proceeding, and respondent Wilson. However, the law judge lifted the stay by order dated March 23, 2007 in response to a motion by respondent Barbera in which he pointed out that the cease-and-desist provision in Exchange Act Section 21C(b) provides that "[t]he notice instituting proceedings . . . shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or later date

2/ See Trautman Wasserman & Co., Inc., Order Dismissing Cease-and-Desist Proceedings Against Barbera, Securities Exchange Act Rel. No. 55848, __ SEC Docket __ (June 1, 2007); Trautman Wasserman & Co., Inc., Order Granting Stay, Admin. Proc. File No. 3-12559 (June 1, 2007).

3/ 15 U.S.C. §§ 78o(b), 80a-9(b), 80b-3(f).

4/ 15 U.S.C. §§ 77h-1, 78u-3, 80a-9(f). The OIP seeks cease-and-desist relief under Securities Act Section 8A and Exchange Act Section 21C against Trautman Wasserman & Company, Inc.; under Securities Act Section 8A, Exchange Act Section 21C, and Investment Company Act Section 9(f) against Trautman, Wasserman, and Wilson; and under Exchange Act Section 21C against Snyder and Prigot. Cease-and-desist proceedings against Barbera under Securities Act Section 8A, Exchange Act Section 21C, and Investment Company Act Section 9(f) were dismissed. See Trautman Wasserman & Co., Inc., Order Dismissing Cease-and-Desist Proceedings Against Barbera, *supra* note 2. The proceedings instituted against Barbera pursuant to Exchange Act Section 15(b) and Investment Company Act Section 9(b) remain.

5/ 17 C.F.R. § 201.210(c)(3).

is set by the Commission with the consent of any respondent so served." ^{6/} In her March 23 order, the law judge set a hearing date for all respondents of April 13, 2007, a date sixty days after Barbera was served with the OIP.

On March 28, 2007, the Division of Enforcement ("Division") notified the law judge by letter that it intended to file a motion with the Commission to withdraw those portions of the OIP that seek cease-and-desist relief against Barbera. On March 30, 2007, following a prehearing conference, the law judge denied the NYAG's request to reconsider her refusal to stay the case. However, the law judge noted in her order that all Respondents except Barbera objected during the conference to commencing the hearing within sixty days and that they voiced concerns that the April 13 hearing date would not allow them sufficient time to review the large number of documents they expected to receive from the NYAG and to prepare their defenses. The law judge ordered that the April 13, 2007 hearing be rescheduled to June 4, 2007.

On April 5, 2007, the Division stated in a letter to the law judge that, given her ruling to postpone the hearing until June 4, the Division had decided not to move the Commission to withdraw the cease-and-desist proceedings against Barbera. The same day, the NYAG notified the law judge by letter that Wilson and Christian had both entered guilty pleas in the NYAG's parallel criminal cases and that sentencing for both defendants was expected to be completed by June 25, 2007; ^{7/} the NYAG therefore asked that the administrative hearing be conducted no sooner than June 25, 2007. On April 6, 2007, Barbera filed a motion with the law judge arguing again that he was entitled to a hearing within sixty days of service of the OIP.

On April 9, 2007, the law judge issued an order denying the NYAG's request to postpone the hearing, stating that Wilson's guilty plea eliminated the NYAG's strongest support for a stay. The law judge therefore also ordered that the Division make its complete investigative file available to respondents. She also clarified that her postponement of the hearing date to June 4, 2007 was dependent upon the Division filing a motion to withdraw those portions of the OIP that sought cease-and-desist relief against Barbera. Her order stated that unless the Division filed such a motion by April 11, 2007, a hearing as to Barbera would begin April 13, 2007.

On April 10, 2007, the Division filed a motion before the Commission seeking to withdraw the cease-and-desist proceedings against Barbera, arguing that withdrawal of those proceedings would permit the Division to proceed against all respondents at one hearing, thereby

^{6/} 15 U.S.C. § 78u-3(b). The cease-and-desist provisions in Securities Act Section 8A(b), 15 U.S.C. § 77h-1(b), and Investment Company Act Section 9(f)(2), 15 U.S.C. § 80a-9(f)(2), contain identical requirements.

^{7/} Court records indicate that sentencing of both defendants was, in fact, completed by this date. See People v. James A. Wilson, Jr., Indictment No. 01488-2006 (N.Y. Sup. Ct., N.Y. County, Crim. Term); People v. Scott A. Christian, No. 03409-2005 (N.Y. Sup. Ct., N.Y. County, Crim. Term).

avoiding substantial prejudice to the Division's case-in-chief. The same day, the law judge issued an order cancelling Barbera's April 13 hearing and confirming that a hearing as to all respondents would commence on June 4, 2007. Also on April 10, 2007, the NYAG filed a motion with the Commission requesting that these proceedings be stayed pending the outcome of its criminal cases against Wilson and Christian.

As noted above, on April 17, 2007, we issued an interim stay of these proceedings while we awaited the filing of any opposing and reply briefs. Barbera opposed both pending motions and in his opposition to the Division's motion simultaneously moved to dismiss the entire proceeding against him. We granted the Division's motion to dismiss the cease-and-desist proceedings against Barbera. ^{8/} We also granted the NYAG's motion, staying the proceedings until June 25, 2007 but requiring the Division in the interim to make its investigative file available to Respondents, with the exception of those documents identified as potentially prejudicial to the NYAG's criminal cases. ^{9/}

III.

Commission Rule of Practice 400(a) provides that "[p]etitions by parties for interlocutory review are disfavored." ^{10/} The Commission adopted this language "to make clear that petitions for interlocutory review . . . rarely will be granted." ^{11/} When a law judge, prior to publication of the initial decision, issues a ruling in a case with which a party takes issue, the Commission will review that ruling "only in extraordinary circumstances." ^{12/} Where, as here, there is no ruling by the law judge to consider, the Commission will consider a party's interlocutory petition for review only if the petition meets the same stringent standard. For the reasons articulated below, we find that Barbera has not presented the Commission with sufficient reason to warrant our intervention at this early stage in the proceeding.

^{8/} See supra notes 2 & 4.

^{9/} Trautman Wasserman & Co., Inc., Order Granting Stay, supra note 2.

^{10/} 17 C.F.R. § 201.400(a). But cf. Rule of Practice 210(c)(3), 17 C.F.R. § 201.210(c)(3) (providing that the Commission may grant criminal prosecutorial authorities leave to participate in a proceeding on a limited basis for the purpose of requesting a stay during the pendency of a criminal investigation or prosecution arising out of the same or similar facts at issue in the administrative proceeding, and noting that, "[u]pon a showing that such a stay is in the public interest or for the protection of investors, the motion for a stay shall be favored").

^{11/} Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, Exchange Act Rel. No. 49412, 82 SEC Docket 1744, 1749 (Mar. 12, 2004).

^{12/} Rule of Practice 400(a), 17 C.F.R. § 201.400(a).

In his petition, Barbera argues that "[t]he Division's pattern of improper behavior throughout this investigation and in prosecution of this OIP warrants dismissal" of the proceedings against him. Barbera alleges that this "pattern of improper behavior" is demonstrated by three things, which we discuss in turn. ^{13/}

Barbera alleges that Division attorneys questioned three witnesses in on-the-record interviews in a manner that was "improper, over-the-top and intended to intimidate witnesses." Barbera adduced excerpts of transcripts of the testimony of respondents Forde Prigot and Jerome Snyder and a third witness not named as a respondent, which purportedly demonstrated that Division counsel engaged in questionable handling of witnesses. The Division, in turn, adduced an additional transcript excerpt that it claims demonstrates the opposite. Barbera has neither alleged nor shown how any of the Division's alleged misconduct resulted in prejudice to him, and our own review of the transcripts adduced thus far does not lead us to conclude that the Division's questioning of witnesses caused Barbera to suffer any prejudice. The testimony adduced does not indicate, and Barbera does not argue, that the witnesses made statements that were adverse to Barbera; nor does Barbera claim that any witness changed his or her testimony because of the Division's questioning. ^{14/} Barbera has not demonstrated either by analysis or citation to any legal authority that dismissal of the entire proceeding against him is the necessary or appropriate sanction even if such prejudice existed.

Barbera also alleges that the Division misled the law judge as to its intentions with regard to withdrawing the cease-and-desist proceedings against Barbera. He points out that the Division advised the law judge twice that it intended to "promptly file a motion with the Commission" seeking to amend the OIP and withdraw the cease-and-desist proceedings. Barbera argues that, in ultimately denying his request for an April 13 hearing date, the law judge placed "full reliance and trust" on the stated intention of the Division.

Our review of the record indicates that the law judge's March 30 order was unclear whether the Division's withdrawal of the cease-and-desist provisions was a predicate to her decision. The law judge herself recognized that her order may have lacked clarity on this point, noting in her April 9, 2007 order, "I apologize to the Division because my March 30, 2007 order

^{13/} In a footnote to his motion, Barbera raises an additional argument. He notes, without further elaboration, that dismissal is warranted because "[t]he OIP, on its face, fails to allege facts demonstrating that Mr. Barbera acted with fraudulent intent or severe recklessness." We find no merit to this argument. The OIP alleges a number of facts that, if proven at the hearing, could support a finding that Barbera acted with scienter. See, e.g., ¶¶ 4, 31, 38, 40, 44, 60 - 64, Trautman Wasserman & Co., Inc., Order Instituting Proceedings, Admin. Proc. File No. 3-12559 (Feb. 5, 2007).

^{14/} We note, too, that neither Prigot nor Snyder have taken issue with the manner in which their testimony was taken.

was not clear that the cease-and-desist provisions must be stricken at least as to Barbera." ^{15/} The Division promptly filed its motion to withdraw the cease-and-desist proceedings after the law judge clarified her position. In any event, even if we accepted Barbera's characterization of the Division's conduct, Barbera has failed to explain, and we fail to see, why such conduct would warrant dismissal of the entire proceeding.

Barbera next argues that the Division engaged in improper conduct in connection with the institution of an investigation of his former counsel, Leon Borstein, by the Commission's Office of the General Counsel ("OGC") and by the subsequent subpoena of Borstein by the Division to appear as a witness against Borstein's current client, respondent Gregory Trautman. In his motion to dismiss, Barbera argues that the investigation and subpoena created a conflict of interest that "initially deprived and subsequently limited Mr. Barbera's access to counsel of his own choosing."

According to party filings, the alleged conflict between Barbera and Borstein apparently first arose on May 9, 2006, when two witnesses, Jeffrey and Lisa Augen, testified in interviews conducted by the Division that Borstein had attempted to tamper with their prospective testimony. In discussing this evidence, we express no view as to the ultimate veracity of the testimony, or to its admissibility or probative value in any proceeding. OGC contacted Borstein on January 17, 2007 and requested that he appear for an interview pursuant to Rule of Practice 102(e). ^{16/} Borstein withdrew from representing Barbera shortly before the OIP was filed in this matter on February 5, 2007. On April 13, 2007, the Division sent Borstein a letter

^{15/} Barbera speculates that the law judge's apology was intended as a "polite rebuke" and to "soften the blow and her criticism." The language of the March 30 order does not support this speculation.

Given the pace at which certain parties have importuned the law judge, and the tenor of their submissions, it is not surprising that one of the law judge's rulings may have been ambiguous. Moreover, our review of the pleadings related to the motions before us suggests that the law judge may have been burdened additionally by arguments that failed to articulate legal theories, cite relevant legal authority, or marshal relevant facts, and that introduced copious amounts of extraneous materials as exhibits. Such tactics are not an appropriate use of the Commission's adjudicatory processes, and we note that Rules of Practice 111 and 180, 17 C.F.R. §§ 201.111 and 201.180, grant the law judges wide latitude to regulate the course of the proceeding and the conduct of the parties and their counsel.

^{16/} 17 C.F.R. § 201.102(e). Rule 102(e) authorizes the Commission to deny persons temporarily or permanently the privilege of appearing or practicing before the Commission if they are found (i) not to possess the requisite qualifications to represent others; or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) to have wilfully violated the securities laws or regulations.

informing him that it intended to call Borstein as a witness in this matter seeking his testimony with regard to his communications with the Augens and with Gregory Trautman. 17/

Barbera argues in his moving papers that the Division is at fault for "causing" OGC to initiate an investigation into the allegations against Borstein. We note first that the Division did not "cause" the investigation. On the facts before us, it appears that the investigation was prompted by the Augens' statements. Moreover, OGC – not the Division – is the office charged with responsibility "for the conduct of administrative proceedings relating to the disqualification of lawyers from practice before the Commission." 18/ OGC discharges that responsibility by conducting an investigation and then making a recommendation to the Commission. We bear the ultimate responsibility for deciding whether to authorize Rule 102(e) proceedings against an attorney. 19/

With respect to Barbera's argument that he was "initially deprived" of counsel of his choosing, we note that respondents in Commission proceedings do not enjoy an absolute right to counsel of their original choosing when a conflict of interest with that attorney threatens the integrity of Commission processes. 20/ Although Barbera asserts that his "access to counsel" was limited, this assertion appears to be inconsistent with representations made by Barbera's current attorney, who has had access to Borstein and who has been in contact with Borstein, gathering information with which to prepare this motion. 21/

17/ On the facts before us here, it is not entirely clear that a conflict exists between Borstein and his former client, Barbera. The Augens' testimony adduced before us does not refer to Barbera; it focuses on alleged discussions with Borstein regarding his current client, Gregory Trautman. The Division's subpoena anticipates Borstein's testimony as to the "conduct and scienter of Mr. Trautman." The relationship between Borstein and Trautman, however, is not currently before us.

18/ 17 C.F.R. § 200.21(a).

19/ See Rule of Practice 200(a)(1), 17 C.F.R. § 201.200(a)(1).

20/ See Clarke T. Blizzard, Advisers Act Rel. No. 2032, 77 SEC Docket 1515, 1520 (Apr. 24, 2002) ("[W]e are sensitive to the rights of individuals to be represented by the attorney of their choice. However, this is not an absolute right. Here, the right to counsel of one's choice is outweighed by the necessity of ensuring that our administrative proceeding is conducted with a scrupulous regard for the propriety and integrity of the process.") (citing Wheat v. United States, 486 U.S. 153, 164 (1988)).

21/ For example, Barbera's current counsel represented in Barbera's reply brief that he contacted Borstein and asked him "what he said during his investigative testimony." Barbera's counsel deduced that Borstein's testimony is unlikely to be useful to the

(continued...)

In his reply brief, Barbera switched course and introduced new theories as to how the Division's conduct with respect to OGC's investigation and the Division's issuance of a subpoena harmed Barbera. Because these theories are raised for the first time in Barbera's reply brief, the Division has not had an opportunity to address them. Nevertheless, our review of these theories leads us to conclude that they lack merit.

In his reply, Barbera argues that, during the "Wells" process 22/ in August and September of 2006, the Division engaged in misconduct by purposefully concealing the alleged conflict of interest between Barbera and Borstein that had been raised by the Augens' testimony. The Division's failure to disclose the alleged conflict, Barbera argues, deprived him of the effective assistance of counsel generally because, Barbera believes, the Division must have viewed Borstein as "untrustworthy." According to Barbera, the Division omitted "any reference to Mr. Augen in the Wells call to avoid tipping off Mr. Borstein about the Augens' testimony and previewing the Division's belief that Mr. Borstein had engaged in witness tampering and obstruction."

Barbera's assertion is speculative. Even if we accepted it for the sake of argument, parties in adversarial proceedings may view with skepticism the position asserted by opposing counsel. In the absence of a clear showing of bad faith, courts must presume that all parties, and in particular government officials, conduct themselves in good faith. 23/ Barbera has not made any showing that the Division acted in bad faith.

21/ (...continued)

Division at the hearing and argues that the Division, therefore, has no motive to subpoena Borstein as a witness other than to remove Borstein from the case. Whether Borstein's testimony is useful is an issue that the law judge will decide after having an opportunity to consider the testimony and its probative value in the full context of the proceeding.

22/ Title 17, Part 202 of the Code of Federal Regulations provides that persons involved in preliminary or formal investigations by the Commission may request that the Division inform them of the general nature of the investigation and "may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation." 17 C.F.R. § 202.6(c). The Division forwards such submissions to the Commission if it recommends that the Commission commence an enforcement proceeding. *Id.* This is known as the "Wells" process.

23/ See United States v. Chem. Found., 272 U.S. 1, 14-15 (1926) ("[I]n the absence of clear evidence to the contrary, courts presume that [public officers] have properly discharged their official duties."); Alaska Airlines v. Johnson, 8 F.3d 791, 795 (Fed. Cir. 1993) (stating that the presumption of good faith "stands unless there is 'irrefragable proof to the contrary'") (citing Torncello v. United States, 681 F.2d 756, 770 (Ct. Cl. 1982)).

Barbera also misconstrues the nature of the Wells process when he argues that he somehow was deprived improperly of the effective assistance of his counsel when the Division failed to refer to the Augens in inviting Barbera to submit a Wells filing. As the governing regulations make clear, a person involved in an investigation may – but need not – submit a written statement to the Commission setting forth his position regarding the subject matter of the investigation. 24/ The Division may, in its discretion, "advise such persons of the general nature of the investigation" 25/ The Division was under no obligation to inform Barbera of every relevant allegation; the Division's decision during the Wells process to withhold information about certain facts, such as the Augens' testimony, does not give rise to any right or remedy. 26/ Barbera's right to notice of the charges against him commences only after proceedings are authorized and the OIP is issued. 27/ Barbera has retained new counsel to represent him in his defense of these proceedings, curing any alleged harm he may have suffered because of

24/ See 17 C.F.R. § 202.6(c).

25/ Id.

26/ Barbera cites United States v. Stringer, 408 F. Supp. 2d 1083, 1092 (D. Or. 2006), in support of his argument that the Division deserves chastisement "for taking advantage of a counsel's conflict of interest to the detriment and prejudice of individuals being investigated." However, Stringer is inapposite. The Stringer court found that, in certain circumstances, "[g]overnment interference with a defendant's relationship with his attorney may render the counsel's assistance so ineffective as to violate the defendant's Fifth Amendment right to due process of law." 408 F. Supp. 2d at 1092. However, this right is violated only when "the intrusion substantially prejudices the defendant." Id., citing United States v. Irwin, 612 F.2d 1182, 1185 (9th Cir. 1980). As examples of government conduct that can cause such substantial prejudice, the Stringer court cites "using evidence gained through the interference against the defendant at trial, using confidential information pertaining to defense plans and strategy, causing the defendant to lose confidence in his or her attorney, and other actions intended to give the prosecution an unfair advantage at trial." 408 F. Supp. 2d at 1092-93. Barbera has not demonstrated that the Division engaged in any analogous conduct or that he suffered substantial prejudice as a result.

27/ See 5 U.S.C. §§ 551, 554 (stating that persons are entitled to notice of an agency hearing, including the matters of fact and law asserted, in an agency adjudication, which is defined as an agency process resulting in an order of final disposition); Rule of Practice 200(a), 17 C.F.R. § 201.200(a) ("Whenever an order instituting proceedings is issued by the Commission, appropriate notice thereof shall be given to each party to the proceeding . . .").

Borstein's alleged conflict. 28/ Even if Barbera had shown that he had been prejudiced by the alleged conflict between Borstein and himself, he has not demonstrated that the appropriate remedy for that prejudice is complete dismissal of the case against him.

Barbera raises other issues in his reply brief that were not introduced in his original motion and that the Division has not had an opportunity to address. He alleges that the Division withheld "critical information" about the request for a stay filed by the NYAG; specifically, he notes that the Division had been producing some Trautman Wasserman documents to respondents in a related case, Warren Lammert, 29/ and therefore should not have opposed disclosure of those same documents to the respondents in this case. Barbera also alleges that for a total of four business days in March and six business days in April, the Division "flouted" the law judge's order to produce its entire investigative file.

These allegations fail to offer support for his argument that the proceedings against him must be dismissed. It is not clear from the record that the Division espoused contrary positions regarding the release of documents in the current case and in the related Lammert case. 30/ Moreover, given the volume of available discovery in the Division's investigative file and the pace and number of motions and orders filed in this case regarding discovery and other matters, the record does not demonstrate that the Division acted in bad faith with respect to making its investigative file available to Respondents. In addition, Barbera has not shown how the alleged

28/ Borstein informed the Commission on February 9, 2007 that "[s]hortly before the Order [Instituting Proceedings]" he had resigned from representing Barbera. Barbera's current counsel appeared on the service list of a Division filing on February 14, 2007.

29/ Admin. Proc. File No. 3-12386 (OIP filed July 31, 2006).

30/ In order to clarify which documents the NYAG sought to protect from disclosure pursuant to its stay request, we issued an order to the respondents in this case and in the Lammert case, as well as to the NYAG and the Division, directing them to advise us as to what documents had been made available to respondents in both cases and what documents the NYAG sought to temporarily sequester. See Warren Lammert and Trautman Wasserman & Co., Inc., Order Directing Additional Briefing, Admin. Proc. File Nos. 3-12386, 3-12559 (Apr. 27, 2007). We determined that the NYAG does not generally object to sharing the Trautman Wasserman file with both sets of respondents, but seeks to protect from disclosure a "small segment" of documents in the Division's file that have not yet been disclosed to any respondent, disclosure of which the NYAG believes could prejudice its criminal cases. The Division does not appear to have misrepresented its position, which was generally to support the NYAG's request for a stay in whatever capacity the NYAG believed would best protect its cases from prejudice.

Division misconduct harmed him. 31/ We stayed the proceeding until June 25, 2007 with the exception that the Division must make its entire investigative file available to Respondents, but for the small segment of materials the NYAG identified as potentially prejudicial to its parallel criminal cases. 32/

In sum, based upon our review of Barbera's motion and accompanying documentation, we find that Barbera has not shown that any of the alleged misconduct he attributes to the Division warrants dismissal. Barbera argues that the "pattern of misconduct justifies a dismissal of all allegations against Mr. Barbera," suggesting that although no single incident of alleged misconduct may be enough to support his motion, the aggregate of many such incidents might be sufficient. However, Barbera has not shown that any single example of alleged misconduct, even if it occurred as he alleges, resulted in any harm at all; thus, even if we consider his allegations in the aggregate, Barbera still has not demonstrated any prejudice to himself, much less that such prejudice is sufficient to justify the extreme remedy of dismissal of all proceedings. We find that Barbera has not presented the Commission with a sufficient basis to overcome the substantial disfavor with which we view interlocutory motions, especially during this early stage of the proceeding. We therefore deny Barbera's petition to dismiss the proceedings instituted against him pursuant to Exchange Act Section 15(b) and Investment Company Act Section 9(b).

Accordingly, it is ORDERED that Barbera's interlocutory motion to dismiss the administrative proceedings against him is denied.

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

Nancy M. Morris
Secretary


By: Florence E. Harmon
Deputy Secretary

31/ See Rule of Practice 230(h), 17 C.F.R. § 201.230(h) (providing that, if the Division is required to make available to respondent a witness statement and fails to do so, "no rehearing or redecision of a proceeding already heard or decided shall be required unless the respondent establishes that the failure to turn over the statement was not harmless error").

32/ See Trautman Wasserman & Co., Inc., Order Granting Stay, Admin. Proc. File No. 3-12559 (June 1, 2007).

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55987 / June 29, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 2627 / June 29, 2007

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA and
ROSEMARY MEYER, CPA

CORRECTED ORDER DENYING
RESPONDENTS' MOTIONS FOR
SUMMARY DISPOSITION
AND ORAL ARGUMENT

Kevin Hall and Rosemary Meyer move for summary disposition. Respondents assert that the Commission should dismiss this proceeding without prejudice because they did not have effective representation of counsel during the investigation and Wells process and that, in part as a result, the Division overlooked exculpatory evidence in recommending that we institute this proceeding. Respondents also complain that the Division was tardy in producing to them certain portions of its investigatory file. They further ask for an extension of time to review these late-produced documents.

Summary disposition does not lie. Rule of Practice 250(b) provides that a "hearing officer may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 1/ Rule of Practice 250(a) further provides that "[i]f the interested division has not completed presentation of its case in chief, a motion for summary disposition shall be made only with leave of the hearing officer." 2/ Respondents have failed to demonstrate that there is no genuine dispute with respect to any material fact alleged in the Order Instituting Proceedings or that they are entitled to an order as a matter of law.

Moreover, a motion for summary disposition generally should be made to the hearing officer, and, in any event, cannot be made before the Division finishes its case in chief, absent leave of the hearing officer. Respondents have not sought such leave. Respondents suggest that

1/ 17 C.F.R. § 201.250(b).

2/ 17 C.F.R. § 201.250(a).

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the law judge stated in a pre-hearing conference that they would have to file this motion with the Commission. However, our review of the transcript indicates the law judge observed that she did not have the power to dismiss the proceeding prior to a hearing.

Most critically, Rule of Practice 400(a) states that the “exclusive remedy for review of a hearing officer’s ruling prior to Commission consideration of the entire proceeding” is a petition for interlocutory review. ^{3/} Rule 400(a) further states that “[p]etitions by parties for interlocutory review are disfavored, and the Commission ordinarily will grant a petition to review a hearing officer ruling prior to its consideration of an initial decision only in extraordinary circumstances.” ^{4/} Rule of Practice 400(c) requires that a “ruling submitted to the Commission for interlocutory review must be certified in writing by the hearing officer.” ^{5/}

Respondents did not seek or obtain certification of any of the law judge’s rulings. Nor have they demonstrated extraordinary circumstances warranting acceptance of their petition. Moreover, we see no basis for the Commission to take the matter up on its own motion. Respondents’ motions with respect to efficacy of counsel during the investigation and their complaints about production of documents do not warrant our interference with the orderly hearing process. We believe that it would be inappropriate to separate these issues from any future consideration of the entire proceeding. ^{6/}

In particular, once we have exercised our prosecutorial discretion to institute a proceeding, the appropriate remedy for any challenge to that exercise of discretion is to litigate the proceeding to a final decision. None of the authorities cited by Respondents contradicts that view; they affirm the unremarkable principle that agency decisions to institute enforcement proceedings may be subject to review without conceding that any such review may be sought prior to the issuance of a final order by the agency in that proceeding.

Beverly Health & Rehab. Servs., Inc. v. Feinstein, ^{7/} cited by Respondents, supports our determination here. In that case, plaintiff brought an action in district court challenging the decision of the General Counsel of the National Labor Relations Board (“NLRB”) to institute an administrative proceeding against the plaintiff while that proceeding was still pending before the

^{3/} 17 C.F.R. § 201.400(a).

^{4/} Ibid.

^{5/} 17 C.F.R. § 201.400(c).

^{6/} See Trautman Wasserman & Co., Inc., Order Denying Petition for Interlocutory Review, Exchange Act Rel. No. 55989 (June 29, 2007), __ SEC Docket __ (with respect to representation by counsel during investigations).

^{7/} 103 F.3d 151 (D.C. Cir. 1996).

NLRB. In affirming the district court's dismissal of the action, the court stated that the issuance of the complaint at issue

is a quintessential example of a prosecutorial decision. It involves a balancing of culpability, evidence, prosecutorial resources, and the public interest. The weighing of all those considerations factors into the issuance of a complaint. The formulation of the proper contours of a complaint is a critical first step in the prosecutorial journey and Beverly's attempt to segregate the framing of the complaint from the enforcement process does not wash. 8/

The court ultimately concluded that plaintiff would be entitled to challenge the decision to bring the complaint in the course of defending against it, and in any ensuing appeal to a Court of Appeals, observing that the plaintiff would, if necessary, "have its day in court on the charging issue, but not today." 9/

We further do not believe that review of the law judge's decision not to postpone the proceeding is appropriate. Rule of Practice 111(d) grants the hearing officer broad authority to "regulate the proceeding." 10/ The law judge has concluded that no postponement of the hearing date is warranted, a determination that a hearing officer must make as part of the regulation of the course of the proceeding. We do not believe that Respondents have shown extraordinary circumstances justifying review of this decision. 11/

We believe that Commission review benefits from having the entire record developed before the law judge. We stress that, absent extraordinary circumstances, we will not entertain motions, no matter how styled, for interlocutory review.

Respondents have requested oral argument. Our Rule of Practice 154(a) states that "[n]o oral argument shall be heard on any motion unless the Commission or the hearing officer

8/ Id. at 153.

9/ Id. at 156.

10/ 17 C.F.R. § 201.111(d).

11/ Respondents have further asked that, pursuant to Rule of Practice 322, 17 C.F.R. § 201.322, their motion and the accompanying submissions be kept under seal. We will consider this request by separate order. Pending a determination of this motion, the documents will be kept under seal pursuant to Rule of Practice 322(d).

otherwise directs.” 12/ We have determined that the presentation in the briefs and the decisional process would not be significantly aided by oral argument. 13/

Accordingly, it is ORDERED that Respondents’ Motion for Summary Disposition be, and it hereby is, denied; and it is further

ORDERED that Respondents’ Motion for Oral Argument be, and it hereby is, denied.

By the Commission.

Nancy M. Morris
Secretary


By: Florence E. Harmon
Deputy Secretary

12/ 17 C.F.R. § 201.154(a).

13/ See 17 C.F.R. § 201.451(a) (stating that “[t]he Commission will consider appeals, motions and other matters properly before it on the basis of the papers filed by the parties without oral argument unless the Commission determines that the presentation of facts and legal arguments in the briefs and record and the decisional process would be significantly aided by oral argument”).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 55996 / June 29, 2007

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2628 / June 29, 2007

ADMINISTRATIVE PROCEEDING

File No. 3-12674

In the Matter of

DWIGHT J. GOSLEE and
HARRY J. HILL,

Respondents.

**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 public cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Dwight J. Goslee and Harry J. Hill ("Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement ("Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings, 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 Respondents' Offers, the Commission finds¹ that:

RESPONDENTS

1. **Dwight J. Goslee** ("Goslee"), age 56, is a resident of Elkhorn, Nebraska. From 1992 to 1994, he was ConAgra Foods, Inc.'s ("ConAgra" or "Company") Corporate Controller. From 1994 to 2001, he was a Vice President at ConAgra and held other senior management positions, including serving as the head of mergers and acquisitions. In around February 2001, Goslee was promoted to Executive Vice President of Operations and Control. In that position, he assumed supervisory responsibilities over ConAgra's Corporate Controller's group and Internal Audit department. From May 2004 to October 2005, Goslee held the position of Executive Vice President for Strategic Development. On October 1, 2005, Goslee resigned from ConAgra, and since that time, he has served as a consultant to the Company. He was licensed as a Certified Public Accountant ("CPA") in Minnesota, however that license has lapsed.

2. **Harry J. Hill** ("Hill"), age 66, resides in Omaha, Nebraska. From 1983 until his retirement in 2004, Hill was employed as ConAgra's Director of Corporate Accounting. From 1994 to 2002, Hill reported directly to ConAgra's Controller, first to Kenneth W. DiFonzo, and then to Jay D. Bolding ("Bolding"). Hill was licensed as a CPA in Nebraska, but that license has expired.

OTHER RELEVANT ENTITY AND PERSONS

3. **ConAgra Foods, Inc.** ("ConAgra"), is a Delaware corporation with headquarters in Omaha, Nebraska. ConAgra's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act, and trades on the New York Stock Exchange. At all times relevant to this Order, ConAgra was a diversified international food company. ConAgra's fiscal year ("FY") ends on the last Sunday in May of each year.

4. **James P. O'Donnell** ("O'Donnell"), age 59, is a resident of Omaha, Nebraska. O'Donnell joined ConAgra in 1978. From 1995 until he retired on April 30, 2004, he served as ConAgra's Executive Vice President and Chief Financial Officer. Since his retirement, O'Donnell has acted as a consultant to the Company.

5. **Jay D. Bolding** ("Bolding"), age 47, is a resident of Omaha, Nebraska. From January 1997 to March 1999, he was the head of ConAgra's Internal Audit department. From March 1999 until approximately April 2004, he served as ConAgra's Corporate Controller. Until his resignation on June 1, 2006, he held the position of Senior Vice President for Capital and Market Investment Effectiveness. He was licensed as a CPA in Kansas and Tennessee; however, both licenses have lapsed.

¹ The findings herein are made pursuant to Respondents' Offers and are not binding on any other person or entity in this or any other proceeding.

6. **Kenneth W. DiFonzo** (“DiFonzo”), age 55, a resident of Newport Beach, California, was ConAgra’s Corporate Controller from May 1994 through February 1999. From February 1999 until May 2004, he held other senior positions with the Company. From May 2004 to September 2005, DiFonzo served in an advisory capacity at ConAgra regarding various operational/management issues. Since September 1, 2005, he has been a consultant to the Company. DiFonzo was a CPA licensed in Illinois; however, his license has become inactive.

ACCOUNTING AT CONAGRA DURING THE THIRD QUARTER OF FY 2001

A. Goslee Caused ConAgra to Improperly Account for the Reduction of At Least \$23.8 Million of Prior Period Excess Reserves

ConAgra Improperly Kept Prior Period Excess Reserves on Its Books

7. As outlined in Statement of Financial Accounting Standards (“SFAS”) No. 5, Accounting for Contingencies, at paragraph 8, Generally Accepted Accounting Principles (“GAAP”) requires that a reserve be created, and that a charge to income be taken, if it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Conversely, when a liability is no longer probable and reasonably estimable, a reserve should be removed from the books and income should be increased. In addition, paragraph 14 of SFAS No. 5 specifically prohibits the accrual of “reserves for general contingencies” or for “[g]eneral or unspecified business risks.”

8. In its year-end “Summary of Uncorrected Financial Statement Misstatements” for FY 2000, ConAgra’s outside auditor identified a potential overstatement of legal and environmental reserves in the range of about \$23.8 million to \$51.5 million.² The outside auditor informed O’Donnell and Bolding about this potential overstatement at the end of FY 2000 and provided them with the summary. Contrary to the requirements of SFAS No. 5, O’Donnell and Bolding declined to reduce any of the excess legal and environmental reserves at the end of FY 2000. These prior-period excess reserves remained on ConAgra’s books in the first and second quarters of FY 2001.

Goslee Reduces ConAgra’s Prior Period Excess Reserves

9. On February 13, 2001, as ConAgra was approaching the end of its third quarter of FY 2001, the Company issued a press release, which it filed with the Commission on Form 8-K, in which it lowered its near-term earnings outlook due to “sharply higher energy costs and a slowing economy.” In this press release, ConAgra disclosed that it expected its earnings per share for the third quarter of FY 2001 to be in the range of \$0.18 to \$0.20. ConAgra’s stock price dropped almost 20% on the day after it issued this press release.

² ConAgra’s attorneys and other Company personnel provided the outside auditor with the exposure estimates and reserve account balances used in making this calculation.

10. Also in the third quarter of FY 2001, after he assumed responsibility for accounting at ConAgra, Goslee learned that ConAgra's outside auditor had identified legal and environmental reserves that were potentially overstated in the range of \$23.8 million to \$51.5 million at least as early as the end of FY 2000 and in the first two quarters of FY 2001. Goslee made the decision to reverse \$35 million of ConAgra's excess legal and environmental reserves to income in the third quarter of FY 2001.³

11. Paragraph 13 of Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes, states that "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared." Paragraphs 36 through 38 of APB Opinion No. 20 require the correction of an error to be reported as a prior period adjustment where the correction has a material effect on current period income before the effect of the change or on the trend of earnings. In addition, paragraph 18 of APB Opinion No. 9, Reporting the Results of Operations, requires a prior period adjustment to be reflected by adjusting the opening balance of retained earnings in the current period, and accordingly, to be excluded from current period income.

12. At a minimum, \$23.8 million of the \$35 million of ConAgra's legal and environmental reserves that Goslee directed be reduced had been in excess since at least the end of FY 2000. Goslee knew, or should have known, that the accounting for this portion of the excess reserves reduction was not in accordance with SFAS No. 5 and improperly increased ConAgra's reported income before income taxes for the third quarter of FY 2001 by nearly 15%. The earnings estimates from the analysts covering ConAgra ranged from \$0.18 to \$0.21 earnings per share during that period. ConAgra's reported earnings of \$0.19 in earnings per share for the third quarter of FY 2001, met the consensus estimate of \$0.19 per share. Without the \$23.8 million reversal to income of the prior period excess reserves, ConAgra would have earned only \$0.16 per share.

13. Goslee knew, or should have known, that ConAgra should have treated the removal of at least \$23.8 million of prior period excess reserves from its books as a correction of an error and reported the correction as a prior period adjustment because the \$23.8 million excess should have been reduced by no later than the end of FY 2000. Also, the \$23.8 million reduction was material to the Company's reported income before income taxes, net income, earnings per share and trend of earnings at least by the third quarter of FY 2001, if not earlier. As a result, the \$23.8 million prior period excess reserves reduction should have been excluded from ConAgra's reported income before income taxes, net income and earnings per share for the third quarter of FY 2001.

14. Goslee's decision to reverse the \$23.8 million of prior period excess reserves caused ConAgra to fail to make and keep books, records, and accounts which accurately and fairly reflected its transactions; circumvented any system of internal accounting controls that ConAgra had to provide reasonable assurances that, among other things, its transactions were recorded as

³ O'Donnell and Bolding were aware of Goslee's decision to reduce the excess legal and environmental reserves by \$35 million.

necessary to permit preparation of financial statements in conformity with GAAP; and caused ConAgra's books, records or accounts to be falsified.

15. The Company's Form 10-Q for the third quarter of FY 2001, which was filed on April 11, 2001, disclosed that the Company's financial results were positively impacted by the \$35 million reserve reduction and negatively impacted, in part, by a significantly higher bad debt expense at its Agricultural Products subsidiary (which included UAP). The disclosure regarding the reserve reduction was misleading because ConAgra failed to disclose that at least \$23.8 million of these reserves were in excess in prior periods.

16. As a result of ConAgra's inaccurate accounting for, and improper disclosure about, the excess legal and environmental reserves reduction, ConAgra's Form 10-Q for the third quarter of FY 2001 was materially inaccurate. Goslee reviewed ConAgra's Form 10-Q for the third quarter of FY 2001, including the disclosure related to the excess reserves reduction.⁴ As a result of the conduct described above, Goslee caused ConAgra to file a materially inaccurate Form 10-Q for the third quarter of FY 2001.

B. Hill Caused ConAgra to Improperly Account for Its Reductions of Various Reserves in FY 1999, FY 2000 and FY 2001

17. ConAgra acquired Beatrice Company ("Beatrice") in FY 1991. Prior to the acquisition, Beatrice estimated that it had hundreds of millions of dollars of liabilities arising from tax disputes with federal and state authorities. Beatrice recorded these tax liabilities as tax reserves on its books and ConAgra inherited these reserves as part of the acquisition. After the Beatrice acquisition, ConAgra increased the tax reserves it had inherited from Beatrice by adding tens of millions of dollars of post-acquisition interest.

18. Although ConAgra reduced the Beatrice reserves in years at various times prior to 1998, by no later than the end of FY 1998, ConAgra no longer had any probable and reasonably estimable tax liabilities that justified maintaining the remaining Beatrice acquisition-related tax and interest reserves on the Company's books. At that time, these reserves exceeded \$181 million. At various times during FY 1999, FY 2000 and FY 2001, at the request of either DiFonzo or Bolding, Hill completed and signed journal entries that improperly reversed to income or reallocated certain of the excess Beatrice acquisition-related tax and interest reserves. For example, during the first and second quarters of FY 1999, DiFonzo and Hill signed accounting journal entries improperly reducing the excess Beatrice-related post-acquisition interest reserves to offset, dollar-for-dollar, additional unrelated, unplanned-for and unreserved-for inventory losses arising from ConAgra's attempted sale of meat and poultry into Russia by over \$33 million.

19. In addition, from at least as early as the end of FY 1998 through the third quarter of FY 2001, ConAgra fraudulently and improperly used the Company's Estimated Liabilities account as a general, or "cookie jar," reserve which was not in conformity with GAAP. During this time period, ConAgra increased this reserve by millions of dollars by transferring into it miscellaneous

⁴ O'Donnell, Bolding and others reviewed, and they both signed, the Form 10-Q.

excess reserves and accruals, and gains from the sale of certain ConAgra assets. In addition, at the same time, ConAgra improperly used this reserve to offset current period operating expenses.

20. By no later than the end of FY 1998, ConAgra no longer had any probable and reasonably estimable liabilities that justified maintaining the balance in the Estimated Liabilities account on its books. On several occasions in FY 1999, FY 2000 and FY 2001, at the request of either DiFonzo or Bolding, Hill completed journal entries that improperly reduced the balance in this account to income or to offset current period operating expenses. For example, in the first quarter of FY 1999, DiFonzo directed Hill to use the Estimated Liabilities account for claims arising out of a legal settlement for which no reserve had previously been created. DiFonzo and Hill signed a journal entry reducing the account by over \$9.6 million for the bulk of these expenses. Also, after the end of the third quarter of FY 2000, Bolding and Hill signed a journal entry offsetting \$6 million of unplanned-for and unreserved-for losses arising from a joint venture in South Africa in that quarter with a dollar-for-dollar reduction of the Estimated Liabilities account.

21. Finally, ConAgra recorded certain reserves in connection with a restructuring charge in FY 1996. In FY 1999, ConAgra transferred more than \$24.4 million of unused FY 1996 restructuring reserves from the books of certain of its subsidiaries to the ConAgra Corporate ledger. ConAgra, however, failed to remove these excess reserves from its books by the end of FY 1999 as required by SFAS No. 5. By no later than the end of FY 1999, at least \$24.4 million of the remaining FY 1996 restructuring reserves were no longer needed and should have been reversed. In the fourth quarter of FY 2000, at Bolding's request, Hill drafted and signed the journal entry that improperly reduced over \$24.4 million of the excess FY 1996 restructuring reserves by lowering the Company's FY 2000 restructuring charge by an identical amount, and thus increased income by that amount.

22. Hill knew or should have known that ConAgra no longer had any probable and reasonably estimable liabilities that justified maintaining the remaining Beatrice acquisition related tax and interest reserves, the balance of the Estimated Liabilities account, and the at least \$24.4 million of the FY 1996 restructuring reserves on its books and that each of these journal entries was not in conformity with GAAP. For example, many of the journal entries reversing prior period excess reserves to increase current period income or decrease current period operating expenses were not in accordance with SFAS No. 5, APB Opinion No. 9 and APB Opinion No. 20. Also, many of these journal entries had the effect of improperly increasing ConAgra's income before income taxes, net income and earnings per share.

23. Accordingly, as a result of the journal entries he made, Hill caused ConAgra to include financial statements that were materially false and misleading in the Company's Quarterly Reports filed on Forms 10-Q for the first, second and third quarters of FY 1999, in its Form 10-K for FY 1999, in its Quarterly Report filed on Form 10-Q for the third quarter of FY 2000, in its Annual Report filed on Form 10-K for FY 2000, and in its Form 10-Q for the third quarter of FY 2001. Also, by signing the improper journal entries, Hill caused ConAgra to fail to make and keep books, records, and accounts which accurately and fairly reflected its transactions; circumvented any system of internal accounting controls that ConAgra had to provide reasonable

assurances that, among other things, its transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP; and caused ConAgra's books, records or accounts to be falsified.

FEDERAL SECURITIES LAW VIOLATIONS

C. Goslee and Hill Caused ConAgra to Violate the Reporting Provisions of the Exchange Act

24. Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 thereunder, require issuers whose securities are registered with the Commission pursuant to Section 12 of the Exchange Act to file annual and quarterly reports with the Commission containing such information as the Commission's rules prescribe. These reports must be complete and accurate. United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991); SEC v. Savoy Indus., 587 F.2d 1149, 1165 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). Rule 12b-20 of the Exchange Act requires that an issuer's periodic reports include any additional information "as necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." No showing of scienter is required to establish an issuer's violation of the corporate reporting provisions. SEC v. McNulty, 137 F.2d 732, 740-41 (2d Cir. 1998). Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

25. Section 21C of the Exchange Act provides that the Commission may issue a cease-and-desist order against a person who is "a cause of [another person's] violation, due to an act or omission the person knew or should have known would contribute to such violation." Where the primary violations underlying a finding that a person is "a cause of" violations do not themselves require a finding of scienter, the standard of liability for being "a cause of" such violations under Section 21C of the Exchange Act is negligence. *See KPMG LLP v. SEC*, 289 F.3d 109, 112 (DC Cir. 2002).

26. As a result of the conduct described above, Goslee caused ConAgra to violate Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13. Goslee's improper accounting for, and disclosure of, the reversal of at least \$23.8 million of prior period excess reserves caused ConAgra's financial statements in its Quarterly Report for the third quarter of FY 2001, filed on Form 10-Q with the Commission on April 11, 2001, to be materially false and misleading.

27. As a result of the conduct described above, Hill caused ConAgra to violate Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13. Hill's signing of journal entries reversing various excess reserves caused ConAgra to include financial statements that were materially false and misleading in the Company's Forms 10-Q for the first, second and third quarters of FY 1999, in its Form 10-K for FY 1999, in its Form 10-Q for the third quarter of FY 2000, in its Form 10-K for FY 2000 and in its Form 10-Q for the third quarter of FY 2001.

D. Goslee and Hill Violated, and Caused ConAgra to Violate, the Books and Records Provisions of the Exchange Act

28. Section 13(b)(2)(A) of the Exchange Act 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. Rule 13b2-1 of the Exchange Act prohibits any person from, directly or indirectly, falsifying or causing to be falsified, any book, record or account subject to Exchange Act Section 13(b)(2)(A). No showing of scienter is required to support a violation of these provisions. See SEC v. WorldWide Coin Investments, Ltd., 567 F. Supp. 724, 749 (N.D. Ga. 1983); McNulty, 137 F.3d at 740-41.

29. As a result of the conduct described above, Goslee caused ConAgra to violate Section 13(b)(2)(A) of the Exchange Act, and he violated Exchange Act Rule 13b2-1. Goslee caused ConAgra's violation of Section 13(b)(2)(A) of the Exchange Act, and violated Exchange Act Rule 13b2-1, when he directed the reduction of at least \$23.8 million of ConAgra's excess legal and environmental reserves in a manner not in conformity with GAAP. The resulting adjustments to ConAgra's reserve accounts and related books and records were false because they did not accurately reflect changes in the Company's probable and reasonably estimable liabilities, or the Company's current period income before income taxes, net income, and earnings per share.

30. As a result of the conduct described above, Hill caused ConAgra to violate Section 13(b)(2)(A) of the Exchange Act, and he violated Exchange Act Rule 13b2-1. Hill caused ConAgra's violation of Section 13(b)(2)(A) of the Exchange Act, and violated Exchange Act Rule 13b2-1, when he completed journal entries reducing various ConAgra excess reserves in the first and second quarters of FY 1999, the third and fourth quarters of FY 2000, and the third quarter of FY 2001 in a manner not in conformity with GAAP. These journal entries, and the resulting adjustments to related accounts, books and records, were false because they did not accurately reflect changes in the Company's probable and reasonably estimable liabilities, or the Company's current period income before income taxes, net income and earnings per share.

E. Goslee and Hill Caused ConAgra to Violate the Internal Controls Provisions of the Exchange Act

31. Section 13(b)(2)(B) of the Exchange Act requires reporting companies to devise and maintain a system of internal accounting controls sufficient to reasonably assure that transactions are recorded and financial statements are prepared in conformity with GAAP. No showing of scienter is required to support a violation of these provisions. See WorldWide Coin Investments, Ltd., 567 F. Supp. at 749.

32. As a result of the conduct described above, Goslee and Hill caused ConAgra to violate Section 13(b)(2)(B) of the Exchange Act.

UNDERTAKINGS

In connection with this action and any judicial or administrative proceeding or investigation related to or arising out of any of the facts, events or transactions alleged in the Order, which is commenced by the Commission or to which the Commission is a party, each of the Respondents undertakes to cooperate with the Commission staff and: (i) agrees to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoints his or her attorney as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses his or her travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (v) consents to personal jurisdiction over him or her in any United States District Court for purposes of enforcing any such subpoena.

In determining whether to accept the Offers, the Commission has considered these undertakings.

IV.

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

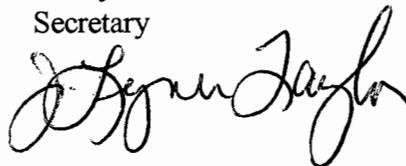
Accordingly, it is hereby ORDERED that:

A. Respondent Goslee cease and desist from committing or causing any violation and any future violations of Rule 13b2-1 of the Exchange Act, and cease and desist from causing any violation and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

B. Respondent Hill cease and desist from committing or causing any violation and any future violations of Rule 13b2-1 of the Exchange Act, and cease and desist from causing any violation and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

By the Commission.

Nancy M. Morris
Secretary



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By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55991 / File No. S7-12-01]

June 29, 2007

Order Extending Temporary Exemption of Banks from the Definition of "Broker" under Section 3(a)(4) of the Securities Exchange Act of 1934

I. Background

The Gramm-Leach-Bliley Act ("GLBA") repealed the blanket exception of banks from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 ("Exchange Act")¹ and replaced it with functional exceptions incorporated in amended definitions of "broker" and "dealer." Under the GLBA, banks that engage in securities activities either must conduct those activities through a registered broker-dealer or ensure that their securities activities fit within the terms of a functional exception to the amended definition of "broker."

The GLBA provided that the amended definitions of "broker" and "dealer" were to become effective May 12, 2001. Starting on May 11, 2001, in connection with various rulemaking proposals,² the Securities and Exchange Commission ("Commission") extended, most recently until July 2, 2007, a temporary exemption that gave banks time

¹ As defined in Exchange Act Sections 3(a)(4) and 3(a)(5) [15 U.S.C. 78c(a)(4) and 78c(a)(5)].

² See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001) (the "Interim Rules"). See also Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004) ("Regulation B"). In the Interim Rules, the Commission adopted Exchange Act Rule 15a-7, 17 CFR 240.15a-7, which, as proposed to be amended, would provide banks and other financial institutions until January 1, 2006, to begin complying with the GLBA. In proposing Regulation B, the Commission proposed Rule 781 as a re-designation of Rule 15a-7. See 17 CFR 242.781.

to come into full compliance with the more narrowly-tailored exceptions from broker-dealer registration under the GLBA.³

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (“Regulatory Relief Act”).⁴ Among other things, the Regulatory Relief Act requires the Commission and the Board of Governors of the Federal Reserve (“Board”) jointly to adopt final rules implementing the bank broker exceptions in Section 3(a)(4) of the Exchange Act.⁵ It also requires the Commission and the Board jointly to issue proposed rules within 180 days of passage of the Regulatory Relief Act.⁶

³ See Exchange Act Release No. 44570 (July 18, 2001); Exchange Act Release No. 45897 (May 8, 2002); Exchange Act Release No. 46751 (Oct. 30, 2002); Exchange Act Release No. 47649 (April 8, 2003); Exchange Act Release No. 50618 (Nov. 1, 2004); Exchange Act Release No. 51328 (March 8, 2005); Exchange Act Release No. 52405 (Sept. 9, 2005); Exchange Act Release No. 54544 (September 29, 2006), 71 FR 58891 (October 5, 2006) (extending the exemption from the definition of “broker” until January 15, 2007); and Exchange Act Release No. 34-54948 (Dec. 18, 2006), 71 FR 247 (Dec. 18, 2006)(extending the exemption from the definition of “broker” until July 2, 2007); During this time, the Commission also extended the temporary exemption from the definition of “dealer” to September 30, 2003. See Exchange Act Release No. 47366 (Feb. 13, 2003). On February 13, 2003, the Commission adopted amendments to certain parts of the Interim Rules that define terms used in the dealer exceptions, as well as certain dealer exemptions (“Dealer Release”), see Exchange Act Release No. 47364 (Feb. 13, 2003), 68 FR 8686 (Feb. 24, 2003). Therefore, this order is limited to an extension of the temporary exemption from the definition of “broker.”

⁴ Pub. L. No. 109-351, 120 Stat. 1966 (2006).

⁵ The Regulatory Relief Act also directs the Commission and the Board to consult with and seek the concurrence of the other Federal banking agencies on the content of the rulemaking. Section 101(c) of the Exchange Act defines the term “Federal banking agencies” as “the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation.” In another provision of the Regulatory Relief Act, Congress extended the bank exceptions and exemptions to thrifts by amending the definition of “bank” in Exchange Act Section 3(a)(6).

⁶ Under the Regulatory Relief Act, a final single set of rules or regulations jointly adopted in accordance with that Act shall supersede any other proposed or final rule issued by the Commission on or after the date of enactment of Section 201 of the GLBA with regard to the definition of “broker” under Exchange Act Section 3(a)(4).

Consistent with the Regulatory Relief Act, on December 18, 2006, the Commission and the Board jointly proposed implementing rules, which were designated as Regulation R.⁷ At that time, the Commission also granted banks⁸ an exemption from compliance with the definition of broker until July 2, 2007 in order to permit the Commission and the Board time to receive and evaluate comments and to take final action on the implementing rules.

To date, the Commission and the Board have received over 70 comments on proposed Regulation R. The Commission and the Board are carefully considering the comments, in consultation with the other Federal banking agencies, and expect to take final action on proposed Regulation R shortly.

II. Extension of Temporary Exemption from Definition of “Broker”

In light of the need to carefully consider, together with the Board and the other Federal banking agencies, the comments on proposed Regulation R, the Commission finds that extending the temporary exemption for banks from the definition of “broker” until September 28, 2007 is necessary and appropriate in the public interest, and is consistent with the protection of investors. The extension of this temporary exemption will prevent banks from incurring interim business disruption, as well as interim implementation and compliance costs before the Commission and the Board jointly adopt final implementing rules. It will also provide the Commission and the Board time fully to

⁷ See Exchange Act Release No. 54946 (Dec. 18, 2006), 71 FR 77522 (Dec. 26, 2006).

⁸ Section 401 of the Regulatory Relief Act also amended the definition of “bank” in Section 3(a)(6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in this order, the term “bank” includes any savings association that qualifies as a “bank” under Section 3(a)(6) of the Exchange Act, as amended.

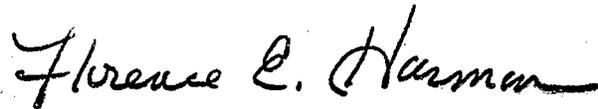
consider the comments, consult with and seek the concurrence of the other Federal banking regulators, and take final action on the proposal.

III. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,⁹

IT IS HEREBY ORDERED that banks are exempt from the definition of the term “broker” under the Exchange Act until September 28, 2007.

By the Commission.



Florence E. Harmon
Deputy Secretary

⁹

15 U.S.C. 78mm.

Commissioner Casey
Not Participating

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 55988 / June 29, 2007

Admin. Proc. File No. 3-12402

In the Matter of the Application of

RICHARD F. KRESGE
c/o Lawrence R. Gelber, Esq.
The Vanderbilt Plaza
34 Plaza Street - Suite 1107
Brooklyn, NY 11238

for Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - - REVIEW OF DISCIPLINARY
PROCEEDINGS

Violations of Conduct and Membership and Registration Rules

Failure to Supervise

Failure to Report Customer Complaints

Failure to Comply with Membership and Registration Requirements

Conduct and Alleged Conduct Inconsistent with Just and Equitable Principles of Trade

Alleged Antifraud and Suitability Violations

President of former member firm of registered securities association failed to establish and maintain a system of supervision that was reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable association rules; failed to report customer complaints; and failed to comply with membership and registration requirements. Held, association's findings of violations are sustained in part, sanctions are vacated, and proceedings are remanded for redetermination of sanctions.

Document 43 of 46

APPEARANCES:

Lawrence R. Gelber, Esq., for Richard F. Kresge.

Marc Menchel, Alan Lawhead, and Michael J. Garawski, for NASD.

Appeal filed: August 29, 2006

Last brief received: November 29, 2006

I.

Richard F. Kresge, formerly the president of Yankee Financial Group, Inc. ("Yankee Financial" or the "Firm"), a former NASD member firm, appeals from NASD disciplinary action. NASD found that Kresge violated NASD Conduct Rules 3010 and 2110 by failing to supervise a branch office and failing to establish or enforce a supervisory system. 1/

NASD also found that Kresge violated NASD Conduct Rules 3070(c) 2/ and 2110 by failing to report to NASD eleven customer complaints. NASD further found that Kresge violated NASD Membership and Registration Rules 1021(a), 1031(a), and IM-1000-3, and Conduct Rule 2110 by failing to register Joseph Ferragamo as a representative and principal of Yankee Financial, and NASD Membership and Registration Rule IM-1000-1 and Conduct Rule 2110 by failing to disclose on the Firm's Uniform Application for Broker-Dealer Registration ("Form BD") Ferragamo's financial support of a branch office of the Firm. 3/ NASD also found that Kresge was liable for violations by certain Yankee Financial registered representatives of Section

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- 1/ Conduct Rule 3010 provides, among other things, that an NASD member shall establish, maintain, and enforce "a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of [NASD]." NASD Manual at 4831-36 (2000). Conduct Rule 2110 requires NASD members to observe high standards of commercial honor and just and equitable principles of trade. Id. at 4111.
- 2/ Conduct Rule 3070(c) requires member firms to report to NASD on a quarterly basis statistical and summary information regarding customer complaints. Id. at 4863.
- 3/ Membership and Registration Rules 1021(a) and 1031(a) require that individuals who function as principals and/or representatives be registered as such. Id. at 3171, 3201. IM-1000-3 provides that failure to register an employee who should be so registered may be deemed conduct inconsistent with just and equitable principles of trade. Id. at 3111. IM-1000-1 prohibits the filing of misleading information as to membership or registration. Id. at 3111.

10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5, ^{4/} and NASD Conduct Rules 2120, 2310, IM-2310-2, and 2110. ^{5/}

NASD barred Kresge in all capacities, ordered restitution to the customers at issue in the amount of \$3,866,426, plus interest, ^{6/} and assessed costs of \$9,519.61. We base our findings on an independent review of the record.

II.

Failure to Supervise

A. Kresge entered the securities industry in 1978 and formed Yankee Financial in 1986. Throughout the Firm's existence, Kresge was its president, chief executive officer, limited principal-financial and operations, and ninety-five percent owner. Kresge also was the Firm's compliance director through January 2002, resuming that position in July 2002. Until January 2001, Yankee Financial primarily engaged in transactions in bonds, mutual funds, and listed equities. The Firm employed approximately ten individuals, who operated out of the Firm's headquarters in Bay Shore, New York.

Yankee Financial Opens an Office in Melville, New York.

In January 2001, Yankee Financial acquired a branch office of Glenn Michael Financial, Inc. ("Glenn Michael") that operated out of Melville, New York. As of the acquisition date, Glenn Michael employed approximately fifty registered representatives. Its business activity generally mirrored Yankee Financial's, although Glenn Michael effected a few transactions in penny stocks. In connection with obtaining NASD's approval of Melville as an office of supervisory jurisdiction ("OSJ"), Kresge provided to NASD a set of written supervisory

^{4/} 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

^{5/} Conduct Rule 2120 prohibits NASD members from effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance. NASD Manual at 4141. Conduct Rule 2310 requires that, "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer." *Id.* at 4261. Conduct Rule IM-2310-2 imposes on members and registered representatives the responsibility for fair dealing with customers. *Id.* at 4261-62.

^{6/} In its decision in this proceeding, NASD also expelled Yankee Financial and ordered it to pay restitution jointly and severally with Kresge. Yankee Financial has not appealed the NASD decision.

procedures ("January 2001 Written Procedures"). 7/ Kresge testified that he created the January 2001 Written Procedures by substituting Yankee Financial's name on Glenn Michael's existing written procedures and reducing the section dealing with options transactions. 8/

Kresge assigned Kenneth Gliwa, a former Glenn Michael principal, the responsibility for handling the Firm's trading, technology, and operations. 9/ Gliwa continued to service his own clients. Kresge supervised Gliwa and Robert Stelz, the Melville branch manager, although initially Kresge continued to operate out of the Bay Shore office. In March 2002, Kresge moved into the Melville branch office on a full-time basis.

Yankee Financial Opens an Office in Brooklyn, New York.

In August 2001, Gliwa told Kresge that Joseph Masone, a client, knew "some reps that [we]re looking for a new home." Masone introduced Kresge to Joseph Ferragamo, among others. 10/ Kresge testified at the hearing that Ferragamo represented to Kresge "that he was the spokesperson for a group of brokers [who wanted to relocate], that he was the person that organized this attempt to move, [and] that he would be the contact person, . . . the chief as far as these five or six people." Kresge also testified that Ferragamo told him that he was licensed at, and owned, a branch office of Valley Forge Securities, Inc., which, according to Ferragamo, engaged primarily in listed equities transactions.

There was no written agreement memorializing the arrangements between Yankee Financial and the Brooklyn branch office. Kresge and Ferragamo agreed upon the site for the

7/ Under Conduct Rule 3010(g), an OSJ means "any office of a member at which any one or more of the following functions take place," including order execution and/or market making; structuring of public offerings or private placements; maintaining custody of customers' funds and/or securities; final acceptance (approval) of new accounts on behalf of the member; review and endorsement of customer orders; final approval of advertising or sales literature for use by persons association with the member; or responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

8/ The record does not contain a copy of the January 2001 Written Procedures.

9/ On June 30, 2003, in connection with the events at issue in this proceeding, Gliwa consented to NASD's entry of findings that he violated Membership and Registration Rules IM-1000-3, 1021(a), and 1031(a), and Conduct Rules 3010(a), 3010(b), and 2110. NASD barred Gliwa in all capacities from association with any NASD member.

10/ On April 22, 2003, NASD barred Ferragamo in all capacities from association with any NASD member following a default decision. Ferragamo failed to respond to an NASD request, pursuant to Investigations Rule 8210, to appear for an on-the-record interview.

Brooklyn branch office and that the Brooklyn branch office would pay all of its own expenses. Ferragamo further represented that he would make up any shortfall if the branch office could not generate enough revenue to cover expenses. The Brooklyn branch office would pay to Yankee Financial \$25 per order ticket plus a fifteen percent override on all gross commissions generated by the Brooklyn branch office. Kresge and Ferragamo further agreed that the Firm would issue a monthly check payable to the Brooklyn branch office's manager for the branch's share of the commissions it generated. Kresge admitted that he did not know how or in what amounts the branch manager would pay the registered representatives in the Brooklyn branch office from Yankee Financial's monthly check. Ferragamo and Kresge also agreed that the Brooklyn branch office would be permitted to direct trades with certain third-party broker-dealers that did not routinely do business with the Firm.

Staffing and Training in the Brooklyn Branch Office.

In September 2001, Kresge hired Gary Giordano ^{11/} to be the Brooklyn branch office manager at Ferragamo's recommendation. Giordano had worked for six firms in the five years before joining Yankee Financial. Kresge had not heard of any of Giordano's former employers, and there is no evidence that he contacted any of them. Giordano had passed his general securities principal examination only six months before being hired as the Brooklyn branch manager. Kresge interviewed Giordano, reviewed his Form U-4, and "felt he was adequate to be in the branch manager position" if Giordano were monitored by Gliwa.

Kresge never provided Giordano with a compliance manual, and the record does not indicate that Giordano ever received any training of any kind. Kresge assigned Giordano responsibility for supervising all aspects of the Brooklyn branch office, including the review and approval of new accounts, review of all order tickets, confirmation with customers regarding all aspects of their orders, including suitability review, and placement of orders to the Melville branch office.

Kresge testified that he believed that a securities representative who changed firms frequently within a short period of time was a red flag for potential compliance issues. However, at Giordano's recommendation, Kresge hired David Anderson, Eric Cenname, and Lawrence Dugo to be general securities representatives in the Brooklyn branch office. Anderson had worked for four different firms during the eighteen months before he joined Yankee

^{11/} On January 6, 2004, in connection with the events at issue in this proceeding, Giordano consented to NASD's entry of findings that he violated Exchange Act Section 10(b) and Rule 10b-5 thereunder and Conduct Rules 2110, 2120, 2130, IM-2310-2, and 3010. NASD barred Giordano in all capacities from association with any NASD member.

Financial. 12/ Cename had worked for ten different firms in the eight years before joining Yankee Financial. Dugo had worked for eight different firms in the seven years before joining Yankee Financial and was the subject of a pending arbitration action alleging a mishandling of an account. Kresge testified that he did not know whether he interviewed Dugo, that he was aware that Dugo may have had "disclosure" information related to a felony conviction for cocaine possession, and that Giordano "convinced" him to hire Dugo. Kresge also hired Adam Klein, who had worked for seven different firms in the six years before joining Yankee Financial, and Cesar Ramos, who had worked for four different firms in the four years before joining Yankee Financial. 13/

Kresge testified that none of the Brooklyn branch office registered representatives received a compliance manual. Kresge stated that he did not know whether any of those registered representatives received training on sales practices or suitability.

12/ Kresge complains that NASD inappropriately criticized him for not discovering that Anderson was a party to an arbitration proceeding. We agree with Kresge that the arbitration was initiated after the facts at issue and have not considered that allegation in our resolution of this proceeding.

13/ NASD found that Klein, Cename, Dugo, Anderson, and Ferragamo previously worked for firms that, as of September 2001, either were (1) "disciplined firms" that had been expelled or had their broker-dealer registrations revoked for violations of sales practice rules, or (2) were subject to the Taping Rule, which requires members to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from disciplined firms.

NASD submitted a printout of firms subject to the Taping Rule dated July 14, 2004. There is no indication, however, that that information was the same or available when Kresge was considering hiring those individuals in 2001. NASD further cites printouts, dated August 7, 2001 and September 6, 2001, of firms that had been disciplined within the last three years. According to the Forms U-4 of Klein, Cename, Dugo, Anderson, and Ferragamo that are in the record, only Cename and Dugo worked for firms that appear on those lists. However, Cename's and Dugo's tenure with those firms preceded the time periods covered by the printouts submitted by NASD. We therefore do not consider these documents or the resulting allegations.

Supervisory System in the Brooklyn Branch Office.

The Brooklyn branch office opened in October 2001. ^{14/} At that time, hundreds of accounts were transferred to Yankee Financial's Brooklyn branch office from L.H. Ross, the previous employer of Anderson and Cenname, as well as Valley Forge Securities, Inc. Although Ferragamo had represented to Kresge that Ferragamo and his associates engaged primarily in transactions in listed equities, the Brooklyn branch office immediately began to sell speculative penny stocks.

Until February 2002, Kresge remained the Firm's compliance director. Kresge admitted that he was "ultimately" responsible for overall supervision. Beyond having a few casual conversations about the financial progress of the Brooklyn branch office with Gliwa and Giordano, Kresge did nothing to monitor Gliwa's or Giordano's supervision.

Kresge testified at the hearing that he visited the Brooklyn branch office only six times to conduct presentations on potential business lines, such as bonds. While in Brooklyn, Kresge did not ask Giordano about his performance of his supervisory duties. Kresge did not review any of the Brooklyn branch office records, such as customer complaints, customer accounts, or order tickets. Kresge admitted that the information available in these records would have raised serious questions about the propriety of certain of the penny stock sales activity.

Kresge claimed that Gliwa was responsible for supervising Giordano. However, Kresge also acknowledged in his investigatory testimony that Gliwa "was overwhelmed." Gliwa already had responsibility for the Firm's trading, technology, and operations, as well as servicing his own customers. Kresge testified at the hearing that he knew that Gliwa "almost never" visited the Brooklyn branch office (perhaps two or three times in total). Kresge admitted that he never specifically asked Gliwa about compliance matters in that office, such as whether Gliwa

^{14/} Kresge never sought approval to operate the Brooklyn branch office as an OSJ, although he knew that Giordano would be approving new accounts on behalf of the Firm. Under Conduct Rule 3010(g), an OSJ includes any office of a member at which "final acceptance (approval) of new accounts on behalf of the member" occurs.

While the record is somewhat unclear, it appears that the Brooklyn branch office had between six to ten registered representatives.

performed his review of Brooklyn branch office order tickets. ^{15/} Kresge knew that Gliwa did not assess the suitability of customer trades from the Brooklyn branch office.

Revision of the Firm's Written Procedures.

In January 2002, Kresge hired Joseph Korwasky as a compliance consultant and subsequently made Korwasky the Firm's Director of Compliance in February 2002. Kresge admitted in NASD investigative testimony that he hired Korwasky ^{16/} because "Brooklyn was becoming overwhelming." Among other things, Kresge assigned Korwasky responsibility for revising the Firm's written supervisory procedures. Kresge recognized that the January 2001 Written Procedures were not sufficiently tailored to the Firm's then-current activities. Although the January 2001 Written Procedures are not in the record, Kresge concedes that these procedures did not establish a supervisory chain of command.

Korwasky determined that the January 2001 Written Procedures were so deficient that he had to start from scratch. Korwasky provided Kresge, Gliwa, and Stelz with a draft of new written procedures on March 15, 2002 ("March 2002 Written Procedures"). Although Korwasky considered the document to be a "work in progress," he was given clearance by Kresge to distribute the draft. Korwasky testified that he provided Giordano with the March 2002 Written Procedures "sometime in April."

The March 2002 Written Procedures covered business activity related to mutual funds, but not to penny stocks or bonds. The March 2002 Written Procedures contained a list of prohibited activities, but they did not provide procedures to detect violations or ensure compliance. For example, the March 2002 Written Procedures provided that "[n]o person shall effect any transaction in, or induce the purchase or sale of, any security by means of any

^{15/} At the hearing, Kresge refuted his on-the-record testimony before NASD that, among other things, he had not asked Gliwa about compliance matters in the Brooklyn branch office and that he knew Gliwa was already overwhelmed when Kresge assigned Giordano to Gliwa. The Hearing Panel found Kresge's hearing testimony not credible given that his earlier contradictory statements, including Gliwa's lack of supervisory involvement, were supported by record evidence. As we have held, "credibility determinations of an initial fact finder are entitled to considerable weight." Joseph Abbondante, Securities Exchange Act Rel. No. 53066 (Jan. 6, 2006), 87 SEC Docket 203, 209 & n.21, petition denied, 2006 WL 3623490 (2d Cir. 2006) (unpublished); Laurie Jones Canady, 54 S.E.C. 65, 78 n.23 (1999) (citing Anthony Tricarico, 51 S.E.C. 457, 460 (1993)), petition denied, 230 F.3d 362 (D.C. Cir. 2000). We find no reason to reject NASD's credibility determination.

^{16/} On December 10, 2004, NASD's Hearing Panel found that Korwasky violated Conduct Rules 3070(c) and 2110 by failing to file one customer complaint and issued him a Letter of Caution.

manipulative, deceptive, or other fraudulent device or contrivance," but they did not set forth any specific procedures that a supervisor could use to detect or prevent those practices. Moreover, the March 2002 Written Procedures did not set forth a detailed supervisory chain of command or describe the division of duties and responsibilities amongst the supervisors.

It appears that none of the registered representatives in the Brooklyn branch office received the January 2001 Written Procedures. Korwasky testified that he provided Dugo with the March 2002 Written Procedures "sometime in April." There is no evidence that anyone with supervisory authority ever implemented either set of written procedures.

Korwasky's Recommendations About Brooklyn's Operations.

Based on the testimony of Kresge, Gliwa, Korwasky, and Giordano, no one had a clear understanding of Korwasky's responsibility. Korwasky did not have hiring or firing authority. Korwasky also repeatedly told Kresge that he had inadequate office space and no access to back office operations or the Central Registration Depository ("CRD") system.

Korwasky first visited the Brooklyn branch office in February 2002, and less than ten times thereafter until he resigned from the Firm in June 2002. Following his first visit, Korwasky recommended that Kresge install a telephone monitoring system for the Brooklyn branch office, but that installation never occurred. Korwasky also recommended banning sales scripts and "rebuttal books" and use of customer activity letters. Kresge ignored these suggestions. In March 2002, NASD staff began an investigation of Yankee Financial. By April 1, 2002, Kresge knew that Yankee Financial had received an NASD request for information.

In April 2002, Kresge was informed of the possibility that Dugo and another Brooklyn branch office registered representative, previously "unknownst to anyone," were operating out of an unauthorized office in Staten Island, New York. ^{17/} Kresge immediately instructed Korwasky to conduct an investigation. It is unclear how long the two registered representatives operated from the Staten Island office. Kresge testified that it could have been for four to six weeks, and Korwasky testified that it probably was "only a couple of weeks" because he had seen the two registered representatives in the Brooklyn branch office shortly before the investigation. Upon Korwasky's recommendation, Kresge closed the office and ordered the two registered representatives to return to the Brooklyn branch office because it "was an unauthorized hybrid of Brooklyn." In May 2002, Kresge accepted Korwasky's recommendation that Kresge place Dugo and Anderson on heightened supervision after determining that customers had made written complaints about their sales practices. Korwasky resigned in June 2002.

^{17/} The record does not explain how Kresge learned about the Staten Island office.

Fraudulent and Unsuitable Recommendations in the Brooklyn Branch Office.

Between October 2001 (when the Brooklyn branch office opened) and April 2002 (a few months before it closed in September 2002), Anderson, Cenname, and Dugo engaged in serious sales practice violations in connection with sales to customers of penny stocks of Silver Star Foods, Inc. ("Silver Star"), Western Media Group, Corp. ("Western Media"), and Golden Chief Resources, Inc. ("Golden Chief"). 18/

Silver Star was a distributor of pre-packaged frozen pasta products. Its Form 10-QSB filed with the Commission for the period ended June 30, 2001 reported no revenues, total current assets of \$100,883, total current liabilities of \$974,480, and a net loss of \$67,890. The filing also disclosed a "going-concern" opinion issued by Silver Star's independent accountants that expressed concerns about the continued viability of the company. Silver Star disclosed that it essentially had ceased doing business and that its survival depended upon a "contemplated offering." Silver Star also disclosed two outstanding legal judgements against it totaling \$372,924 owed to vendors. Subsequent filings showed no improvement in Silver Star's financial condition.

Western Media operated through three diverse, wholly-owned subsidiaries. Its quarterly filing for the period ended September 30, 2001 reported total current assets of \$46,284, of which \$3,494 was cash. It had liabilities of \$6,452. The Form 10-QSB also noted that Western Media had relied almost exclusively on one customer for its revenue. The filing disclosed a "going-concern" opinion issued by Western Media's independent accountants. The independent accountants projected that Western Media had only enough revenue to continue operating for twelve months, unless it obtained additional capital or could acquire and integrate another technology service company. Western Media reported no improvement in its financial condition in subsequent Commission filings.

Golden Chief held gas and oil interests in Texas and Louisiana. On its Form 10-QSB for the period ended June 30, 2001, Golden Chief reported that it had no operations from 1986 to 1999, re-entered the development stage, and was entirely dependent on raising new capital, which it doubted being able to do. The company reported total current assets of \$23,802, including \$102 in cash, total current liabilities of \$717,316, and a net operating loss of \$994, 678. In that filing, Golden Chief's independent accountants expressed doubt as to the company's

18/ In connection with the events at issue in this proceeding, Anderson and Cenname each consented, on October 25, 2002 and January 30, 2003, respectively, to NASD's entry of findings that they failed to appear and provide testimony pursuant to Procedural Rule 8210. On July 24, 2003, in connection with the events at issue in this proceeding, Dugo consented to NASD's entry of findings that he violated Exchange Act Section 10(b) and Rule 10b-5 thereunder and Conduct Rules 2110, 2120, and 2310. NASD barred Anderson, Cenname, and Dugo in all capacities from association with any NASD member.

ability to continue as a going concern. Subsequent Commission filings showed no improvement in the company's financial condition.

From October 2001 through April 2002, at least Anderson, Cenname, and Dugo solicited Yankee Financial customers to purchase over eight million shares of Silver Star, Western Media, and Golden Chief worth \$6.3 million, \$1.6 million, and \$500,000, respectively, for a total of \$8,377,270. During that time, Anderson, Cenname, and Dugo enthusiastically recommended the purchase of these companies to at least ten Yankee Financial customers, who testified before NASD. Anderson, Cenname, and Dugo made unfounded claims about the merits of the investments and predicted rising stock prices without disclosing the poor financial condition of the companies. Many of the customers were retirees, and none expressed an interest in, or had a history of, investing in speculative stocks.

For example, one customer, who was eighty years old and caring for an ailing wife (who subsequently died during the period at issue), purchased \$757,576.58 worth of Golden Chief after Anderson told him that his purchase price of \$0.88 "would go up in the neighborhood of from \$8 to \$15," and that Anderson was "conservative, and . . . putting [the estimation] on the low side." Another customer, who had three teenage children and wanted a "steady" portfolio in order to save for impending college expenses and retirement, purchased \$228,000 worth of Silver Star after Cenname told him that "he was putting all the money he could put his hands on and his parents' money into it, and he felt it would be losing the opportunity of a lifetime not to do it." A third customer, who was fifty-three years old, self-employed after being laid off from his job of twenty-two years, and saving for retirement, purchased \$10,000 worth of Western Media after Dugo "was very forceful in telling [him that he] needed to . . . invest in this because [the stock price] was going to double or triple, and [he] could make some decent money."

Before NASD, Kresge did not dispute that registered representatives in the Brooklyn branch office violated antifraud and suitability requirements in connection with sales of Silver Star, Western Media, and Golden Chief. Before us, Kresge claims that the "stories" of the customers "were never truly tested by meaningful cross-examination" because none "ever brought any action against Yankee or against Kresge to recover their alleged losses." ^{19/}

^{19/} On appeal, Kresge claims that one customer witness, James Cassanos, falsely testified "that Anderson never advised him of the risks in Silver Star." Kresge asserts that Cassanos "settled all his litigated claims with Yankee." Kresge seeks to adduce additional evidence in the form of a "Penny Stock Acknowledgment Form" and a confirmation statement dated January 31, 2002, in the amount of \$32,861.50. Kresge has not shown that these documents are material or that there are reasonable grounds for his failure to adduce the evidence previously, as required by Commission Rule of Practice 452. 17 C.F.R. § 201.452. The acknowledgment form, which has not been authenticated, is dated after Cassanos' transactions in Silver Star. The confirmation statement merely

(continued...)

However, each of the customers testified at the hearing, and Kresge had ample opportunity to cross-examine, and did cross-examine, them. 20/ We conclude that the record supports NASD's findings that the representatives violated Exchange Act Section 10(b), Exchange Act Rule 10b-5, and Conduct Rules 2110, 2120, 2310, and IM-2310-2.

Kresge stated in investigative testimony before NASD that he knew that the Brooklyn branch office was selling penny stocks. Kresge testified at the hearing that he received commission reports from a clearing firm every couple of days and that the reports specified the transactions effected for each registered representative of the Firm. 21/ From October 2001 to January 2002, while Kresge was the Firm's compliance director, the Brooklyn branch office sold \$3 million in Silver Star stock. Kresge also testified that the Firm did not regularly conduct any sort of analysis to determine whether the Firm was in compliance with any requirements related to penny stock activity. 22/

B. Assuring proper supervision is a critical component of broker-dealer operations. 23/ Conduct Rule 3010(a) requires a member to "establish and maintain a system for supervising the activities of each registered and associated person that is reasonably designed to achieve compliance with applicable laws and regulations, and with applicable NASD Rules." Conduct Rule 3010(b) further requires that a member "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD." Whether a

19/ (...continued)

reports the purchase of 2,000 shares of a security labeled "EMC" at \$16.35 per share. We therefore will not accept these documents.

20/ Below, Kresge complained that the registered representatives never testified. However, NASD introduced the customers' testimony, and Kresge was free to call the representatives. Kresge did not do so.

21/ Kresge also testified that he was unaware of the level of penny stock activity conducted in the Brooklyn branch office. Given the evidence above, however, we are not persuaded by this statement.

22/ See, e.g., 17 C.F.R. §§ 240.15g-2 - 240.15g-100 (rules with respect to penny stock transactions). Kresge admitted that neither he nor anyone else in the Firm had any real understanding of any of the requirements related to penny stock activity and that the Firm had violated certain penny stock rules as a result.

23/ See Rita H. Malm, 52 S.E.C. 64, 68 n.13 (1994) (citing Gary E. Bryant, 51 S.E.C. 463, 470-71 (1993)).

particular supervisory system or set of written procedures is in fact “reasonably designed to achieve compliance” depends on the facts and circumstances of each case. 24/

Until January 2001, Yankee Financial operated out of one office that employed approximately ten registered representatives who engaged primarily in bond, mutual fund, and listed equities transactions. In 2001, the Firm experienced a major change to its organizational structure and business. The Firm added two new branch offices and acquired a substantial number of new personnel, including supervisory personnel, in those offices. The Brooklyn branch office engaged in a new line of business, penny stocks, and had permission to direct trades to third-party broker-dealers. 25/

We have frequently emphasized that the president of a brokerage firm is responsible for the firm’s compliance with all applicable requirements unless and until he or she reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties. 26/ Kresge, as the Firm’s president, chief executive officer, financial and operations principal, and, at least until February 2002, the compliance director, admittedly had ultimate responsibility for the Firm’s operations. 27/ Kresge argues that he reasonably delegated supervisory responsibility to Gliwa, Giordano, and Korwasky, and that he had no reason to doubt their supervisory skills. We reject these contentions for the reasons set forth below.

We have often stressed “the obvious need to keep [a] new office with . . . untried personnel under close surveillance.” 28/ The Brooklyn personnel were new to the Firm, and their

24/ La Jolla Capital Corp., 54 S.E.C. 275, 281 & n.15 (1999), (citing Christopher J. Benz, 52 S.E.C. 1280, 1284 & n.19 (1997) (citing cases), aff’d, 168 F.3d 478 (3d Cir. 1998) (Table)). “Regardless of its size and complexity, each member must adopt and implement a supervisory system that is tailored specifically to the member’s business and must address the activities of all its registered representatives and associated persons.” NASD Notice to Members 99-45 at 294 (June 1999).

25/ Courts have recognized that directed trades may be evidence of manipulation. Sharon M. Graham, 53 S.E.C. 1072, 1082 & n.29 (citing United States v. Corr, 543 F.2d 1042, 1046 (2d Cir. 1976); United States v. Cohen, 518 F.2d 727, 734-35 (2d Cir.)).

26/ Rita H. Malm, 52 S.E.C. at 69 & n.15 (citing Universal Heritage Invs. Corp., 47 S.E.C. 839, 845 (1982); Gary E. Bryant, 51 S.E.C. at 471); Consol. Inv. Servs., Inc., 52 S.E.C. 582, 590 & n.30 (1996) (citations omitted).

27/ See Rita H. Malm, 52 S.E.C. at 69.

28/ La Jolla Capital Corp., 54 S.E.C. at 282 & n.18 (citing SECO Secs., Inc., 49 S.E.C. 873, 876 (1988)); see also Consol. Inv. Servs., Inc., 52 S.E.C. at 586 (recognizing “obvious
(continued...)

Forms U-4 suggested particular compliance issues. Kresge admitted that changing firms frequently within a short period of time was a red flag for potential compliance issues. At least five of the registered representatives Giordano was to supervise in the Brooklyn branch office had worked at numerous firms within a short period of time. One registered representative had less than two years of experience in the securities industry. Another representative had a prior felony conviction and a pending arbitration. Kresge did not direct that this registered representative be subject to heightened supervision in the Brooklyn branch office. Kresge testified that none of the Brooklyn branch office registered representatives received a compliance manual and that he did not know whether any of those registered representatives received training on sales practices or suitability.

Kresge hired Giordano to be the Brooklyn branch office manager on Ferragamo's recommendation. However, Giordano had passed his principal's examination only six months earlier. Giordano also had repeatedly changed firms in the five years before joining Yankee Financial. The record does not indicate that Kresge spoke with any of Giordano's previous employers to discuss Giordano's qualifications. Conduct Rule 3010(a)(6) provides that, as part of its supervisory system, each member shall make "reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities." Under the circumstances, Kresge did not make "reasonable efforts" to determine that Giordano was qualified.

Nonetheless, Kresge assigned to Giordano responsibility for supervising all aspects of the Brooklyn branch office, including the review and approval of new accounts, review of all order tickets, confirmation with customers regarding all aspects of their orders, including suitability review, and placement of orders to the Melville branch office. ^{29/} Kresge also gave Giordano unfettered discretion on the amounts of commissions paid to Brooklyn branch office representatives. Kresge never provided Giordano with a compliance manual, and the record does not indicate that Giordano ever received any training of any kind. While Kresge visited the Brooklyn branch office a few times, he did not review Giordano's performance of his supervisory duties or review any of the Brooklyn branch office records.

^{28/} (...continued)
need" to keep untried personnel under close surveillance); Conrad C. Lysiak, 51 S.E.C. 841, 845 (1993) (quoting SECO Secs., Inc., 49 S.E.C. at 876), aff'd, 47 F.3d 1175 (9th Cir. 1995) (Table).

^{29/} Because Giordano had authority for approving new accounts, Kresge was required to seek approval to operate the Brooklyn branch office as an OSJ under Conduct Rule 3010(a)(3). Under Conduct Rule 3010(g), an OSJ includes any office of a member at which "final acceptance (approval) of new accounts on behalf of the member" occurs. Kresge failed to obtain this approval.

Kresge notes that Gliwa was Giordano's direct supervisor. However, Gliwa had worked at the Firm for approximately six months when he was assigned responsibility for Giordano and the Brooklyn branch office. At that time, Gliwa already had a wide range of duties, as well as his own customers. Kresge knew that Gliwa was "overwhelmed" with his other responsibilities and "almost never" visited the Brooklyn branch office (perhaps two or three times in total). Kresge did not ask Gliwa how he performed his review of order tickets placed by Brooklyn. Moreover, Kresge knew that Gliwa did not conduct suitability reviews for the Brooklyn customer accounts. 30/

Based on the testimony of Kresge, Gliwa, Korwasky, and Giordano, no one had a clear understanding of Korwasky's responsibilities. Korwasky had no hiring or firing authority. Thus, it is unclear whether Korwasky was a supervisor. 31/ Korwasky first visited the Brooklyn branch office in February 2002, and less than ten times thereafter until he resigned from the Firm in June 2002. He repeatedly told Kresge that he had inadequate office space and no access to back office operations or the CRD system. Following his first visit, Korwasky recommended that Kresge install a telephone monitoring system for the Brooklyn branch office, but that installation never occurred.

Kresge argues that Gliwa, Giordano, and Korwasky were "NASD approved supervisory personnel." NASD has stated that even if an individual has passed the principal's examination, that fact "does not in and of itself qualify a supervisor. Members should determine that supervisors understand and can effectively conduct their requisite responsibilities." 32/ Moreover,

30/ Kresge claims that Gliwa and Giordano deliberately concealed evidence of misconduct from him that prevented him from taking action sooner. Kresge maintains that he received constant reassurances from Gliwa and Giordano that the Brooklyn branch office "was operating appropriately." Even if Kresge's statements about Gliwa and Giordano are true, his passive reliance on their general reassurances was not reasonable under the circumstances. Kresge knew that the Brooklyn branch office was active in penny stocks because he received commission reports from a clearing firm every couple of days. However, as described above, he did nothing to monitor the office's operations.

31/ See Arthur James Huff, 50 S.E.C. 524, 535 (1991) (finding that respondent was not a supervisor because he neither was "in the line of authority . . . to hire, fire, reward or punish" the salesperson who engaged in misconduct, nor "knew or should have known that he had the authority and responsibility within the administrative structure of [the Firm] to exercise such control over [the salesperson's] activities that he could have prevented [the salesperson's] violations").

32/ NASD Notice to Members 99-45 at 297.

we have repeatedly held that members and their associated persons “cannot shift their burden of compliance to the NASD.” 33/

Even if Giordano, Gliwa, and Korwasky were highly qualified, “[i]t is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention. . . Implicit is the additional duty to follow up and review that delegated authority to ensure that it is being properly exercised.” 34/ Kresge did not discharge that duty. As discussed above, beyond having a few casual conversations about the financial progress of the Brooklyn branch office with Giordano and Gliwa, Kresge did nothing to follow up and review their performances.

Kresge argues that he “diligently enforced the [Firm’s supervisory] system.” In support of his argument, he contends that (1) when he became aware of Korwasky’s concern about the conduct of Anderson and Dugo, he instructed Korwasky to place them on heightened supervision and required Giordano to document it; when Kresge later became aware of customer complaints against Dugo, Kresge caused the Firm to fire him; (2) when Kresge became aware of the possibility of the operation of an unauthorized office in Staten Island, he dispatched Korwasky to investigate and, following Korwasky’s recommendation, ordered the registered representatives to return to the Brooklyn branch office; (3) Kresge “banned” Ferragamo from the Brooklyn branch office on Korwasky’s recommendation; and (4) Kresge also banned Masone from the Melville office after Korwasky told him that Masone had been answering telephones and carrying documents between the Melville and Brooklyn offices. However, Kresge’s actions occurred months after the misconduct at issue already had transpired and after NASD had begun its investigation.

Kresge argues that no type of supervisory system could have prevented the vast misconduct carried out in the Brooklyn branch office because he was “duped and victimized by Ferragamo,” who, he claims, “contrived and planned secretive actions, by which he alone

33/ B.R. Stickle & Co., 51 S.E.C. 1022, 1025 (1994); see also Michael G. Keselica, 52 S.E.C. 33, 37 (1994) (“attempts to blame others for his misconduct . . . demonstrate that [respondent] fails to understand the seriousness of . . . violations”).

34/ Rita H. Malm, 52 S.E.C. at 73 (quoting Stuart K. Patrick, 51 S.E.C. 419, 422 (1993) (footnote omitted), aff’d, 19 F.3d 66 (2d Cir. 1994)); Castle Secs. Corp., 53 S.E.C. 406, 412 (1998) (citations omitted); La Jolla Capital Corp., 54 S.E.C. at 284 & n.24 (citations omitted); Harry Glikzman, 54 S.E.C. 471, 485 & n.30 (1999), aff’d, 24 Fed. Appx. 702 (9th Cir. 2001) (unpublished).

controlled and supervised the wrongful activities . . . unbeknownst to Kresge.” ^{35/} While it is possible for serious misconduct to occur despite the existence of a reasonably designed supervisory system, for the reasons discussed above, Yankee Financial’s supervisory system was not reasonably designed to achieve compliance with applicable federal securities laws and regulations and NASD rules. The record indicates instead that Kresge turned a blind eye to the activity that occurred.

Kresge argues that the Firm’s supervisory procedures, including the January 2001 Written Procedures and the March 2002 Written Procedures, met the standards set forth in Conduct Rule 3010(a) and (b). However, we find the Firm’s written procedures deficient. Kresge created the January 2001 Written Procedures by substituting Yankee Financial’s name on Glenn Michael’s existing written procedures, with minor amendments. Conduct Rule 3010(b)(4) provides that “[e]ach member shall amend its written supervisory procedures as appropriate within a reasonable time . . . as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.” When the Brooklyn branch office opened, Yankee Financial’s activity in penny stocks increased dramatically. As noted above, the January 2001 Written Procedures are not in the record. However, Kresge offered no evidence that he amended the January 2001 Written Procedures to cover the addition of the Brooklyn branch office or the increased penny stock activity. There is no dispute that the January 2001 Written Procedures did not set forth a supervisory chain of command or describe the division of supervisory duties at each office.

Kresge argues that NASD’s approval of the January 2001 Written Procedures demonstrates their adequacy. However, Kresge received NASD approval of the January 2001 Written Procedures well before opening the Brooklyn branch office. ^{36/} Kresge conceded that it was critical for Korwasky to update the January 2001 Written Procedures because they did not cover sufficiently the Firm’s activities. In turn, Korwasky concluded the January 2001 Written Procedures were so inadequate that he had to start from “scratch.”

^{35/} In support of this contention, Kresge seeks to adduce additional evidence in the form of (1) a criminal indictment against Ferragamo filed by the United States Attorney in the United States District Court for the Southern District of New York on December 30, 2004 regarding an alleged scheme to defraud Yankee Financial customers through the sale of certain penny stocks, and (2) Ferragamo’s related plea agreement in which he admits to being the “manager or supervisor of the relevant criminal activity.” We take official notice of these documents pursuant to Rule of Practice 323, 17 C.F.R. § 201.323.

^{36/} As we already have made clear, Kresge cannot shift his burden of compliance to NASD. See Kirk A. Knapp, 50 S.E.C. 858, 862 n.15 (1992) (applicant “cannot shift his responsibility for compliance with regulatory requirements to . . . NASD”) (internal citations omitted).

In March 2002, Kresge approved Korwasky's distribution of the draft 2002 March Written Procedures. Even though Korwasky considered the document to be a "work in progress," the March 2002 Written Procedures were far from adequate. They addressed business activity related to mutual funds, but not to penny stocks (the chief business of the Brooklyn office) or bonds (a traditional line of Yankee Financial's business). The March 2002 Written Procedures contained a list of certain prohibited activities (e.g., fraudulent representations, but not unsuitable recommendations). However, they did not identify procedures for detecting and preventing such activities. Moreover, the March 2002 Written Procedures did not adequately set forth a supervisory chain of command or describe the division of duties and responsibilities among the Firm's supervisors.

Kresge admitted that none of the registered representatives received any compliance manual. Korwasky testified that he provided Dugo with the March 2002 Written Procedures "sometime in April." There is no evidence that anyone at the Firm ever implemented either set of written procedures. 37/

We conclude that neither the January 2001 Written Procedures nor the March 2002 Written Procedures met the Conduct Rule 3010(b) standard. Accordingly, we find that Kresge failed to maintain and enforce written procedures that were reasonably designed to achieve compliance with applicable federal securities laws and regulations and NASD rules. It is well settled that a violation of a rule promulgated by the Commission or by NASD also violates Conduct Rule 2110. 38/ We accordingly sustain NASD's findings that Kresge violated Conduct Rules 3010 and 2110.

III.

Failure to Report Customer Complaints

A. In response to a request to the Firm for information under NASD Investigations Rule 8210, Giordano provided NASD with eighteen customer complaints. Yankee Financial was required to report these complaints by January 15, 2002, April 15, 2002, and July 15, 2002, which would have covered the complaints received during the quarters ending December 31,

37/ Even if the Firm's written procedures were adequate, "the presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not assure compliance." Rita H. Malm, 52 S.E.C. at 69 & n.17.

38/ See, e.g., Joseph Abbondante, 87 SEC Docket at 219 & n.54; Chris Dinh Hartley, Exchange Act Rel. No. 50031 (July 16, 2004), 83 SEC Docket 1239, 1244; Stephen J. Gluckman, 54 S.E.C. 175, 185 (1999). See also Gerald James Stoiber, 53 S.E.C. 171, 180 n.22 (1997), petition denied, 161 F.3d 745 (D.C. Cir. 1998).

2001, March 31, 2002, and June 30, 2002, respectively. ^{39/} There is no dispute that the Firm received these complaints and that Yankee Financial did not report them to NASD.

Kresge was the Firm's compliance director, except between February 19, 2002 and June 30, 2002 when Korwasky was the Firm's compliance director. While compliance director, Kresge was responsible for reporting customer complaints, but did not review any customer complaint files or discuss with Giordano whether customer complaints were received.

B. Conduct Rule 3070(c) requires a member firm to report to NASD on a quarterly basis statistical and summary information regarding customer complaints. ^{40/} The requirement that member firms file reports on customer complaints is intended to protect public investors by helping to identify potential sales practice violations in a timely manner. ^{41/} That protection is undermined when member firms do not file such reports.

Kresge, as the Firm's compliance director, was responsible for filing the reports due on January 15, 2002 (Korwasky was not yet the Firm's compliance director) and July 15, 2002 (Korwasky resigned on June 30, 2002), covering eleven of those complaints. ^{42/} Kresge claims

^{39/} Conduct Rule 3070(c).

^{40/} A "complaint" includes "any written grievance by a customer involving the member or person associated with a member." Conduct Rule 3070(c).

^{41/} See Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change by the Nat'l Assoc. of Secs. Dealers, Inc. Relating to Supervision and Record Retention Rules, Exchange Act Rel. No. 39510 (Dec. 31, 1997), 66 SEC Docket 663, 665 ("[P]roviding for the reporting of customer complaints in compliance with NASD Rule 3070(c) may help firms to identify potential sales practice problems."); Notice of Filing of Proposed Rule Change and by the National Association of Secs. Dealers, Inc. Amending NASD Rule 3070 Concerning the Reporting of Criminal Offenses by Members and Persons Associated with a Member to the NASD, Exchange Act Rel. No. 45493 (Mar. 1, 2002), 77 SEC Docket 99, 100 ("... NASD Rule 3070 assists the NASD in the timely identification and investigation of problem members, branch offices, and registered representatives that may pose heightened risks to public investors.").

^{42/} As we have already stated, the president of a brokerage firm is responsible for the firm's compliance with all applicable requirements unless and until he or she reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties. Rita H. Malm, 52 S.E.C. at 69 & n.15 (citing Universal Heritage Invs. Corp., 47 S.E.C. at 845; Gary E. Bryant, 51 S.E.C. at 471); Consolidated Inv. Services, Inc., 52 S.E.C. at 590 &

(continued...)

that he did not receive any customer complaints between October 2001 and February 2002. There is no dispute, however, that the Firm received those complaints. Kresge's lack of awareness of the complaints evidences the inadequacy of the Firm's supervisory system and his abdication of his supervisory responsibilities. ^{43/} Accordingly, we sustain NASD's finding that Kresge violated Conduct Rules 3070(c) and 2110.

IV.

Failure to Register Ferragamo

A. As described above, Ferragamo initiated contact with Kresge and Yankee Financial about opening the Brooklyn branch office. Kresge negotiated the terms under which the Brooklyn branch office was opened solely with Ferragamo. Ferragamo appeared on the list of "Brokers Who Will Be Receiving Calls for the New York Office" that he provided to Kresge prior to the opening of the Brooklyn branch office. Ferragamo also received an office tracking number, "B01," for his anticipated role as a registered representative of the Firm.

Once the office opened, Ferragamo often was present there. He attended Kresge's introduction of Korwasky to office staff as the new compliance director in February 2002. Ferragamo was again present in the Brooklyn branch office when Korwasky made his second visit approximately two weeks later. When Korwasky inquired about Ferragamo's role in the Firm, Kresge said that Ferragamo was "somehow involved in the organization" and had funded the Brooklyn branch office. Kresge also disclosed that he agreed to postpone Ferragamo's registration with the Firm because Ferragamo wanted to avoid being financially responsible for a pending arbitration at his former firm. When Korwasky met with Dugo in March 2002, Ferragamo "burst in and just hung out," which Korwasky found very unusual. On the day that Korwasky visited the Staten Island office, Ferragamo again was present.

Kresge admits that he should have, but did not, amend the Firm's Form BD to disclose that Ferragamo was financing the operation of the Brooklyn branch office. Kresge also admits that he "was after Mr. Ferragamo to get licensed, to get registered," and that Ferragamo's unregistered status "became very weird." Kresge further admits that he never registered Ferragamo with the Firm based on Ferragamo's request that his registration be postponed.

^{42/} (...continued)

n.30 (citations omitted). NASD found that Kresge reasonably delegated the responsibility to Korwasky to file the April 15, 2002 report and had no reason to know that Korwasky was not fulfilling this obligation.

^{43/} Kresge argues that Giordano "deliberately hid" from Kresge the complaints received after Korwasky's resignation. Kresge does not offer any evidence to substantiate his claim.

B. Membership and Registration Rules 1021(a) and 1031(a) require that all persons who act as a principal or as a representative of an NASD member firm be properly registered as a principal or representative, respectively, with NASD. Rule 1021(b) defines a "principal" as a sole proprietor, officer, partner, branch manager, or director of an NASD member firm who is "actively engaged in the management of the [member firm's] investment banking or securities business," including supervision, solicitation, conduct of business, or training of associated persons. Rule 1031(b) defines "representative" as any person associated with an NASD member firm who is "engaged in the investment banking or securities business for the [member firm]," including supervision, solicitation, conduct of business, or training of associated persons. Kresge never registered Ferragamo as either a principal or a representative of the Firm. Kresge failed to register Ferragamo in any capacity.

Kresge argues that he was told that Ferragamo would not engage in any securities business activities and that Ferragamo was neither functioning as a Firm representative nor supervising the Brooklyn branch office. While other individuals were present during discussions about opening the Brooklyn branch office, Kresge negotiated solely with Ferragamo. Kresge testified that Ferragamo represented that he was licensed at, and owned, a branch office of Valley Forge Securities, Inc. Ferragamo also told Kresge "that he was the spokesperson for a group of brokers [who wanted to relocate], that he was the person that organized this attempt to move, that he would be the contact person, he was the chief as far as these five or six people."

The agreement between Kresge and Ferragamo covered the site for the Brooklyn branch office, the division of revenue and expenses, the power to direct trades to third-party broker-dealers, and payment of a monthly check payable to the branch manager of the Brooklyn branch office for the commissions generated by the Brooklyn branch office. Ferragamo undertook to pay for any expenses that were not covered by the Brooklyn branch office revenues.

Moreover, Kresge hired Giordano, the branch manager of the Brooklyn branch office, and two registered representatives who had worked with Ferragamo at Valley Forge Securities, Inc. on Ferragamo's recommendation. Ferragamo often was present in the Brooklyn branch office and made himself present during compliance meetings with the office's registered representatives. Under the circumstances, Ferragamo actively engaged in the management of the Firm's securities business. ^{44/} He provided financial support to the office, played a substantial role in the finances of the office, was actively involved in hiring, participated in meetings, and

^{44/} Cf. Vladislav Steven Zubkis, 53 S.E.C. 794, 799-800 (1998) (finding that applicant was an "associated person" and "engaged in the [firm's] securities business" based, in part, on his financial support of a branch office); Kirk A. Knapp, 50 S.E.C. 858, 860-861 (1992) (finding that applicant actively engaged in the management of the firm's securities business based on, among other things, his participation in firm meetings and hiring firm personnel); Samuel A. Sardinia, 46 S.E.C. 337, 343 (1976) (finding that applicant was a principal based, in part, on his having "spent a substantial amount of time in connection with the affairs of the firm").

acted as the leader of the personnel initially opening the office. Accordingly, we sustain NASD's finding that Kresge violated Membership and Registration Rule 1021(a) by permitting Ferragamo to act as a principal of the Firm without being so registered.

We also find that Kresge violated Membership and Registration Rule 1031(a) by permitting Ferragamo to act as a representative of the Firm without being so registered. By acting as a principal, Ferragamo also acted as a representative. ^{45/} Ferragamo also was assigned a sales number and was authorized to receive calls for the office. Kresge described Ferragamo's unregistered status as "very weird," and Kresge admits that he never registered Ferragamo with the Firm at Ferragamo's request. Kresge further admits that he should have, but did not, amend the Firm's Form BD to disclose that Ferragamo was financing the operation of the Brooklyn branch office.

As the president of the Firm, Kresge was responsible for ensuring that the Firm registered Ferragamo as a registered representative pursuant to Membership and Registration Rule IM-1000-3 and disclosing on the Firm's Form BD Ferragamo's financial support of the Brooklyn branch office pursuant to Membership and Registration Rule IM-1000-1. ^{46/} Kresge did not fulfill his responsibilities. Accordingly, we sustain NASD's finding that Kresge also violated Membership and Registration Rules IM-1000-3 and IM-1000-1, as well as Conduct Rule 2110.

V.

Secondary Liability

A. NASD found that Kresge was liable, under Exchange Act Section 20(a), ^{47/} for violations by certain registered representatives of Yankee Financial of Exchange Act Section

^{45/} See Membership and Registration Rule 1022(a) (requiring that, in order to be registered as a general securities principal, one must first be registered as a general securities representative.); L.H. Alton & Co., 53 S.E.C. 1118, 1125-26 (1998) (finding that individual who acted as a principal also acted as a representative).

^{46/} See Rita H. Malm, 52 S.E.C. at 69. Kresge does not claim to have delegated these responsibilities.

^{47/} 15 U.S.C. § 78t(a). Exchange Act Section 20(a) provides that:

Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

10(b) and Rule 10b-5 thereunder. We conclude that the record does not support a finding of liability under Exchange Act Section 20(a). Accordingly, we set aside NASD's finding.

B. With respect to Kresge's liability for the registered representatives' violations of Conduct Rules 2120, 2310, IM-2310-2, and 2110, NASD determined not to "address whether a president of a broker-dealer may be held responsible pursuant to Section 20(a) for firm representatives' violations of NASD rules alone." We concur with this decision. We have held that Section 20(a)'s coverage "is limited to persons 'who . . . control [] any person liable under any provision of [the Exchange Act] or of any rule or regulation thereunder . . .'" 48/

C. NASD found Kresge liable for the registered representatives' violations of NASD's rules on the basis that "Kresge was president of his firm and accordingly ha[d] an overarching responsibility for his firm's regulatory obligations. It is axiomatic that 'the president of a brokerage firm is responsible for his firm's compliance with all applicable requirements unless and until he reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties.'" (citing Kirk A. Knapp, 51 S.E.C. 115 (1992) and William H. Gerhauser, Sr., 53 S.E.C. 933 (1998)."

However, in Gerhauser, we found that the president made misrepresentations to the firm's limited principal-financial and operations that resulted in the firm's net capital violation. In Knapp, the president orchestrated transactions to circumvent the financial responsibility rules. Accordingly, we found that each president directly violated Conduct Rule 2110 as a result of his participation in the underlying violation. The record does not demonstrate Kresge's participation in the conduct that led to NASD's finding that the registered representatives violated NASD's antifraud and suitability provisions or the requirement that the representatives observe high standards of commercial honor and "just and equitable principles of trade." Consistent with Knapp and Gerhauser, we set aside NASD's findings of violation.

VI.

Kresge claims that the Hearing Panel inappropriately discredited his testimony about his conversation with the compliance officer at Valley Forge Securities, Inc., Robert Montani. Kresge had testified that Montani had said that Ferragamo had "no issues." However, Montani testified that he had been silent as to whether Ferragamo had any disciplinary issues, during his conversation with Kresge. Kresge states that NASD should not have credited Montani's testimony because Montani was then under criminal investigation. Kresge also complains that the Hearing Panel discredited Kresge's own testimony that he did not know that "federal prosecutors had issued an indictment alleging that Valley Forge's New York City office was controlled by organized crime figures," because "[t]here was no evidence of such indictment," or

48/ SIG Specialists, Inc., Exchange Act Rel. No. 51867 (June 17, 2005), 85 SEC Docket 2679, 2695.

that he failed to discover a second pending arbitration against Ferragamo. NASD's National Adjudicatory Council ("NAC") made clear that it did not rely on this portion of the Hearing Panel's conclusions. Nor have we considered them. 49/

Kresge also claims that a dismissal is warranted based on a "conflict of interest" that applies to the chairman of the NAC panel that heard Kresge's appeal below because he also authored NASD's opposition brief on appeal to the Commission. We have approved the rule that permits NASD staff to sit on the NAC. We do not see a conflict in the fact that staff works on a brief defending its earlier decision.

VII.

Exchange Act Section 19(e)(2) 50/ provides that we will sustain NASD's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 51/

NASD barred Kresge in all capacities, ordered restitution to the customers at issue in the amount of \$3,866,426, plus interest, and assessed costs of \$9,519.61. NASD stated, "[W]e aggregate respondents' misconduct for purposes of imposing sanctions because such misconduct emanated from a single, underlying problem: respondents' addition of, and failure to monitor, the Brooklyn office." We have sustained NASD's findings that Kresge violated Conduct Rules 2110, 3010, and 3070(c) and Membership and Registration Rules 1021(a), 1031(a), IM-1000-1, and IM-1000-3. However, we have set aside NASD's findings that Kresge was liable for

49/ Even if Kresge's claims that these Hearing Panel findings somehow tainted the NAC opinion were true, our de novo review of NASD's findings ensures that Kresge has been treated fairly. See Cathy Jean Krause Kirkpatrick, 53 S.E.C. 918, 930 & n.20 (1998) (citations omitted) (finding that the Commission's de novo review of NASD's findings ensured fair treatment of applicant in addition to finding that NASD's cross examination of applicant's history regarding a misdemeanor charge for stolen property, employment termination, and customer complaints was appropriate).

50/ 15 U.S.C. § 78s(e)(2).

51/ Id. Kresge does not claim, and the record does not show, that NASD's action imposed an undue burden on competition.

violations by certain registered representatives of Yankee Financial of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and Conduct Rules 2120, 2310, and IM-2310-2. Under the circumstances, we deem it appropriate to remand this proceeding to NASD for a redetermination of the sanctions to be imposed upon Kresge. We do not intend to suggest any view as to a particular outcome.

An appropriate order will issue. 52/

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

Nancy M. Morris
Secretary



By: Florence E. Harmon
Deputy Secretary

52/ We have considered all of the arguments advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Rel. No. 55988 / June 29, 2007

Admin. Proc. File No. 3-12402

In the Matter of the Application of

RICHARD F. KRESGE
c/o Lawrence R. Gelber, Esq.
The Vanderbilt Plaza
34 Plaza Street - Suite 1107
Brooklyn, NY 11238
for Review of Disciplinary Action Taken by

NASD

ORDER REMANDING DISCIPLINARY PROCEEDING

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

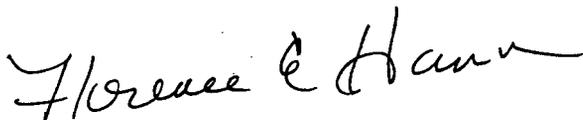
ORDERED that the findings by NASD that Richard F. Kresge violated NASD Conduct Rules 3010, 3070(c), and 2110 and Membership and Registration Rules 1021(a), 1031(a), IM-1000-3, and IM-1000-1 be, and they hereby are, sustained; and it is further

ORDERED that the findings by NASD that Kresge was liable for violations by certain registered representatives of Yankee Financial Group, Inc. of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and NASD Conduct Rules 2110, 2120, 2310, and IM-2310-2 be, and they hereby are, set aside; and it is further

ORDERED that the sanctions and costs imposed by NASD on Kresge in this proceeding be, and they hereby are, vacated; and it is further

ORDERED that this proceeding be, and it hereby is, remanded to NASD for further proceedings in accordance with that opinion.

By the Commission.



By Florence E. Harmon
Deputy Secretary

Nancy M. Morris
Secretary

Chairman Cox?
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55990 / June 29, 2007

INVESTMENT COMPANY ACT OF 1940
Release No. 27881 / June 29, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12559

In the Matter of

TRAUTMAN WASSERMAN &
COMPANY, INC.,
GREGORY O. TRAUTMAN,
SAMUEL M. WASSERMAN,
MARK BARBERA,
JAMES A. WILSON, JR.,
JEROME SNYDER, AND
FORDE H. PRIGOT,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTIONS 15(b) AND
21C OF THE SECURITIES EXCHANGE
ACT OF 1934 AND SECTION 9(b) OF
THE INVESTMENT COMPANY ACT
OF 1940 AS TO JEROME SNYDER

I.

On February 5, 2007, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against respondents including Jerome Snyder ("Respondent").

II.

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

Document 44 of 46

the subject matter of these proceedings, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 9(b) of the Investment Company Act of 1940 as to Jerome Snyder ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

1. This matter concerns a scheme to defraud mutual funds through, among other conduct, deceptive market timing of mutual funds through Trautman Wasserman & Company, Inc. ("TWCO"), a registered broker-dealer. TWCO employed deceptive tactics to evade mutual funds' efforts to restrict TWCO's hedge fund customers' market timing of mutual funds. This illegal conduct generated significant revenues for TWCO and harmed mutual fund investors by diluting the value of their investment.

2. TWCO's mutual fund trading department consisted principally of two registered representatives ("RRs"), James A. Wilson, Jr. ("Wilson") and Scott A. Christian ("Christian"). Numerous mutual funds notified Wilson, Christian, and others at TWCO that frequent trading by TWCO's customers violated prohibitions in the mutual funds' prospectuses, and the mutual funds instructed TWCO to stop permitting its customers to trade those funds. Christian and others, acting at Wilson's direction, then employed deceptive tactics to continue trading the mutual funds that had requested TWCO's customers to stop.

3. TWCO's former chief administrative officer, Snyder, also participated in TWCO's fraudulent market timing. Snyder took steps to deceive mutual fund companies about TWCO's customers' market timing to evade the mutual fund companies' efforts to curtail the practice.

Respondent

4. **Snyder**, age 66, is a resident of Lakewood, NJ. Snyder was chief administrative officer of TWCO from 1999 until December 31, 2002, and he has served as a consultant to TWCO between May 14, 2004 and the present. During 2002, Snyder was the de facto chief compliance officer of TWCO. At all relevant times, Snyder was associated with TWCO. Snyder holds or has held Series 1, 3, 4, 5, 7, 8, 12, 15, 24, 40, 53, 55, 63, and 65 licenses.

Related Entity

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

5. TWCO, based in New York, New York, was at all relevant times a broker-dealer registered with the Commission.

Market Timing

6. Market timing includes (a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing, while not illegal per se, can harm other mutual fund shareholders because it can dilute the value of their shares. Market timing can also disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer.

Snyder Participated in TWCO's Deception of Mutual Funds That Sought To Curtail Market Timing

7. In March 2001, as TWCO began large-scale market timing for its customers, mutual fund complexes began notifying TWCO that the funds restricted or prohibited such transactions. For example, on March 16, 2001, a fund complex wrote Christian to warn him about excessive trading by customer accounts in one of the complex's mutual funds. The letter explained that excessive trading could hurt the mutual fund's performance and that the fund's prospectus therefore reserved to the fund complex the right to refuse an exchange request if there were more than two exchanges from the same fund in any three-month period. The letter notified Christian that "exchange activities in your client's account have become excessive and we are writing you in an effort to have you and your clients adhere to the guidelines stated in our Prospectus," and warned that further excessive trading would result in a trading freeze in the accounts.

8. In total, during the period March 2001 through April 2003, TWCO, Wilson, and Christian received 307 "kick out" letters from 40 mutual fund families that addressed trading activity in 113 accounts.

9. In response, Wilson and Christian attempted to deceive mutual fund companies and evade their restrictions. Wilson had learned many of these techniques from his hedge fund customers while Wilson was working at other broker-dealers. Wilson explained these techniques to Christian, and directed him to employ them.

10. Based on Wilson's instructions, Christian opened multiple accounts for TWCO's market timing customers and entered transactions using one of numerous RR numbers. Christian did this because he understood that mutual fund companies would be less likely to detect market timing by a customer if the customer's trades occurred in numerous accounts with different account numbers, account names, or RR identification numbers.

11. More specifically, TWCO "cloned" accounts to evade mutual funds' restrictions. For example, a fund complex sent a letter to TWCO on February 22, 2002 concerning account number 70087, an account that TWCO maintained for Hedge Fund A, warning that the account

was approaching the limit on exchanges. On March 4, 2002, Christian opened two new accounts, each with a new account number (70089 and 70110), for the same entity, and two days later entered a market timing trade in one of the mutual fund complex's mutual funds. Similarly, on June 4, 2002, the same fund complex sent to TWCO a letter imposing restrictions on trading by account number 70104, an account that TWCO maintained for Hedge Fund B. On June 7, 2002, Christian opened a new account for the same entity with a new account number (70139), and less than three weeks later began trading the fund complex's mutual funds using the new account.

12. Consistent with this deceptive practice, TWCO opened a total of 140 accounts for eleven institutional customers. These included 68 accounts for its customer Hedge Fund A; 35 accounts for Hedge Fund B; nine accounts for Hedge Fund C; 15 accounts for Hedge Fund D; and five accounts for Hedge Fund E. Christian prepared the new account forms, which he then submitted to Snyder or others for approval and signature.

13. Christian, assisted by Snyder and/or others, also established 16 different RR identification numbers at TWCO for use in mutual fund trading, as a means of evading restrictions imposed by mutual funds that tracked excessive trading through RR numbers.

14. Snyder supervised Wilson and Christian during much of the time period that TWCO engaged in deceptive market timing. Snyder received numerous warning or kick out letters from mutual funds. Snyder received a number of these letters from funds during the approximately seven-month period that he acted as chief compliance officer in addition to serving as chief administrative officer. Despite receiving these letters, Snyder failed to act to stop Wilson and Christian from market timing as the funds requested.

15. During the period he was chief administrative officer, Snyder was responsible for obtaining RR identification numbers for TWCO RRs by calling B of A and getting numbers assigned. Snyder obtained numerous RR ID numbers for Wilson and Christian, which they then used to engage in deceptive market timing.

16. Snyder also signed numerous account opening forms as the firm's principal, including during the period he was serving as TWCO's chief compliance officer. This enabled TWCO to create duplicate accounts for customers and continue to market time mutual funds without the funds' knowledge. For instance, between June 25 and June 29, 2001, Snyder signed new account forms to create four accounts for Hedge Fund A, and on August 30, 2001, he signed new account forms to create an additional five accounts for Hedge Fund A.

17. Further, on at least one occasion Snyder misrepresented the purpose of mutual fund trades to a representative of a mutual fund complex. The representative of the mutual fund complex asked Snyder if he knew who were the TWCO RRs attached to accounts that had recently made fourteen mutual fund trades worth \$500,000 each. Snyder responded that it was probably a "house account." When the representative asked who handled those accounts, Snyder responded that he did. In fact, Snyder knew that the RRs attached to the trades were Wilson and Christian, who were using a so-called "house account" to conceal their identities and thus to evade the mutual fund complex's restrictions on trading. The representative of the mutual fund complex then

informed Snyder that there was a potential problem with the accounts because they appeared to be set up for market timing. Although Snyder knew that all of Wilson's and Christian's business related to market timing of mutual funds, Snyder falsely stated that, to his knowledge, the accounts were not being used for market timing.

Violations

18. By virtue of the conduct of its officers and employees as discussed above, TWCO violated, and Snyder aided and abetted and caused violations of, Section 15(c) of the Exchange Act and Rule 10b-3 thereunder. Section 15(c) of the Exchange Act and Rules 10b-3 thereunder prohibit fraudulent conduct by brokers or dealers in connection with the purchase or sale of securities. TWCO violated Section 15(c) of the Exchange Act and Rule 10b-3 when TWCO and its RRs misrepresented and concealed the identities of TWCO's RRs and customers, as well as the nature of their customers' market timing activity, from the mutual funds. Snyder substantially assisted this violation. Snyder received numerous warning or kick out letters from mutual funds requesting TWCO to stop market timing, but Snyder did not stop the market timing as the funds requested. Instead, Snyder signed numerous account opening forms for TWCO and assisted in procuring multiple RR numbers for Wilson and Christian. Wilson and Christian then used the multiple RR numbers and accounts to market time mutual funds. After at least one mutual fund questioned whether certain trades were market timing trades, Snyder falsely told a representative of the mutual fund that money invested at the mutual fund belonged to a TWCO house account and that the trades were not market timing trades. Snyder was generally aware that his conduct was wrongful.

19. As a result of the conduct described above, TWCO, Wilson, Christian, and their customers violated, and Snyder willfully aided and abetted and caused violations of, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Section 10(b) of the Exchange Act and Rule 10b-5 prohibit fraudulent practices in connection with the purchase or sale of securities. Among other things, TWCO, Wilson, Christian, and their customers engaged in deceptive market timing. Snyder and others substantially assisted this conduct. For example, Snyder received numerous warning or kick out letters from mutual funds, but Snyder failed to stop the market timing as the funds requested. Moreover, Snyder created multiple RR numbers for Wilson and Christian. Snyder also signed numerous account opening forms for TWCO. Wilson and Christian then used the multiple RR numbers and accounts to deceive mutual funds about the identity of their customers in order to market time mutual funds. Additionally, after at least one mutual fund contacted Snyder and asked if particular trading was market timing, Snyder falsely told a representative of the mutual fund that money invested at the mutual fund belonged to a TWCO house account. Snyder was generally aware that his conduct was wrongful.

Undertakings

20. Respondent undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings brought by the Commission relating to or arising from the matters described in the Order and agrees:

- a. To comply with any and all reasonable requests by the Commission's staff for documents or other information;
- b. To be interviewed at such times as the Commission's staff reasonably may direct;
- c. To appear and testify in such investigations, depositions, hearings or trials as the Commission's staff reasonably may direct; and
- d. That in connection with any (i) testimony of Respondent to be conducted by testimony session, deposition, hearing or trial, or (ii) requests for documents or other information, that any notice or subpoena for such may be addressed to Respondent's counsel, and be served by mail or facsimile.

IV.

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

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

A. Respondent Snyder cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

B. Respondent Snyder cease and desist from causing any violations and any future violations of Section 15(c) of the Exchange Act and Rule 10b-3 thereunder;

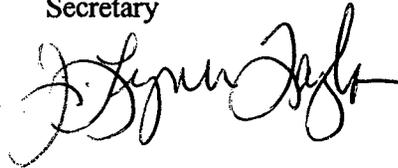
C. Respondent Snyder be, and hereby is barred from association with any broker or dealer, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

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

E. It is further ordered that Respondent shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 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 Jerome Snyder 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, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, NY 10281.

By the Commission.

Nancy A. Morris
Secretary

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

By: J. Lynn Taylor
Assistant Secretary

*Commissioner Casey
Not Participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8815 / June 29, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 55982 / June 29, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2626 / June 29, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12673

In the Matter of

CVS CAREMARK
CORPORATION, PHILIP C.
GALBO, AND LARRY
SOLBERG

Respondents.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE SECURITIES
ACT OF 1933, SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against CVS Caremark Corporation ("CVS"), Philip C. Galbo ("Galbo"), and Larry Solberg, CPA ("Solberg") (collectively, "Respondents") pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and, as to Respondent Solberg, Rule 102(e)(ii) of the Commission's Rules of Practice.¹

¹ Rule 102(e)(1)(ii) provides, in pertinent part, that:

II.

In anticipation of the institution of these proceedings, each of the Respondents has submitted an Offer of Settlement (collectively, the "Offers") which the Commission has determined to accept.² Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

A. SUMMARY

This case concerns incorrect accounting by CVS, a national chain of pharmacy and retail merchandise stores and a pharmaceutical benefits management company, for a transaction (the "Transaction") that senior executive Phil Galbo negotiated and the accounting for which Larry Solberg approved. As accounted for, the book value of the excess plush toy inventory, such as seasonal stuffed animals, was not reduced in connection with the Transaction. As a result of recording the Transaction in this manner, CVS materially overstated its pretax earnings for the third quarter of 2000 by approximately \$18.1 million (approximately \$10.8 million after tax), or approximately 7% of net income for the third quarter of 2000.

During the late spring and summer of 2000, Galbo and Solberg became aware that CVS was carrying the plush toy inventory on its books at \$32 million, a value higher than \$13.9 million, the inventory's approximate market value at the time. Instead of writing down the value of the inventory to market value, CVS entered into the Transaction with a barter company pursuant to which CVS contracted to exchange the plush toy inventory for credits with a face value of \$42.5 million. CVS then replaced the \$32 million toy inventory on its books with the credits at a value of \$42.5 million.

The Commission may ... deny, temporarily or permanently, the privilege of appearing or practicing before it ... to any person who is found ... to have engaged in ... improper professional conduct.

² As part of a final resolution of the Commission's claims against them, Galbo and Solberg have also agreed to consent to the entry of a district court judgment ordering Galbo to pay a civil monetary penalty of \$30,000 and Solberg to pay a civil monetary penalty of \$30,000.

Rather than exchange a set of goods or services with CVS, the barter company received no goods or services from CVS. It received \$12.5 million in cash. Under the terms of the deal, the barter company transferred the \$42.5 million in credits and CVS liquidated the inventory in its capacity as agent for the barter company while guaranteeing the barter company \$12.5 million. CVS valued the credits on its books at their full face value of \$42.5 million.

Evidence existed that the credits should not have been recorded at their face value. The credits consisted of \$18.8 million in telecommunications credits and \$23.7 million of credits with the barter company. Although CVS could have theoretically applied the telecommunications credits to pay its own telecommunications bills, CVS used a different telecommunications provider, thereby making the credits harder for CVS to utilize, and arguably of lesser value. The terms of the Transaction also were such that CVS could not use the \$23.7 million in barter company credits alone to purchase more goods from the barter company. Rather, the terms of the barter credit agreement were such that the ratio of barter credits in each transaction would vary from transaction to transaction, subject to mutual agreement between CVS and the barter company, but would generally be a 60-75% cash and 25-40% barter credit configuration.

Finally, even if CVS had properly transferred the toy inventory to the barter company, Generally Accepted Accounting Principles ("GAAP") required (a) that the toys be written down to their fair market value prior to entering the Transaction and (b) that CVS disclose the existence and certain details of the Transaction. CVS neither recorded the required write-down in the value of the toys nor properly disclosed the Transaction in its financial statements. Failing to reduce the book value of the toys to their market value had a material effect on CVS's financial results for the third quarter of 2000 (although not on CVS's financial results for the 2000 fiscal year).

B. RESPONDENTS

1. **CVS Caremark Corporation** is a Delaware corporation headquartered in Woonsocket, Rhode Island. Its primary business is the operation of over 6,200 retail stores that sell pharmacy and consumer products and the operation of a pharmaceutical benefits management company headquartered in Nashville, Tennessee. Its shares are registered under Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. CVS files periodic reports with the Commission pursuant to the Exchange Act. For the year 2000, its fiscal year ended December 30 and its fiscal third quarter ended September 30.

2. **Philip C. Galbo**, age 56, is a resident of Gladwyn, Pennsylvania. Galbo, who is not an accountant, was treasurer of CVS during the relevant period.

3. **Larry Solberg**, age 58, is a resident of Holmes Beach, Florida, and former controller of CVS. He is a certified public accountant whose license in the state of Minnesota is inactive. He was the principal accounting officer at CVS during the relevant period.

C. FACTS

CVS Discovers Sales of Excess Plush Toy Inventory Are Down, Which Poses a Threat to the Company's Achieving Its Financial Goals

1. At year-end 1999, CVS determined that its plush toys should be held over for the following year at full book value. Subsequently, in April and May 2000, CVS analyzed the status of its plush toy programs, which it had determined to terminate. The analysis revealed, among other things, that projected sales were less than the cost at which CVS was carrying the toys on its books and that the rate at which certain lines of plush toys were selling was low in comparison to historical rates and sales rates on other products. One then CVS vice president (the "CVS vice president") informed Solberg, the then controller, that poor sales were a potential threat to CVS achieving its gross margin goals for 2000.

2. During the summer of 2000, the value of the plush toys continued to decline according to some internal reports. Both Solberg and Galbo were sent a written analysis on August 25, 2000 that projected sales of \$13.9 million for the \$32 million (at cost) of plush toy inventory. In addition, in September, CVS agreed to liquidate 18% of the inventory at fourteen cents per dollar of cost. Ultimately, CVS realized approximately \$12 million on the liquidation of the plush toy inventory.

3. Throughout the summer of 2000, Solberg received documents indicating several threats, including the plush toys, to CVS achieving its financial goals. Galbo stated to his contact at the barter company that CVS's independent outside auditors had indicated that if the plush toy inventory were not sold, CVS may be facing some possible write-downs.

CVS Does Not Take a Charge to Reflect the Toys' Impaired Value, But Instead Enters Into the Transaction

4. To address the potential plush toy issue, Galbo, who was not involved in accounting for the Transaction, began negotiating the Transaction on CVS's behalf in or around May 2000. Galbo received an email from another then CVS executive which stated that avoiding markdowns on the plush toys through the proposed Transaction was "a major element of fixing [CVS's] significant profit gap." The value of the toys as reflected on CVS's books was \$32 million, but reports circulated to Galbo and Solberg indicated that their actual fair market value was much less. Solberg also reviewed and presented periodic reports to senior management that suggested the failure to close the Transaction was a potential threat to CVS's financial goals. Indeed, some of these reports, generated in September 2000, stated that there was "no margin for error" in achieving the consensus target for the third quarter 2000 and that management was to continue to "manage and monitor" a number of risk areas, including the proposed Transaction. Galbo received at least one such copy of the September 2000 report.

CVS Exchanges Credits With a \$42.5 Million Face Value for \$12.5 Million Cash, And Accounts for the Transaction As If CVS Had Transferred the Risks and Rewards of the Toy Inventory

5. On the last business day of CVS's third quarter 2000, after evaluating and presenting various transaction alternatives involving multiple entities, Galbo executed a letter of intent concerning the plush toy inventory with a barter company with which CVS had previously done business. Pursuant to this Transaction, CVS paid the barter company \$12.5 million (referred to as a guaranteed liquidation fee) in return for (a) a coupon entitling CVS to \$18.8 million of phone services with a vendor that CVS did not use and (b) barter credits entitling CVS to \$23.7 million of discounts off purchases of future unspecified goods and services from the barter company. In the Transaction, CVS also undertook to transfer title of the toys to the barter company, but the agreement left CVS with the risks and rewards of, and responsibility for, selling the plush toys, and CVS at all times retained physical possession of them.³

6. Nonetheless, CVS accounted for the Transaction as if it had transferred the toys to the barter company. Through a series of journal entries, CVS effectively replaced the \$32 million plush toy inventory with coupon/barter credit inventory at its face value of \$42.5 million. The effect of replacing toy inventory with coupon/credit inventory was that - at least on its books - CVS no longer owned a plush toy inventory that had a market value that was less than its book value. Accordingly, it did not take the appropriate impairment charge. In addition, on September 30, 2000, CVS reversed \$3.5 million of markdown expenses it had taken on a portion of the plush toy inventory during the summer months. By doing so, CVS not only retained the benefit of the cash generated by the summer sales of some of this inventory at marked down prices, but also, for purposes of markdown expense, treated the previously sold toys as if they had been exchanged to the barter company in return for credits. Solberg was aware of the reversal of markdown expense, but he did not know that a portion of the markdown reversal had been applied to previously sold toys. In connection with the year-end audit for 2000, Solberg discussed the Transaction with CVS's independent outside auditors. Based on the internal reports he received earlier in the year, Solberg should have known of the decline in the toys' value relative to their cost and discussed that with the independent outside auditors, but he did not.

Galbo and Solberg Should Have Known That the Toys Should Have Been Written Down at the End of the Third Quarter

7. Both Galbo and Solberg should have known that not taking an impairment charge to the plush toy inventory was incorrect. Each was exposed to red flags that signaled the error of not taking that charge. For example, each reviewed the contracts that showed that CVS retained responsibility for liquidating the plush toys, retained the risk of their loss, and retained to some extent the rewards of their sale. Moreover, based on the internal reports that were circulated to them, each should have known that CVS's internal estimates of plush toy sales were far less than the pre-

³ Although CVS referred to the Transaction as a "barter transaction," in economic substance it involved a payment of cash for credits and was not an exchange of non-monetary goods or services.

September 2000 book value and far less than the combined face value of the credits and phone services coupon received from the barter company. Just days prior to the Transaction, Galbo wrote a memo which Solberg received, in which he acknowledged, "We need to cover \$41.5 MM of margin with only \$12MM of inventory market value." Indeed, the CVS vice president, who was not an accountant, expressed to Solberg and Galbo that she thought the Transaction was "a little screwy" because it seemed to allow CVS not to take markdowns to inventory. The CVS vice president also expressed to Solberg her lack of understanding of how anyone would pay CVS so much for something the CVS vice president could not see value in.

8. With respect to Solberg, there were other red flags. The CVS vice president asked Solberg whether it would not be more appropriate to reduce the book value of the plush toy inventory first and then engage in the Transaction. Solberg should have known that CVS had not yet identified any uses for the barter credits or phone services coupon, should have known CVS had no experience retrading credits or coupons to third parties, and received other information casting doubts on the idea that the coupon and credits were worth their face value.

9. Galbo, too, was exposed to a number of red flags from which he should have known that the credits were not worth their face value. For example, the phone service coupon was issued by a telecommunications provider CVS could not use due to its contractual commitments to its own provider and therefore would need to be retraded to achieve value for CVS. Although Galbo was reassured by his barter company contact that the telephone credits could be placed, Galbo knew that (a) CVS had no history retrading coupons, (b) no CVS vendor had committed to accepting the coupon, and (c) only four of CVS's top fifty vendors were current users of the telecom provider (and those four in very small amounts). CVS nevertheless recorded the coupon at face value. Furthermore, in July 2000, Galbo acknowledged that absent assurance of current or future vendors' acceptance of them, trade credits offered by a different barter company would most likely have to be "significantly discounted" if CVS elected to pursue a transaction with that company. Though no such guarantee existed with respect to the barter credits that CVS ultimately acquired from another company, and although his contact at that barter company informed Galbo that it did not normally issue barter credits and noted some potential risks of barter credits versus a direct asset exchange, CVS also recorded the barter credits at face value. CVS ultimately utilized a majority of the credits and wrote down the balance in 2003.

**Galbo and Solberg Cause CVS to File False Financial Results for the Third
Quarter 2000 That Are Repeated in Year-End Results And
Incorporated by Reference in Filings Related to a June 2001 Offering**

10. As a result of the foregoing, CVS did not provide in its financial results for the third quarter of 2000 for the reduction in value of the toys from their book value of \$32 million to their projected market value of \$13.9 million. Accordingly, its pretax earnings for the third quarter were overstated by approximately \$18.1 million (the amount of the impairment), and after tax earnings were overstated by approximately \$10.8 million, or approximately 7% of net income. These overstated results were also made part of CVS's filing for the year-end 2000 which were in turn incorporated by reference in filings in connection with a June 2001 secondary offering of securities by CVS. As principal accounting officer, Solberg signed the year-end 2000 filings.

11. Both Galbo and Solberg received bonuses for year-end 2000 that were tied to CVS's financial results. The failure to reflect the reduction of the value of the toys therefore caused each to receive a higher bonus than he otherwise would have. In addition, Galbo received additional discretionary bonuses explicitly tied in part to work on the Transaction and its benefit to CVS's bottom line.

D. VIOLATIONS

1. Section 17(a)(2) of the Securities Act prohibits a person, in the offer or sale of a security, "directly or indirectly ... to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading." Section 17(a)(2) has no scienter requirement. *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980). Negligent conduct can violate Section 17(a)(2). *See, e.g., SEC v. Hughes Capital Corp.*, 124 F.2d 449, 453 (3d Cir. 1997); *In the Matter of Raymond James Financial Services, Inc.*, Exchange Act Release No. 49234 (Feb. 12, 2004).

2. As described above, Solberg violated Section 17(a)(2) by causing untrue statements of fact concerning third quarter 2000 results to be incorporated by reference in filings related to CVS's June offering. Although Solberg should have been aware that CVS's financial accounting for the Transaction was incorrect and that CVS should have written the plush toys down to their market value in the third quarter of 2000, Solberg reviewed the erroneous accounting for the Transaction, which was incorporated by reference in filings related to the June 2001 offering of securities.

3. As described above, Galbo violated Section 17(a)(2) by causing untrue statements of fact concerning third quarter 2000 results to be incorporated by reference in filings related to CVS's June offering. Although Galbo should have been aware that CVS's financial accounting for the Transaction was incorrect and that CVS should have written the plush toys down to their market value in the third quarter of 2000, Galbo nevertheless negotiated the Transaction, the erroneous accounting for which was incorporated by reference in filings related to the June 2001 offering of securities.

4. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file quarterly and annual reports with the Commission and to keep this information current. The obligation to file such reports embodies the requirement that they be true and correct. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).

5. As discussed above, Solberg caused CVS to file a false and misleading quarterly report with the Commission that misrepresented the financial results of CVS, overstating operating income and earnings. By his conduct described above, Solberg caused CVS's violations of Section

13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, and CVS violated Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

6. As discussed above, Galbo caused CVS to file a false and misleading quarterly report with the Commission that misrepresented the financial results of CVS, overstating operating income and earnings. By his conduct described above, Galbo caused CVS's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, and CVS violated Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

7. Section 13(b)(2)(A) of the Exchange Act requires Section 12 registrants to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of their assets.

8. As a result of the actions taken by Solberg as described above, CVS's books and records reflecting the transactions and dispositions of its plush toy assets were not accurate. Based on the conduct described above, Solberg caused CVS's violation of Section 13(b)(2)(A) of the Exchange Act, and CVS violated Section 13(b)(2)(A) of the Exchange Act.

9. As a result of the actions taken by Galbo as described above, CVS's books and records reflecting the transactions and dispositions of its plush toy assets were not accurate. Based on the conduct described above, Galbo caused CVS's violation of Section 13(b)(2)(A) of the Exchange Act.

10. Rule 102(e)(1)(ii) of the Commission's Rules of Practice provides, in relevant part, that the Commission may deny the privilege of appearing or practicing before the Commission to any person who is found by the Commission to have engaged in improper professional conduct, which includes negligent conduct consisting of "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." Rule 102(e)(1)(iv)(A)(2). As described above, Solberg engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

E. FINDINGS

1. Based on the foregoing, the Commission finds that Solberg (a) violated Section 17(a)(2) of the Securities Act; and (b) caused CVS's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.

2. Based on the foregoing, the Commission finds that Galbo (a) committed a violation of Section 17(a)(2) of the Securities Act; and (b) caused CVS's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.

3. Based on the foregoing, the Commission finds that CVS committed violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.

4. Based on the foregoing, the Commission finds that Solberg engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

IV.

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

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

A. Respondents Solberg and Galbo shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Act, and from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.

B. Respondent Solberg is denied the privilege of appearing or practicing before the Commission as an accountant.

C. After one year from the date of this order, Respondent Solberg 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 Solberg'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 Solberg, 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 Solberg, 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 Respondent Solberg will not receive appropriate supervision;

(c) Respondent Solberg 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 Solberg acknowledges his responsibility, as long as Respondent Solberg 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.

D. The Commission will consider an application by Respondent Solberg 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 Solberg's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

E. Respondent CVS shall cease and desist from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.

F. IT IS FURTHERED ORDERED that Respondent Galbo shall, within ten days of the entry of this Order, pay disgorgement of \$22,000 and prejudgment interest of \$8,727.62 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 United States Treasury; (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 Galbo 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 John T. Dugan, Associate District Administrator, Division of Enforcement, Securities and Exchange Commission, Boston District Office, 33 Arch Street, 23rd Floor, Boston MA 02110.

G. IT IS FURTHERED ORDERED that Respondent Solberg shall, within ten days of the entry of this Order, pay disgorgement of \$16,000 and prejudgment interest of \$6,476.21 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 United States Treasury; (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 Solberg 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 John T. Dugan, Associate District Administrator, Division of Enforcement, Securities and Exchange Commission, Boston District Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

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

17 CFR Parts 230, 232, and 239

[RELEASE NOS. 33-8814; 34-55980; 39-2446; IC-27878;

FILE NO. S7-12-07]

RIN 3235-AJ87

ELECTRONIC FILING AND SIMPLIFICATION OF FORM D

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is publishing for comment proposals that would mandate the electronic filing of information required by Securities Act of 1933 Form D. We also are proposing revisions to Form D and to Regulation D in connection with the electronic filing proposals. The revisions would simplify and restructure Form D and update and revise its information requirements. The information required by Form D would be filed with us electronically through a new online filing system that would be accessible from any computer with Internet access. The data filed would be available on our Web site and would be interactive and easily searchable by regulators and members of the public who choose to access it.

DATES: Comments should be submitted 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.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-12-07 on the subject line; or

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- 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 S7-12-07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. We will post all comments on our Internet Web site

(<http://www.sec.gov/rules/proposed.shtml>). Comments also are available for public inspection and copying in our Public Reference Room, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Questions about this release should be addressed to Gerald J. Laporte, Chief, Corey A. Jennings, Attorney-Advisor, Office of Small Business Policy, Division of Corporation Finance, or Mark W. Green, Senior Special Counsel (Regulatory Policy), Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628, (202) 551-3460.

SUPPLEMENTARY INFORMATION: We are proposing revisions to Rules 100,¹ 101,² 104,³ 201,⁴ and 202⁵ of Regulation S-T,⁶ Rules 502⁷ and 503⁸ of Regulation D,⁹ and Form D¹⁰ under the Securities Act of 1933 (“Securities Act”).¹¹

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⁹ 17 CFR 230.501-508.

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¹¹ 15 U.S.C. 77a et seq.

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X. STATUTORY BASIS AND TEXT OF PROPOSED AMENDMENTS

I. BACKGROUND

A. History and Purpose of Form D

Form D serves as the official notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D.¹² Both public and nonpublic companies file information using this form.

¹² Regulation D contains several separate exemptions for limited offerings. Form D also is to be used by issuers making offerings of securities without registration in reliance on the exemption contained in Section 4(6) of the

Regulation D was part of a Commission initiative in the early 1980s to provide a more coherent pattern of exemptive relief from the registration requirements of the Securities Act, and particularly to address the capital formation needs of small business.¹³ At the time, we intended the Form D filing requirement in Rule 503 of Regulation D to serve an important data collection objective.¹⁴ We expected that the empirical data provided in the Form D filings would enable us to evaluate the effectiveness of Regulation D as a capital raising device and eventually to further tailor our rules to provide appropriate support for both capital formation, especially as it relates to small business, and investor protection.¹⁵

We modified the requirements relating to Form D in 1986, making Form D a uniform notification form that could be filed with state securities regulators.¹⁶ This effort was undertaken with the cooperation of the North American Securities Administrators Association, the organization of state securities regulators, as part of the Commission's efforts to reduce the costs of capital formation for small business and to promote uniformity between federal and state securities regulation. We also eliminated the requirement to amend a Form D filing for an offering every six

Securities Act [15 U.S.C. 77d(6)]. Although we primarily discuss Regulation D in this release, the revised Form D also would continue to apply to Section 4(6) offerings. Regardless of the type of offering to which revised Form D would apply, it would be required to be filed electronically.

¹³ We adopted Form D and Regulation D in 1982. Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251] (adopting Form D as a replacement for Forms 4(6), 146, 240 and 242). They had been proposed in the previous year. Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791] (proposing Regulation D and Form D).

¹⁴ We stated in the proposing release:

“An important purpose of the notice . . . is to collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones Further, the proposed Form would allow the Commission to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses.”

Id.

¹⁵ Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791].

¹⁶ Release 33-6663 (Oct. 2, 1986) [51 FR 36385].

months during the course of the offering and the requirement to make a final Form D filing within 30 days of the final sale in the offering. We left intact the requirement to file a Form D notification within 15 days after the first sale of securities in an offering, leaving that as the sole current explicit requirement for a Form D filing.¹⁷

In 1989, we amended the Regulation D exemptions to eliminate the filing of Form D information as a condition to the availability of the exemptions.¹⁸ At that time, we also added Rule 507 to Regulation D to provide an incentive for issuers to make a Form D filing, even though it was no longer a condition to the availability of the exemptions.¹⁹ Specifically, Rule 507 disqualifies an issuer from using a Regulation D exemption in the future if it has been enjoined by a court for violating Rule 503 by failing to file the information required by Form D. Consequently, an issuer has an incentive to make a Form D filing to avoid the possibility that a court would enjoin the issuer for violating Rule 503 and, as a result, disqualify the issuer from using a Regulation D exemption in the future.

In 1996, we proposed to eliminate the Form D filing requirement and replace it with an issuer responsibility to complete a Form D and retain it for a period of time.²⁰ At the time, our Task Force on Disclosure Simplification had suggested that the Commission consider the continued need for a Form D filing requirement.²¹ After reviewing comments on the proposal, we determined that the information collected in Form D filings was still useful to us in conducting economic and other

¹⁷ 17 CFR 230.503.

¹⁸ Release No. 33-6825 (Mar. 15, 1989) [54 FR 11369].

¹⁹ Id.

²⁰ Release No. 33-7301 (May 31, 1996) [61 FR 30405].

²¹ SEC Task Force on Disclosure Simplification, Final Report 17 (Mar. 5, 1996), available at <http://www.sec.gov/news/studies/smpl.txt>.

analyses of the private placement market and retained the requirement.²² In 1998, we solicited public comment on, but did not propose, requiring electronic filing of the Form D notice.²³

Commenters generally favored electronic filing in principle but expressed concern about Form D filers needing to follow the same procedures as then were required generally for filings with the Commission's electronic filing system, called the Electronic Data Gathering, Analysis and Retrieval or "EDGAR" system.

In summary, our previous statements on Form D have suggested that, at the federal regulatory level, the Form D filing serves primarily as a notification document that serves two primary purposes:

- collection of data for use in the Commission's rulemaking efforts; and
- enforcement of the federal securities laws, including enforcement of the exemptions in Regulation D.²⁴

The information submitted in Form D filings also is useful for other purposes. The staffs of state securities regulators and NASD, formerly the National Association of Securities Dealers, also use Form D information to enforce federal and state securities laws and the rules of securities self-regulatory organizations. Form D filings also have become a source of disclosure for investors. Our Web site advises potential investors in Regulation D offerings to check whether the company making the offering has filed a Form D notice and advises that "[i]f the company has not filed a Form D, this should alert you that the company might not be in compliance with the federal securities laws."²⁵ Our staff suggests that investors considering an investment in a Regulation D

²² Release No. 33-7431, at 5 (July 18, 1997) [62 FR 39755, 39756].

²³ Release No. 33-7541 (May 21, 1998) [63 FR 29168].

²⁴ Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251]; Release No. 33-7431 (July 18, 1997) [62 FR 39755].

²⁵ See <http://www.sec.gov/answers/formd.htm>.

offering check the issuer's Form D filing if they are seeking a public source of information about the issuer and the offering. In addition, the information in Form D filings serves as a source of business intelligence for commercial information vendors, as well as for practitioners in the venture capital, private equity, and other industries that rely on Regulation D offerings and for competitors of issuers who file Form D information. Academic researchers use Form D information to conduct empirical research aimed at improving the workings of these industries.²⁶ Journalists use Form D information to report on capital-raising in these industries.²⁷

B. Need to Update Form D and Require Electronic Filing

Currently, much of the information required by Form D appears to be useful and justified in the interests of investor protection and capital formation.²⁸ It also appears that some useful information that could be required by Form D currently is not required. On the other hand, Form D currently requires some information that may no longer be useful. Our staff receives many inquiries from market participants suggesting that Form D could be clarified and simplified. Moreover, the absence of an electronic system for filing Form D information prevents issuers from filing through efficient modern methods and limits the usefulness of the information collected on Form D. The rules we propose today would address deficiencies in the Form D data collection requirements.²⁹

²⁶ For a discussion of how academic researchers are using available data on private investments to improve the workings of the venture capital industry, see A. Ginsberg, Truth, or Consequences: Academic Researchers are Helping Policy Makers and Practitioners Understand the Problems Facing the Venture Capital Industry, Innovation Review 8 (Berkley Center for Entrepreneurial Studies, Fall 2002).

²⁷ See, e.g., R.J. Terry and B. Hammer, NEA Closes \$2.5 Billion Fund, Baltimore Bus. Journal, July 10, 2006.

²⁸ For example, information provided in response to the requirement to check the applicable specified exemptions from registration claimed by the issuer helps the Commission monitor and evaluate use of the claimed exemptions in order to protect investors and facilitate the development of a private market in which to raise capital.

²⁹ Additional changes to Regulation D are being proposed in a companion release on Regulation D which, if adopted, would result in exemption disqualification provisions in a new subparagraph (e) of Rule 502 and a new exemption under a revised Rule 507 of Regulation D. On May 23, 2007, the Commission approved for

1. Eased Filing Burdens

Our proposed rules are intended to ease the costs and burdens of preparing and filing Form D information. The informational requirements would be streamlined and updated. The instructions would be clarified and simplified. Issuers would file the Form D information electronically through a new online filing system that would be accessible from any computer with Internet access. Issuers would provide the information in data fields by responding to a series of discrete questions. It is expected that the fields would be checked automatically for appropriate characters and consistency with other fields and the questions would be accompanied by easily accessible links to instructions and other helpful information. We believe these system features, among others, would help facilitate a relatively easy-to-use filing process that would deliver accurate information quickly, reliably, and securely.³⁰ The Form D filing would continue to be required within 15 days of an issuer's first sale in an offering without Securities Act registration in reliance on one or more of the exemptions provided in Regulation D, and the rules would clarify when amendments are required. Paper filing of Form D would be eliminated. Currently, our rules require issuers to file five paper copies of the Form D with us by mail or physical delivery to Commission headquarters.³¹ Our goal is to make filing Form D information as easy as many tasks commonly performed by people using the Internet today.

issuance the companion proposing release. The proposed new Form D reflects that proposed exemption.

³⁰ The new online filing system is discussed in further detail in Part III of this release.

³¹ 17 CFR 230.503(a). The Commission received 25,239 Form D filings in its most recently ended fiscal year, fiscal year 2006.

2. Better Public Availability of Form D Information

Requiring the electronic filing of Form D data would make the information filed more readily available to regulators and members of the public who choose to access it.³² The information would be available on our Web site and, because the online filing system would automatically capture and tag data items, the data would be interactive and easily searchable. The system would enable users to view the information in an easy-to-read format, download the information into an existing application, or create an application to use the information.

Unlike forms filed with us electronically, paper filings are available from us only in person in our Public Reference Room or by means of a mail request. We charge a nominal fee for copies of Form D filings. Some Form D filings are available at higher cost through private vendors through the Internet and telephone requests.

3. Federal and State Uniformity and Coordination

For over 20 years, Form D has served as a means to promote federal and state uniformity in securities regulation by providing a uniform notification form that can be filed with the Commission and with state securities regulators.³³ The contemplated electronic filing system for Form D information would continue that tradition and could enhance the utility of Form D as a means to promote uniformity between federal and state securities regulation. The system would include an electronic database that could be more easily searched for information needed by both federal and

³² Most filings made with us currently are filed through our EDGAR system. We began to make EDGAR filing mandatory in 1993. Initially, a number of forms – including Form D – were excluded from mandated electronic filing. Since the launch of the EDGAR system, we have increased the number of forms that are required to be filed on the EDGAR system, but Form D remains a paper-only filing.

³³ According to a unit of the American Bar Association, 48 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands accept filings on Form D. New York prescribes its own Form 99. Florida does not require any filing for the types of transactions other jurisdictions require to be reported on Form D. See Report on Blue Sky Survey of the NSMIA Subcommittee, Committee on State Regulation of Securities, American Bar Association Business Law Section (Feb. 2006).

state securities regulators to monitor the exempt securities transaction markets. The system also would permit improved coordination among federal and state regulators, which is essential to efficient and effective capital formation through exempt transactions, especially by smaller companies, and to investor protection. State securities regulators would be able to access the information on our Web site to learn if new Form D information of interest to them has been filed. It is our hope that state securities regulators would permit “one-stop” filing with the Commission and rely on Commission filings as satisfying state law filing requirements for offerings covered by a federal Form D filing.³⁴ This would reduce significantly the costs and burdens of preparing and filing Form D information with the Commission and with state securities regulators. This could represent a substantial savings for small businesses and others filing Form D information.

4. Improved Collection of Data for Commission Enforcement and Rulemaking Efforts

The proposed conversion to electronic filing of Form D information in an interactive data format would result in creation of a database and allow us and others to better aggregate data on the private securities markets and the use of the various Regulation D exemptions. Further, the software we intend to use for the Form D electronic filings would require that filers address each required data field in the form, thus reducing incomplete filings. Because of these and other features, the Form D electronic filing system should assist in our enforcement efforts and ease our ability to make use of filed Form D information. The Form D information database would allow us to evaluate our exemptive schemes on a continuing basis in order to facilitate capital formation in a manner consistent with investor protection. The evaluation could lead to improvements that would

³⁴ The contemplated electronic filing system would not, however, collect any fee a state might charge on behalf of the state.

result in significant benefits to companies that rely on the Regulation D exemptions, especially smaller companies, as well as benefits to investors.

II. DISCUSSION OF PROPOSED AMENDMENTS

As noted above, we believe today's proposal would have a positive effect in many areas of interest to the Commission, state securities regulators, investors, and companies that rely on Regulation D exemptions. The proposed revisions generally involve simplifying Form D, easing the burdens of complying with the requirements of the form, and modernizing the information capture process.

For each offering of securities that is made without Securities Act registration in reliance on a claimed exemption under Regulation D, the issuer must file the information required by Form D with the Commission no later than 15 days after the first sale of securities. The form calls for issuers to provide basic identifying information and fundamental information about the offering.

Some of the requirements of Form D have become outdated with the passage of time since the Commission adopted them. Further, some of the form's requirements and instructions could be clarified and made less burdensome. The revisions we propose today would address these issues. In addition, the move to electronic filing necessitates several modifications.

A. Proposed Amendments to the Substantive Content of Form D

Currently, Form D requires presentation of preliminary information and other information required by five sections designated "A" through "E." The proposed revisions organize the information requirements around 14 numbered "items" or categories of information. Instructions at the end of the form would explain the requirements for each item. On the online form, we plan that terms and items at the front of the form would be linked to the instructions at the back of the form which would be immediately available by clicking on a particular term or item. In this regard, we

propose to add to the General Instructions a sentence that provides that terms used but not defined in the form that are defined in Regulation D or Rule 405³⁵ have the meanings given to them in Regulation D and Rule 405. The sentence would make explicit staff interpretive advice regarding Regulation D and, to the extent it defines the term “promoter,” Rule 405.

1. Basic Identifying and Contact Information

Item 1 would require basic identifying information, such as the name of the issuer of the securities, any previous names, type of legal entity and the issuer’s year and place of incorporation or organization.³⁶ Item 2 would require issuers to provide place of business and telephone contact information.³⁷ Item 3 would require information about related persons (executive officers, directors, and promoters).³⁸ These requirements primarily are carried over from the current Form D, with restructuring to reflect the electronic form of the filing. We would, however, revise the form to provide specifically for the identification of multiple issuers in multiple issuer offerings. Form D currently does not provide for this, leading to confusion as to how multiple issuer offerings should be reported.³⁹ In addition, the form would ask for the Commission file number, if applicable.

³⁵ 17 CFR 230.405.

³⁶ Issuers would specify their legal entity type (e.g., corporation or limited partnership) from a dropdown menu.

³⁷ Some information of the type that Items 2 and 3 would require might automatically appear in appropriate places when the filer accesses the new online filing system. The system may replicate information provided by the filer in the course of obtaining the codes needed to access the new online filing system or in updating such information. The issuer would be able to make changes to such information.

³⁸ The instructions to Item 3 would clarify that disclosure would be required of each person who has functioned as a promoter of the issuer within the past five years of the later of the first sale of securities or the date upon which the Form D filing was required to be made.

³⁹ Currently, in multiple issuer offerings, there is uncertainty as to whether all issuers can be listed in the same Form D or whether each issuer must submit essentially the same Form D. In this situation, the staff currently advises each issuer to submit a separate Form D notice because the forms are retrievable only by reference to the name of one issuer. The proposed changes would clarify the requirements of this item and eliminate the burden on issuers to file what are essentially duplicate forms in order to comply with the requirement to file

The revised form would include instructions to clarify that post office box numbers and “care of” addresses are not acceptable as place of business information. The purpose of this information is to allow securities enforcement authorities to determine the location of the issuer’s operations and personnel responsible for the offering. Post office box numbers and “care of” addresses do not provide this information. The proposed form would not provide for submission of more than one place of business or telephone number in multiple issuer offerings. Issuers in multiple-issuer transactions typically have the same place of business, and we generally do not need more than one address to contact the responsible personnel for enforcement purposes.

We propose to delete the current requirement that issuers identify owners of 10 percent or more of a class of their equity securities as “related persons.” Investors will continue to have access to this information, if it is material, in the private placement memorandum customarily supplied to them or in other information made available through the issuer.⁴⁰ We believe we can collect sufficient information to satisfy the regulatory objectives of Form D by requiring only the identification of executive officers, directors, and promoters. Moreover, issuers that are not reporting companies have raised privacy concerns with respect to the requirement to identify 10 percent equity owners who are not executive officers, directors, or promoters when the issuers are private companies, because they do not already have to disclose this information. From time to time issuers have asked us to grant confidential treatment to this information under Securities Act

Form D information. The new online filing system would be designed to support multiple issuer filings. As a result, all issuers easily could be identified in a single filing.

⁴⁰ Under some circumstances, an issuer must provide, rather than merely make available, beneficial holder information. For example, an issuer that offers securities to non-accredited investors without registration under the Securities Act in reliance on an exemption provided by Rules 505 [17 CFR 230.505] or 506 [17 CFR 230.506] must provide beneficial holder information under the circumstances specified by Rule 502(b) [17 CFR 230.502(b)].

Rule 406,⁴¹ but we have denied such requests consistently because the information currently is required by Form D. We estimate that about 95% of the companies filing Form D notices last year were private companies. With the electronic filing of the Form D information, the widespread availability of such data on our Web site may raise additional privacy concerns of issuers seeking to raise capital through a private offering.

We also propose to delete the requirement that issuers provide the name of the offering, because naming offerings reported on Form D is not as common today as it was before the 1986 tax reforms,⁴² when the current Form D requirement was adopted. As such, we understand issuers have found this requirement to be unclear. The proposed form also would omit the current requirement to indicate whether a limited partnership issuer already has been formed or is in formation. We believe sufficient information will be obtained from the requirement to provide an issuer's year of incorporation or organization.

2. Information About Issuer

The form would ask for basic information about the issuer in Items 4 and 5. Issuers would identify their industry group and their revenue range from dropdown menus.⁴³ The industry group information would replace the current requirement in Form D to provide a description of the issuer's business. We believe simply selecting an industry group classification from a pre-established list is less burdensome for issuers and more useful for the regulatory purposes underlying the Form D filing requirement. The industry group classifications will provide us better,

⁴¹ 17 CFR 230.406.

⁴² Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (Oct. 22, 1986).

⁴³ As proposed, the revenue range would be for the most recently completed fiscal year. Where an issuer has been in existence for less than a year, it would identify its revenues to date.

and more easily retrievable, information about industries and offerings where we may have identified policy issues.⁴⁴

Information on revenues was required in Form D before 1986.⁴⁵ Because Form D was submitted on paper, however, that information was not able to be efficiently used for rulemaking purposes. We propose to include revenue range information in the Form D filing to help determine the types and sizes of issuers that rely on the Regulation D and Section 4(6) exemptions. For instance, this information would increase significantly the effectiveness of the data collected as a tool for assessing the use of the Regulation D exemptions for small businesses and other different sizes of issuers. The proposed item does, however, provide a “Decline to Disclose” option, which might be used if a private company considered its revenue range to be confidential information.

3. Identification of Claimed Exemptions and Exclusions

Item 6 would require the issuer to identify the exemption or exemptions being claimed for the offering, from among Rule 504’s⁴⁶ paragraphs and subparagraphs, Rule 505, Rule 506, Rule 507 and Section 4(6), as applicable. This requirement, in general, is carried over from the current Form D requirement, but with a reference to proposed Rule 507⁴⁷ and added specificity, requiring the issuer to identify the specific paragraph or subparagraph of any Rule 504 exemption being

⁴⁴ The instruction to Item 4 would provide that an issuer or issuers that could be categorized in more than one industry group should be categorized based on the industry group that most accurately reflects the use of the bulk of the offering proceeds. The instruction also would provide that, for purposes of responding to Item 4, the issuer should “use the ordinary dictionary and commonly understood meanings of the terms identifying the industry groups.” If an issuer selected the checkbox for “Pooled Investment Fund,” pop-ups would require the issuer also to select from among lower level checkboxes designating a specific type of pooled investment fund and to select between “yes” and “no” checkboxes as to whether the issuer is registered as an investment company under the Investment Company Act of 1940 (“Investment Company Act”) [15 U.S.C. 80a-1 *et seq.*].

⁴⁵ Release No. 33-6663 (Oct. 2, 1986) [51 FR 36385].

⁴⁶ 17 CFR 230.504.

⁴⁷ As previously noted, a companion release proposes a new exemption under a revised Rule 507.

claimed as well as any specific paragraph of Investment Company Act Section 3(c)⁴⁸ which the issuer claims for an exclusion from the definition of “investment company” under the Investment Company Act.⁴⁹ We propose to require this increased level of specificity and additional type of information because of the need for data to assist our policymaking and rulemaking efforts in various areas. Identification of a claimed exemption or exclusion often is key to analysis of the appropriateness of the claim. State securities regulators also need this information to determine the extent of their jurisdiction over the offering.⁵⁰ Unlike current Form D, however, Item 6 would not enable the issuer to check a box to indicate a claim to the Uniform Limited Offering Exemption (ULOE) from state securities law requirements. We are inclined to believe that the ULOE box causes confusion and burdens for companies completing Form Ds without resulting in a significant amount of useful information. Most, if not all, companies claiming a ULOE exemption also will check the Rule 505 box, because Rule 505 is the Commission’s companion exemption to the ULOE exemption.⁵¹ Similarly, revised Form D would omit all other references to ULOE and the provisions that, in general, require specified information on a state-by-state basis in an appendix to

⁴⁸ 15 U.S.C. 80a-3(c).

⁴⁹ The issuer would be able to select all the exclusions on which it relies. Regulation D provides an exemption from the Securities Act and not an exclusion from the definition of the term “investment company” under the Investment Company Act. Some companies that use a Regulation D exemption, however, also are excluded from the definition of investment company under the Investment Company Act.

⁵⁰ Section 102(a) of the National Securities Markets Improvement Act of 1996 (“NSMIA”) [Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996)] enacted new Section 18 of the Securities Act [15 U.S.C. 77r], which limits the authority of the states to regulate offerings exempt under Commission “rules or regulations issued under section 4(2)” of the Act [15 U.S.C. 77d(2)], which includes Rule 506 but not Rules 504 or 505, and offers and sales to “qualified purchasers” as defined by the Commission under the Securities Act, which term would include persons specified in proposed Rule 146(c) of our companion release in which revised Rule 507 is proposed.

⁵¹ See Release No. 33-7644 (Feb. 25, 1999) [64 FR 11090].

the form and require specified representations and undertakings. We are inclined to believe that this information is burdensome to provide without sufficient benefits.⁵²

4. Indication of Type of Filing

a. Proposed Amendments

We propose to carry over in new Item 7 the current Form D requirement to indicate whether the filing is a new filing or an amendment. Item 7 also would be used to designate the states to which the Form D is directed.⁵³ Including identification of a filing as new or an amendment is appropriate, because the form permits amendments and issuers may have valid reasons to wish to update or correct information previously provided in a Form D filing through an amendment. In addition, as discussed immediately below, we intend to clarify the circumstances where amendments are required.

b. Amendments to Form D

We recognize that some uncertainty may exist about when, how, and why an amendment to a Form D may or must be filed because those issues are not expressly addressed in the form. While both Rule 503 and the instructions to the current Form D discuss the information that is required when an amendment is filed,⁵⁴ neither explicitly requires the filing of an amendment. In certain

⁵² We note, however, that Section 18(c)(2)(A) of the Securities Act [15 U.S.C. 77r(c)(2)(A)] generally provides that nothing under Section 18 prohibits “any State from requiring the filing of any document filed with the Commission [under the Securities Act], together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State (if such sales data is not included in documents filed with the Commission), solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee.”

⁵³ We propose to permit issuers to designate the states to which the Form D is directed, on the assumption that some states would adopt one-stop filing and allow filings that specify that they are directed to those states to constitute filings with those states.

⁵⁴ Rule 503(d) states that amendments to Form D “need only report the issuer’s name and the information required by Part C and any material change in the facts from those set forth in Parts A and B.” The instructions to Form D set forth the information required in an amendment as only “the name of the issuer and offering, any changes thereto, the information requested in Part C, and any material changes from the information previously supplied in Parts A and B.”

offerings and situations, however, an issuer may have made a mistake of fact in the filed Form D. Situations also arise where changes occur and the initially filed Form D may not be an accurate expression of the current facts in an ongoing offering. Our staff currently interprets Rule 503 and the Form D instructions to require amendments in ongoing offerings where there has been a material change in information filed about the offering and where basic information previously submitted about the issuer has materially changed.

The staff has received questions regarding offerings of extended duration, and how to determine whether and how to file Form D amendments. For example, when offerings are expected to continue for an extended period, the Commission's staff often is asked to assist issuers in determining how to calculate an offering's aggregate offering price and when an amendment to the Form D should be filed. The staff's practice in this regard has been to advise issuers to use a good faith and reasonable belief standard to calculate the aggregate offering price and to amend the Form D annually.

We propose to revise Rule 503 and the instructions to and description of Form D to require amendments to Form D in the following three instances only:

- to correct a mistake of fact in the previously filed notice (as soon as practicable after discovery of the mistake);
- to reflect a change in the information provided in a previously filed notice (as soon as practicable after the change), except that no amendment would be required to reflect a change that occurs after the offering terminates or a change that occurs in the following only:⁵⁵

⁵⁵ We believe the specified changes should not require an amendment because changes of this type are expected to occur in the course of an offering. It is not necessary to report them for Form D to serve its primary function as a notice of an exempt offering.

- an issuer's revenues;
 - the amount of securities sold in the offering;
 - the total offering amount, if the change, together with all other changes in that amount since the previously filed notice, does not result in an increase of more than 10%;
 - the number of accredited investors who have invested in the offering;
 - the number of non-accredited investors who have invested in the offering (as long as the change does not increase the number to more than 35);
 - in offerings that last more than a year, information on related persons, if the change was due solely to the filling of a vacant position upon the death or departure in the ordinary course of business of the previous occupant of the position; and
- in offerings that last more than a year, annually, between January 1 and February 14, to reflect information about the offering on or before its termination since the later of the filing of the Form D or the filing of the most recent amendment.

Rule 503 also would require an issuer that files an amendment to provide current information in response to all requirements of Form D regardless of why the amendment is filed. We believe it would be relatively easy to provide such current information in most instances due to the form's streamlined information requirements, the likelihood that much of the information would not require change, and the expectation that the new online filing system would make available to the issuer the version of the Form D to be amended to enable the issuer to respond only to the changed items.

5. Information About Offering

Items 8 through 14 would require factual information about the offering itself. Most of the information sought currently is required by Sections B and C of Form D.

Duration of Offering. Item 8 would require the issuer to indicate whether it intends that the offering will last over a year. Such information currently is not specifically required by Form D. The absence of an information requirement of this type has presented compliance questions because regulators may not know whether an offering may span an extended period of time based on the information currently required by Form D.

Type of Securities Offered. Item 9 would carry over the current requirement to specify the type of securities being offered, such as debt or equity, with additional categories of securities added. Some of the additional categories would provide more clarity. The rest of the additional categories would identify types of securities, the specification of which we believe would help facilitate our rulemaking efforts.⁵⁶ The issuer would be required to specify all categories that apply to the securities that are the subject of the exemption(s) specified in response to Item 6.⁵⁷

Business Combination Transaction. Form D currently requires that the issuer indicate only whether the offering is an exchange offer. Item 10, however, would require the issuer to indicate whether the offering is being made in connection with a business combination transaction such as a merger, acquisition or exchange offer regardless of the type of offering. We believe that, for

⁵⁶ The new categories would be "Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security," "Pooled Investment Fund Interests," "Tenant-in-Common Securities," and "Mineral Property Securities."

⁵⁷ If, for example, an issuer were filing a Form D as to the offering of both immediately exercisable options and their underlying common stock, the issuer would specify the categories "Option, Warrant or Other Right to Acquire Another Security" and "Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security." In contrast, if the issuer were filing a Form D as to the offering of options exercisable over a year after purchase but not as to the offering of the underlying common stock, the issuer only would specify the category "Option, Warrant or Other Right to Acquire Another Security."

purposes of Form D, it is important to identify whether an offering is being made in connection with a business combination transaction, whether structured as an exchange or in some other manner, because such transactions often give rise to policy concerns.

Minimum Investment Amount. Item 11 would carry over the requirement in Form D to specify the minimum investment amount per investor. We are maintaining this requirement because offerings that have low minimum investment amounts have presented particular enforcement challenges in the past.

Sales Compensation. Item 12 generally would carry over but reformat and, as a result, simplify the response to the requirements in Form D related to information on sales compensation. It would, however, add a requirement to provide the CRD number of each recipient named in response to Item 12. A CRD number corresponds to a broker or broker-dealer's record located in the Central Registration Depository, a computer database of brokers and broker-dealers owned jointly by state regulators and NASD. We believe it should be relatively easy for an issuer to obtain the CRD numbers from the brokers and broker-dealers it retains. Requiring disclosure of the CRD numbers would facilitate checking the brokers or broker-dealers' records.⁵⁸

Offering and Sales Amounts. Item 13 would carry over the current requirements to provide the amount of total sales and the total offering amount, but in a restructured, simplified format. Instructions would be added to clarify interpretive issues that have arisen in completing the form, such as how to respond to this requirement if the amount of an offering is undetermined when the Form D filing is made.

⁵⁸ Issuers and investors can check a broker's CRD record by accessing <http://brokercheck.nasdaq.com> or by calling a state regulator or the NASD's public disclosure hotline at 800-289-9999. See http://www.nasaa.org/Investor_Education/Investor_Alerts_Tips/292.cfm.

Investors. Item 14 would elicit information on whether the issuer intends to sell securities to persons who do not qualify as accredited investors and the number of such persons, as well as the number of accredited investors who already have purchased securities in the offering. The form currently requires this information because it affects how we and state securities evaluate claimed exemptions.

Other Information. We propose to eliminate the items requiring information on use of proceeds and expenses of the offering because they do not yield information necessary for an evaluation of the claimed exemption or for rulemaking efforts. Many, if not most, Form D filings do not provide information that serves the form's purposes, because they specify only that the majority of proceeds will be used for "general corporate purposes." In addition, because of the diversity in use of proceeds in Regulation D offerings, attempting to standardize responses to provide searchable data may be challenging and not worthwhile.

6. Signature and Submission

We propose to combine the federal and state signature requirements currently in Sections D and E of Form D into one signature requirement. This would simplify the filing and make it consistent with other signature requirements of Commission forms. We propose to incorporate into the signature block the consent to service currently in Form U-2, which is required to be filed separately but simultaneously with a Form D by many states. We are mindful in making these changes that the signature block continues to be of significance to state securities regulators. Our intention with these proposed changes is to maintain this usefulness in a manner that is consistent with easing burdens on filers.

The combined signature requirement, in general, would provide that each issuer signing the revised Form D⁵⁹ has read the Form D, knows the contents to be true, has duly caused the Form D to be signed on its behalf by the undersigned duly authorized person, and is⁶⁰

- notifying the Commission and the states in which the Form D is filed of the offering and undertaking to furnish to them, on written request, the information provided by each issuer to offerees;
- consenting to service of process on individuals holding specified positions; and
- certifying that it is not disqualified from relying on Regulation D for one of the reasons stated in proposed Rule 502(e).⁶¹

In undertaking to furnish to the states in which the Form D is filed, on written request, the information provided to offerees, the issuer would not be affecting any limits NSMIA imposes on the ability of these states to require information.⁶²

The proposed signature requirement would be more extensive than the current federal signature requirement and would differ in various ways from the current state and Form U-2 signature requirements. The proposed signature requirement would be more extensive than the current state signature requirement, for example, by requiring a consent to service of process. The proposed signature requirement would be less extensive than the current state signature requirement

⁵⁹ Each issuer in a multiple-issuer offering would be required to sign the Form D. If all issuers authorized the same person to sign on their behalf, however, only that person would need to sign.

⁶⁰ Both the current federal and state signature requirements expressly provide that the issuer has duly caused the Form D to be signed on its behalf by the undersigned duly authorized person. Only the current state signature requirement, however, expressly provides that the issuer has read the Form D and knows the contents to be true.

⁶¹ As previously noted, a companion release proposes that exemption disqualification provisions appear in a new subparagraph (e) of Rule 502. If the new subparagraph were not adopted, the certification would address the current disqualification provisions in Regulation D, as applicable.

⁶² See Section 18 under the Securities Act.

principally because it would not ask whether any party described in Rule 262⁶³ currently was subject to any of the disqualification provisions of that rule.⁶⁴ The principal difference between the proposed signature requirement and the Form U-2 signature requirement is that Form U-2 requires the notarized signature of a corporate officer (or that person's equivalent in the case of other entities) and requires a consent to jurisdiction and venue as well as a consent to service.⁶⁵

Request for Comment:

- Would the proposed presentation of the revised Form D, together with linked instructions, be generally understandable, sensible, and helpful to individuals completing the form? Should all terms that need to be defined to facilitate compliance with the form's requirements, such as the term "promoter," appear in Regulation D?
- Should other items of information be required to be submitted in a Form D filing? Would requiring the CUSIP number of securities that have a CUSIP number be appropriate? Would requiring the trading symbol of securities that have a trading symbol be appropriate? Should we provide for the submission of a separate address for each issuer in multiple-issuer offerings to help assure securities regulators can contact the responsible personnel? Should we require issuers to provide information on ten percent or greater holders? Is such information useful to the public and other regulators

⁶³ 17 CFR 230.262.

⁶⁴ The proposed signature requirement, unlike the current state signature requirement, would omit both an undertaking to provide a Form D to specified state administrators and a representation regarding ULOE. As noted above, however, under the proposed signature requirement, issuers would undertake to furnish to the states in which the Form D is filed, on written request, the information provided by each issuer to offerees. Also as noted above, revised Form D would omit all references to ULOE and the provisions that, in general, require specified information on a state-by-state basis in an appendix to the form and require specified representations and undertakings.

⁶⁵ The proposed signature requirement's addressing consent to service but not consent to jurisdiction or venue would be consistent with the signature requirement in Form ADV [17 CFR 279.1], which can satisfy both federal and state filing requirements for investment adviser registration.

and does it serve the purposes of the Form D filing requirement? If multiple types of securities are offered, should we require information about each type of security? Should we permit issuers to check an exemption box for ULOE or “None” and, if so, why? Should we require or permit issuers to provide the items of information current Form D requires on a state-by-state basis in an appendix to the form? Should we require or permit issuers to describe potential waivers to minimum investment amounts or minimum investment amounts based on the identify of the offeree?⁶⁶ Should we require issuers that are pooled investment vehicles to disclose whether their advisers are registered as investment advisers under the Investment Advisers Act of 1940?⁶⁷ Should we require such issuers to disclose the number of their knowledgeable employees purchasing in the offering?⁶⁸

- Should we eliminate any items of information that we propose to request in the revised Form D? Should we not require specified information because it does not provide sufficiently useful information or because providing it is unnecessarily burdensome? Should we retain any information requirements from the current Form D that we propose to eliminate? For example, should we retain, because it would provide useful information, the part of the current state signature requirement that asks whether any party described in Rule 262 currently was subject to any of the disqualification provisions of that rule? Should we require information that we have not proposed to require? For example, should we require an issuer to disclose information about the

⁶⁶ For example, an issuer might set a lower minimum investment amount for its management than it would for an offeree with no prior relationship to the issuer.

⁶⁷ 15 U.S.C. 80b-1 et seq.

⁶⁸ We use the term “knowledgeable employees” as defined in Rule 3c-5 [17 CFR 270.3c-5] under the Investment Company Act.

value of its assets such as the range of the value of its total assets or whether the value of its total assets was \$5 million or less on the last day of its most recently ended fiscal year?⁶⁹ Is requiring a reporting company's Commission file number appropriate or might it be unduly burdensome without resulting in the collection of significant, useful information?

- Are the revised instructions on filing amendments to a Form D filing clear and appropriate? For example, should the proposed requirements to file an amendment to correct a mistake of fact or reflect specified changes be limited to material matters explicitly? Should amendments be required under other circumstances? For example, should an amendment be required to report the termination of an offering that lasts more than a year? Should the obligation to amend for a mistake end at a specified time and, if so, when? For offerings that last more than a year, should an issuer be permitted to wait at least a year since the later of the filing of the Form D or the filing of the most recent amendment if, as proposed, it otherwise would be required to file an annual amendment between January 1 and February 14? Should an issuer that files an amendment be permitted to provide responses only to some items of proposed Form D? If an issuer were permitted to respond to only some items, to which items should the issuer be required to respond?
- Should Form D filings for offerings that last more than a year be required to be updated over time? Should the proposed annual update requirement apply to offerings that have

⁶⁹ An issuer other than an investment company that had total assets of \$5 million or less on the last day of its most recently ended fiscal year is, as further described in Part VIII, a small entity under the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78a *et seq.*] and may be under the Securities Act for purposes of the Regulatory Flexibility Act [5 U.S.C. 603]. As a result, our receipt of such information may facilitate our regulatory flexibility analysis in future rulemaking.

not lasted over a year as of the proposed February 14 annual update due date? Should an annual update be required within a specified number of days of the anniversary of an offering rather than by February 14?

- Would the proposed requirement that an issuer identify its industry group(s), in lieu of providing a description of its business, provide data useful to the public and other regulators regarding the types of businesses that rely upon Regulation D?
- Would the proposed addition of Item 5 requiring an issuer to specify its revenue range provide useful data to the public and other regulators regarding the sizes of businesses that rely upon Regulation D? Is it necessary to provide an option to decline to disclose their revenue range for both companies that are and are not reporting companies under the Exchange Act?⁷⁰
- Would the proposed addition in Item 12 of a requirement to provide each broker's CRD number provide useful information to the public and other regulators with minimal burden on the issuer?
- Should proposed Item 13 permit an issuer to state that the amount of total sales and total offering amount are undetermined rather than, as proposed, provide a good faith estimate, where the securities are offered in exchange for property other than cash and the value of the property cannot be determined without unreasonable effort or expense?
- Should we include language in Form D clarifying that an issuer's undertaking in the signature block to furnish information to states in which the Form D is filed does not affect any limits NSMIA imposes on the ability of these states to require information?

⁷⁰ A reporting company is a company that files reports under Section 13(a) [15 U.S.C. 78o] or 15(d) [15 U.S.C. 78m] of the Exchange Act.

- Do the current requirements for information on use of proceeds and expenses in the Form D, which would be eliminated, provide useful information to the public and other regulators?
- Would the proposed combined federal and state signature requirement be adequate to replace the current state signature requirement and make it unnecessary for issuers to file Form U-2?
- Do issuers and others have an interest in “one-stop” filing with the Commission, in which states would rely on Commission filings as satisfying state law filing requirements for an offering covered by a Form D filing? Should such a one-stop filing service include the centralized collection of state filing fees? Would issuers be willing to pay a fee to the Commission or to an organization of state regulators for one-stop filing, if the collection of such a fee were properly authorized? How much would issuers be willing to pay for one-stop filing services?

B. Required Electronic Filing of Form D

We propose to amend Regulation S-T,⁷¹ Rule 503 of Regulation D, and Form D to implement a requirement for issuers to file the information required by Form D with us electronically through an online filing system.⁷²

Rule 101(c)(6) of Regulation S-T⁷³ currently requires the information required by Form D to be filed in paper. The proposed amendments would delete the reference to Form D from Rule

⁷¹ Regulation S-T is the Commission’s general regulation governing electronic filing.

⁷² The online filing system would automatically capture and tag data items and is discussed in further detail in Part III of this release.

⁷³ 17 CFR 232.101(c)(6).

101(c)(6) and would revise subparagraph (a)(1) of Rule 101⁷⁴ to add a new subparagraph (xiii) that would add Form D to the rule's list of documents required to be filed electronically.

Rule 100 of Regulation S-T,⁷⁵ which specifies the persons or entities subject to the electronic filing requirements of Regulation S-T, expressly includes, among others, Exchange Act reporting companies whose filings (such as Form D) are subject to review by the Division of Corporation Finance. In order to assure that Rule 100 also would apply to non-reporting companies that would file Form D, the proposed amendments would revise paragraph (a) of Rule 100 of Regulation S-T⁷⁶ to add a reference to entities that are not Exchange Act reporting companies but whose filings are subject to review by the Division of Corporation Finance.

We also propose to amend Regulation S-T to make hardship exemptions unavailable to Form D filings. The proposed amendments would revise subparagraph (a) of Rules 201⁷⁷ and 202⁷⁸ to exclude Form D from the filings for which hardship exemptions are available. We believe hardship exemptions should not be available for Form D filings because of the relative ease of electronic filing and the limited value of paper filings. In proposing the conversion of the Form D filing from a paper system to an electronic system, we assume that issuers will have access to a computer and the Internet. In the absence of an issuer's having a personal or office computer and Internet access, public libraries around the country often have computer and Internet access that an

⁷⁴ 17 CFR 232.101(a)(1).

⁷⁵ 17 CFR 232.100.

⁷⁶ 17 CFR 232.100(a).

⁷⁷ 17 CFR 232.201(a).

17 CFR 232.202(a).

issuer could use. We therefore do not envision the need for a hardship exemption to permit paper filing.⁷⁹

The proposed amendments would revise Rule 503 of Regulation D and Form D in several ways related to electronic filing. The proposed amendments would delete from Rule 503 references to the paper-based concept of copies in subparagraphs (a) and (b) and a manual signature in subparagraph (b). Subparagraph (a) would continue to specify when a notice on Form D initially must be filed⁸⁰ and would be revised to specify also when an amendment to a Form D filing must or could be filed.⁸¹

Subparagraph (b) would continue to require a signature. Rule 302 of Regulation S-T⁸² would specify the manner of signature for Form D as it does for electronic filings generally.⁸³ The proposed amendments also would add to subparagraph (b) a statement that electronic Form D filing through our new online filing system is mandatory. In addition, the proposed amendments would delete subparagraphs (c), (d), and (e). Subparagraph (c) requires an issuer that makes sales under

⁷⁹ We also propose an amendment to Rule 104(a) of Regulation S-T [17 CFR 232.104(a)] to make it clear that unofficial PDF copy submissions are unavailable to Form D notices. The new online filing system, further described below, is expected to make filed Form D information available on our Web site in an easy-to-read format similar to that which could be provided through an unofficial PDF copy.

⁸⁰ As proposed, Rule 503(a)(1) generally would provide that an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file a Form D for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. As previously noted, a companion release proposes a new exemption under a revised Rule 507. If that proposal were adopted, Rule 503(a)(1) would be revised to specify Rule 507 as well.

⁸¹ Subparagraph (a) would continue to provide that an issuer must file the Form D no later than 15 calendar days after the first sale of securities in the offering. As currently, an issuer could, however, file the Form D at any time before that if it has determined to make the offering. Also as currently, a mandatory capital commitment call would not constitute a new offering, but would be made under the original offering, so no new Form D filing would be required solely as a result. See Part II.A.4.b of this release for a discussion of when an amendment must or could be filed.

⁸² 17 CFR 232.302.

⁸³ Rule 302 requires, in general, that electronic filings contain typed signatures, that each signer manually sign a signature page or other document confirming the typed signature by the time the filing is made, and that the issuer maintain the manually signed document for five years and make it available to the Commission and its staff upon their request.

Rule 505 to provide an undertaking on its Form D to provide specified information to the Commission upon the staff's written request. This paragraph no longer would be necessary because, as noted above, the proposed signature requirement would provide that each issuer signing the Form D would be undertaking to furnish to the Commission and the states specified on the Form D, on written request, the information provided by each issuer to offerees. Subparagraph (d), regarding amendments, no longer would be necessary because subparagraph (a) would address when to file amendments and it is expected that the new online filing system would make available to the issuer the version of the Form D to be amended to enable the issuer to key in only the changes. Subparagraph (e), regarding the date a Form D filing is considered filed, no longer would be necessary because Rule 13 of Regulation S-T⁸⁴ would specify the way to determine the filing date for a Form D filing as it does for electronic filings generally.⁸⁵ Finally, the proposed amendments similarly would revise the General Instructions of Form D regarding copies required, manual signatures, amendments, mandatory electronic filing and filing date.

Request for Comment:

- Would Form D filers of all sizes have easy access to the Internet?
- Is it necessary or appropriate to provide for a hardship exemption?⁸⁶
- Are the proposed amendments intended to mandate electronic filing of Form D clear and appropriate?

⁸⁴ 17 CFR 232.13. Rule 13 generally provides that a filing by direct transmission beginning on or before 5:30 p.m. Eastern time on a business day is deemed filed that day and, if such a filing were to begin after that time, it would be deemed filed on the next business day.

⁸⁵ The description of Form D at 17 CFR 239.500 is similar to Rule 503 and would be amended similarly. In this regard, if the proposed new exemption under a revised Rule 507, as proposed in the companion release, is adopted, the form description also would be amended to add revised Rule 507 to the list of Regulation D rules providing exemptions in the same manner as previously discussed above with respect to proposed Rule 503(a)(1).

⁸⁶ See Part III of this release for details on the contemplated electronic filing procedure.

C. General Solicitation and General Advertising Issues Presented by Electronic Filing of Form D

Rule 502(c) of Regulation D⁸⁷ sets forth the prohibition on general solicitation and general advertising applicable to most Regulation D offerings. Specifically, issuers and persons acting on the issuer's behalf are prohibited from offering or selling securities by any form of general solicitation or general advertising. Information filed using Form D has up to now been available to the general public.⁸⁸ The electronic filing and availability of Form D information, however, may present the concern that it is being used as a marketing document to generate interest in offerings because the information would be easily and broadly available. This, in turn, may raise concerns regarding compliance with Regulation D's prohibition on the use of general solicitation and general advertising. To address these compliance concerns, we propose to revise Rule 502(c) to include a safe harbor from the prohibition on "general solicitation" and "general advertising" for information provided in a Form D filed electronically with the Commission if the information was provided in good faith and the issuer made reasonable efforts to comply with the requirements of Form D. An issuer that complied with the terms of the safe harbor would be assured that the electronic availability of its Form D filing would not, in and of itself, cause the issuer to have violated this prohibition.

Such a safe harbor would not be warranted if it merely shielded activity that is, in fact, intended to generate interest in the offering. Accordingly, we propose to limit the amount of

⁸⁷ 17 CFR 230.502(c).

⁸⁸ In 1998, we issued a release soliciting comment on a proposal to require the filing of an exhibit to certain Form D filings on a nonpublic basis. Release No. 33-7541 (May 21, 1998) [63 FR 29168]. We recognized that adoption of the proposal would raise issues under the Freedom of Information Act, 5 U.S.C. 552 *et seq.*, *Id.* [63 FR 29168, 29171]. Some of the proposals made in that release were adopted in 1999, but the nonpublic filing proposal was not acted upon. Release No. 33-7644 (Feb. 25, 1999) [64 FR 11090].

information submitted on the form⁸⁹ and limit the application of the safe harbor to where the information has been provided with a good faith and reasonable effort to comply with the requirements of Form D. Electronic Form D would not contain any place where “free writing” could occur. When submitting a paper filing, filers may insert information that is not required by the form, but that could be a vehicle for attracting investors. The electronic form would not permit such misuse. Limiting the safe harbor to information provided with a good faith and reasonable effort to comply with the requirements of Form D would be consistent with Preliminary Note 6⁹⁰ to Regulation D, and Rule 508,⁹¹ and the “notification” nature of Form D’s requirements.

Request for Comment:

- How should the Commission address any general solicitation and general advertising issues related to filing Form D information electronically or the widespread availability of such information?
- Do filers anticipate that the proposed omission from Form D of any place to provide information customarily placed in footnotes or otherwise to engage in “free writing” would inhibit their ability to file the information required by the form in accordance with applicable requirements? If so, are there particular types of additional information Form D could permit or require that would enable issuers to respond adequately consistent

⁸⁹ Similarly, current Rule 502(c) includes a safe harbor from the prohibition on general solicitation and general advertising for a notification in compliance with Rule 135c of an unregistered offering by an issuer required to file reports under Section 13 or 15(d) of the Exchange Act. The information allowed to be included in a Rule 135c notification is limited to very basic identifying information about the issuer and the offering.

⁹⁰ Preliminary Note 6 to Regulation D provides, in part, that “Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with the these rules, is part of a plan or scheme to evade the registration provisions of the [Securities] Act.”

⁹¹ 17 CFR 230.508. Rule 508 provides, in part, that “A failure to comply with a term, condition or requirement of [specified rules under Regulation D] will not result in the loss of [an] exemption . . . if the person relying on the exemption shows . . . [a] good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of [such rules].”

with our goal of not allowing Form D filings to be used as marketing documents that would raise issues of compliance with an applicable ban on general solicitation and general advertising?

- Is the proposed safe harbor from the prohibition on general solicitation and general advertising necessary and appropriate?

III. ELECTRONIC FILING PROCEDURE

We propose to mandate electronic filing of the Form D notice through an online filing system expected to be developed, which would be accessible from any computer with Internet access. The information filed would be available on our Web site and, because the online filing system would automatically capture and tag data items, the data would be interactive and easily searchable. The system would enable users to view the information in an easy-to-read format, download the information into an existing application, or create an application to use the information.⁹² As discussed above, our objectives in converting Form D filings to an electronic format include lessening the burden on issuers of filing the Form D notice, enhancing federal and state coordination, increasing the information available regarding the effectiveness of our Securities Act exemptions and increasing the information available to researchers using Form D data to conduct empirical research aimed at improving the efficiency and effectiveness of our private markets. We believe our approach to filing and dissemination formats would make it relatively easy to file, access and analyze Form D information.

⁹² Using this system would result in the Form D information being filed in the standard format of XML. We would disseminate the information in two formats – normal textual and XML tagged.

A. Mechanics

We expect that the new online filing system for Form D information would be accessible from any computer with Internet access. An issuer could both submit and amend its Form D filing through this system. The new online system would permit an issuer, in Item 7, to designate the states to which the Form D is directed. The Form D itself would include drop-down menus and other guidance functions to assist in completing the form.

In order to file, we expect that issuers would need the same codes as are required to file on our electronic filing system, EDGAR, today. An issuer that does not already have EDGAR filing codes, and to which the Commission has not previously assigned an identification number, which we call a “Central Index Key (CIK)” code, would obtain the codes by filing electronically a Form ID⁹³ at www.filermanagement.edgarfiling.sec.gov and filing, in paper by fax within two business days before or after filing the Form ID, a notarized authenticating document. The authenticating document would be manually signed by the applicant over the applicant’s typed signature, include the information contained in the Form ID, confirm the authenticity of the Form ID⁹⁴ and, if filed after electronically filing the Form ID, include the accession number assigned to the electronically filed Form ID as a result of its filing.⁹⁵ Under the online system, if the Form D filing is made on behalf of multiple issuers, each issuer most likely would be required to have its own CIK code and a confirming code, which we call a “CIK Confirmation Code (CCC)” for validation.

⁹³ 17 CFR 239.63, 249.446, 269.7 and 274.402.

⁹⁴ An issuer could confirm the authenticity of a Form ID by, for example, stating that “[name of issuer] hereby confirms the authenticity of the Form ID [filed] [to be filed] on [specify date] containing the information contained in this document.”

⁹⁵ 17 CFR 232.10(b). An “accession number” is a unique number generated by EDGAR for each electronic submission. Assignment of an accession number does not mean that EDGAR has accepted a submission.

To access and file a Form D through the new online system, issuers would begin by having a valid identification number, confirming code and password, which we call a "Password (PW)" and logging on to the system. The identification number, confirming code and password, together with a password modification authorization code, which we call a "Password Modification Authorization Code (PMAC)," we call "EDGAR access codes." The issuer should have all necessary information available before going online to file.⁹⁶ Data entry would be required to be performed quickly enough to avoid time-outs that end the session. A time-out most likely would occur one hour following the user's last activity on the system. Time-outs would be implemented due to cost and technical limitations. The system would not provide a way to save an incomplete form online from session to session.

An issuer most likely would be able to prepare an amendment based on the content of a previously filed form.⁹⁷ The system would validate as many fields as possible for data type and required fields while the filer fills in the fields on the screen. Issuers would have an opportunity to correct errors and verify the accuracy of the information before submitting the filing. An online help function likely would be available.⁹⁸

⁹⁶ Some information provided by the filer in the course of obtaining EDGAR access codes or updating such information might automatically appear in appropriate places when the filer accesses the new online filing system. As a result, in order to make changes to such information, it might be necessary to do so through an updating process through the main EDGAR system rather than the Form D online filing system. The updating process is a well-established typically online process applicable to EDGAR filers generally that would be relatively easy to complete.

⁹⁷ When an issuer files an amendment to a Form D filing, it most likely would access its Form D filing on the online filing system and type over the inaccurate information. In that case, the online filing system would replace the inaccurate information with the new information, save the revised version of the Form D filing in its amended state causing it to be an amendment and a new filing, and record the date of amendment. The information in the Form D that was accessed for purposes of the amendment would, however, remain unchanged on the system accessible to the public.

⁹⁸ The new online filing system technically would be part of EDGAR but would be similar to the online filing system for Forms 3 [17 CFR 249.103 and 274.202], 4 [17 CFR 249.104 and 274.203], and 5 [17 CFR 249.105] filed under Section 16(a) [15 U.S.C. 78p(a)] of the Exchange Act, in general, by officers, directors and principal security holders of reporting companies that have a class of equity securities registered under Section 12 [15 U.S.C. 78j] of the Exchange Act. Form D filers would access the

The issuer would be able to download and print the filing before and after submission. Once the filing is submitted, the system would indicate receipt of the filing. In many cases, the system would display a unique number assigned to the submission, which we call an "accession number" but, in any event, the accession number would follow in an e-mail notification to the filer. A filer would be able to see the filing on our Web site shortly after filing.

Consistent with our prior goals for the Form D and interaction with the states, upon filing of the Form D notice with the Commission, state securities regulators would be able to identify on our Web site Form D filings that specify their states.⁹⁹ Filers generally would specify one or more states in response to proposed Items 1 (jurisdiction of incorporation or organization), 2 (principal place of business and contact information), 3 (related person addresses), 7 (states to which Form D directed) and 12 (addresses of recipients of sales compensation) of Form D. State specification information would be interactive and easily searchable because the new online filing system would automatically capture and tag that information as it would other Form D filing information.

Most Form D filings currently are made by law firms on behalf of issuers.¹⁰⁰ We expect that the simplification and restructuring of Form D and the conversion of Form D filings to an electronic system may decrease legal fees to make Form D filings and perhaps allow more issuers to file a Form D notice themselves without the assistance of a law firm.

online filing system and, essentially, prepare the filing by responding to questions and filling in blanks. The Form D online filing system, unlike the online filing system for Forms 3, 4 and 5, likely would not, however, provide Form D filers the alternative of preparing their Form D filings before accessing the system and then submitting them through, rather than preparing them on, the online system.

⁹⁹ In Release No. 33-6339 (Aug. 18, 1981) [46 FR 41791], the Commission stated the following in its discussion of Rule 503: "It should be noted that, although the revised filing requirements do not require that the user also file a notice with the state(s) in which the offering is to be sold, it is anticipated that the Commission will routinely furnish copies of the notice forms to the appropriate state commissions."

¹⁰⁰ Our Division of Corporation Finance conducted a one-month review of Form D filings and determined that, based primarily on the cover letters that accompany most Form D filings, about 75% of the forms were filed by law firms on behalf of issuers.

B. Database Capabilities of Electronic Form D Repository

A review of Form D filings by our Division of Corporation Finance uncovered errors and omissions in the information provided.¹⁰¹ In an effort to enhance the quality of the data collected by the proposed electronic Form D, we anticipate including internal checks in the new online system that would decrease the number of errors and omissions in Form D filings. Such a system would prevent an issuer from submitting Form D information electronically unless all necessary data fields were completed in a manner consistent with the nature of each field¹⁰² and the logical relationships between or among the fields.¹⁰³ This would not only promote the integrity of the data collected by the Form D repository, but would also make it easier for issuers to complete or amend their filings.

C. System Implementation

We expect that the new online system would begin receiving mandated filings on a specified date if we were to adopt a final rule mandating electronic filing of Form D information. We are considering a period before that date during which we would permit voluntary electronic filing of Form D information using the new online filing system and form to enable issuers to become familiar with them. This period also would help alert us to any problems in the electronic Form D filing process. Issuers that chose not to file electronically during the transition period could use the current paper form. Although the information in proposed new Form D is somewhat different from

¹⁰¹ Some of the most frequent errors were failures to indicate whether a filing is an amendment or a new filing and claims that do not match the facts described (for example, issuers claiming that an offering is limited to accredited investors and then including information regarding participation of non-accredited investors in the offering).

¹⁰² The system would check, for example, to make sure that number characters were used in responding to the field in proposed Item 13 for the offering and sales amounts.

¹⁰³ The system would check, for example, whether the filer has specified Rule 505 or Rule 506 as a claimed exemption in response to proposed Item 6 but also has specified that there have been over 35 non-accredited investor purchasers in response to proposed Item 14. If the filer has done so, a pop-up would warn that only 35 non-accredited investors are permitted in these types of offerings and would require the filer to select "OK" before proceeding.

that in current paper Form D, we believe a short period when either version of the form could be used may be appropriate.

Request for Comment:

- Do filers of Form D anticipate any burdens of filing electronically that we have not addressed in this release and should consider?
- What information, if any, included on the Form D filing should be unavailable for the public to view online?
- We would like comments regarding the availability of technology required to complete the form online. We also would like comments on any possible additional burdens an electronic filing requirement may place upon issuers that may prevent them from making Form D filings.
- Should any field in the proposed Form D be optional because it may not be applicable to certain issuers or offerings?
- What types of data should the database be able to sort and ascertain about the use of Form D and reliance upon Regulation D?
- Would a voluntary period be needed for electronic Form D filing? Would the need depend upon the length of time between any adoption and effectiveness of mandated electronic filing? If a voluntary period were needed, how long should it last? Would issuers be likely to volunteer during this period?
- Should public companies be phased in to mandated electronic filing of Form D sooner than private companies?
- Where a Form D is filed on behalf of multiple issuers, would it be unduly burdensome to require all of the issuers to have EDGAR access codes and, if they do

not already have them, require them to file a Form ID authenticated by a faxed notarized document? Should only one issuer specified in such a filing be required to obtain EDGAR access codes?

- Is the Form ID authenticating process unduly burdensome for the purpose of filing a Form D notice? Would other less burdensome processes provide adequate security measures? Should issuers that only file Form D with the Commission be able to authenticate a Form ID by providing to the Commission a copy of a local business license rather than by faxing the otherwise required notarized authenticating document? Would this be easier for issuers?
- In the future, should public companies be exempted from the Form D filing requirement in Rule 503 and instead be required to file Form D information as part of their periodic annual and quarterly reports? Should these companies be exempted from the Form D filing requirement and instead be required to include that information on a current report on Form 8-K?¹⁰⁴ If these companies were required to include that information as part of their periodic annual and quarterly reports or on a current report on Form 8-K, should the companies also be required to tag the information in a manner consistent with the automatic tagging that would occur as to Form D filings made on the new online system in order to realize the benefits of uniformly tagged Form D information?

IV. GENERAL REQUEST FOR COMMENT

The Commission is proposing these revisions to Form D and Regulation D to improve the functioning and efficiency of Regulation D. We welcome your comments. We solicit comment,

¹⁰⁴

17 CFR 249.308.

both specific and general, upon each component of the proposals. We request and encourage any interested person to submit comments regarding:

- the proposals that are the subject of this release;
- additional or different changes relating to Form D; and
- other matters that may have an effect on the proposals contained in this release.

Comment is solicited from the point of view of both issuers and investors, as well as of capital formation facilitators, such as brokers-dealers, and other regulatory bodies, such as state securities regulators. Any interested person wishing to submit written comments on any aspect of the proposal is requested to do so.

V. PAPERWORK REDUCTION ACT ANALYSIS

The proposed amendments would affect two forms that contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).¹⁰⁵ The titles of the affected information collections are Form D (OMB Control No. 3235-0076) and Form ID (OMB Control No. 3235-0328). The purposes of the proposed amendments are, in general, to clarify, simplify and update the information requirements of Form D and modernize the related information capture process. We are submitting the revisions to the Form ID collection of information to the Office of Management and Budget (“OMB”) for review under 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid control number. Compliance with the collections of information as proposed to be revised would be mandatory. The information required by the collection of information in Form D as proposed to be

¹⁰⁵ 44 U.S.C. 3501 *et seq.*

revised would not be kept confidential by the Commission; the information required by Form ID would be kept non-public, subject to a request under the Freedom of Information Act.¹⁰⁶

Form D is filed by issuers as a notice of sales without registration under the Securities Act based on claims of exemption under Regulation D and Section 4(6) of the Securities Act.

Form ID is filed by registrants, individuals, third-party filers or their agents to request the assignment of access codes that permit the filing of securities documents on EDGAR.¹⁰⁷ This form enables the Commission to assign an identification number (CIK), confirmation code (CCC), password (PW) and password modification authorization code (PMAC) to each EDGAR filer, each of which is essential to the security of the EDGAR system.

We expect that, if adopted, the proposed amendments would not affect the number of Form D filings made and, on balance, would obligate issuers to report on Form D essentially the same amount of information as they are required to report on Form D today. We therefore believe that the overall information collection burden of Form D would remain approximately the same as it is today.¹⁰⁸

We estimate that approximately 196,800 respondents file Form ID each year at an estimated burden of .15 hours per response, all of which is borne internally by the respondent for a total annual burden of 29,520 hours. We expect that, if adopted, the proposed amendments would cause an additional 18,600 respondents to file a Form ID each year and, as a result, would cause an additional annual burden of 2790 hours.¹⁰⁹

¹⁰⁶ 5 U.S.C. 552. The Commission's regulations that implement that statute are at 17 CFR 200.80 et seq.

¹⁰⁷ 17 CFR 239.63, 249.446, 269.7 and 274.402.

¹⁰⁸ We estimate the burden of Form D to be 4.0 hours per response of which one hour is borne internally and three hours are borne externally

¹⁰⁹ We arrived at our estimate that an additional 18,600 respondents would file a Form ID each year based on the following information and analysis. In 2006, 16,829 companies made 25,239 Form

We solicit comment on the expected Paperwork Reduction Act effects of the proposed rule amendments, including the following:

- the accuracy of our estimates of the additional burden hours that would result from adoption of the proposed amendments;
- whether the proposed changes to the collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- ways to enhance the quality, utility and clarity of the information to be collected;
- ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- any effects of the proposed amendments on any other collections of information not previously identified.

D filings. Of these companies, 15,914 (94.6%) did not report under the Exchange Act and 915 (5.4%) did report under the Exchange Act. The annual number of Forms D filings rose from 17,390 in 2002 to 25,239 in 2006 for an average increase of approximately 2000 Form D filings per year. Assuming the number of Form D filings continues to increase by 2000 filings per year for each of the next three years, the average number of Form D filings in each of the next three years would be about 29,300. Assuming that the ratio of the number of companies that make a Form D filing to the number of Form D filings in 2006 remains constant over the next three years, an average of about 19,600 companies would make Form D filings in each of the next three years. Assuming also that the ratio between the number of non-reporting and reporting companies under the Exchange Act that made Form D filings in 2006 remains constant over the next three years, an average of about 18,600 non-reporting and 1000 reporting companies would make Form D filings in each of the next three years. Assuming further that all non-reporting companies that would make a Form D filing would not already have EDGAR access codes and, as a result, would be required to file a Form ID, the number of companies that would need to file a Form ID as a result of the proposed amendments would on average be about 18,600 per year over the next three years. Because each Form ID filing is estimated to require .15 hours, the total additional burden would, on average, be about 2790 hours per year over the next three years (18,600 Forms ID x .15 hours per Form ID). We consider the average number of Form ID filings expected to be made per year over the next three years because the PRA requires that our estimates represent the average yearly burden over a three-year period.

Any member of the public may direct to us any comments concerning these burden estimates and suggestions for reducing the burdens. Persons submitting comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303, with reference to File No. [S7-12-07]. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. [S7-12-07], and be submitted to the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. COST-BENEFIT ANALYSIS

A. Background

The proposed amendments, if adopted, would restructure and mandate the electronic filing of the information required by Form D. Currently, much of the information required by Form D appears to be useful and justified in the interests of investor protection and capital formation. It also appears that some useful information that could be required by Form D currently is not required. On the other hand, Form D currently requires some information that may no longer be useful. Our staff receives many inquiries from market participants suggesting that Form D could be clarified and simplified. Moreover, the absence of an electronic system for filing Form D information prevents issuers from filing through efficient modern methods and limits the usefulness of the information collected on Form D. The rules we propose today would address deficiencies in the

Form D data collection requirements. We believe the amendments, in general, would provide benefits by clarifying, simplifying and updating the information requirements of Form D and modernizing the related information capture process.

B. Benefits

The proposed amendments should benefit issuers, regulators and members of the public who choose to access Form D information. In particular, the proposed amendments should

- ease filing burdens;
- result in better public availability of Form D information;
- enhance the utility of Form D as a means to promote federal and state uniformity and coordination; and
- improve collection of data for Commission enforcement and rulemaking efforts.

The proposed amendments should ease filing burdens because filers would find it easier to respond to the revised information requirements of Form D and easier to file the responsive information.¹¹⁰ It should be easier to respond to the revised information requirements of Form D because they would be clarified, simplified and updated. It should be easier to file the responsive information because issuers could use efficient modern methods of information transfer through electronic filing. Issuers would provide the information in data fields by responding to a series of discrete requests for information. It is expected that the fields would be checked automatically for appropriate characters and consistency with other fields and the questions would be accompanied by easily accessible links to clear instructions and other helpful information. It is intended that that these system features, among others, would help to facilitate a relatively easy-to-use filing process that would deliver accurate information quickly, reliably, and securely.

¹¹⁰ Although we believe it would be easier to respond to the revised information requirements of Form D, as discussed in Part V regarding the PRA, we believe the overall collection of information burden of Form D would remain approximately the same as it is today.

Requiring the electronic filing of Form D data would result in increased public availability of Form D information because it would make the information filed more readily available to regulators and members of the public who choose to access it. The information would be available on our Web site and, because the Form D filing system would automatically capture and tag data items, the data would be interactive and easily searchable. The filing system would enable users to view the information in an easy-to-read format, download the information into an existing application, or create an application to use the information. Unlike information filed with us electronically, paper filings are available from us only in person in our Public Reference Room or by means of a mail request. We charge a nominal fee for copies of Form D filings. Some Form D filings are available at higher cost through private vendors over the Internet and through telephone requests.

The required electronic filing of Form D information could enhance the utility of Form D as a means to promote federal and state uniformity and coordination. For over 20 years, Form D has served as a means to promote federal and state uniformity in securities regulation by providing a uniform notification form that can be filed with the Commission and with state securities regulators. The electronic filing system would include an electronic database that could be more easily searched for information needed by both federal and state securities regulators to monitor the exempt securities transaction markets. The system also would permit improved coordination among federal and state regulators, which is essential to efficient and effective capital formation through exempt transactions, especially by smaller companies, and to investor protection. State securities regulators would be able to access the information on our Web site to learn if new Form D information of interest to them has been filed. It is our hope that state securities regulators would permit "one-stop" filing with the Commission and rely on Commission filings as satisfying state

Form D information.¹¹¹ In order to file a Form ID, an issuer would need to learn the related electronic filing requirements, obtain access to a computer and the Internet, use the computer to access the Commission's EDGAR Filer Management Web site, respond to Form ID's information requirements and fax to the Commission a notarized authenticating document.¹¹² Similarly, in order otherwise to prepare to make an initial electronic filing of Form D information, an issuer would need to learn about the revised Form D information content and electronic filing requirements, obtain access to a computer and the Internet, use the computer to access the Form D filing system and respond to Form D's information requirements.

Ongoing costs are those associated with maintaining the framework developed through the initial costs (for example, updating information required by Form ID) and additional costs arising from each subsequent filing of Form D information.

We expect that the vast majority of issuers would need to incur few, if any, additional costs related to obtaining computer and Internet access. We believe that the vast majority of issuers already would have access to a computer and the Internet.¹¹³

¹¹¹ Issuers that already have EDGAR access codes would not need to file a Form ID. As further discussed in Part V, however, we assume that about 95% of Form D filers would not already have the codes.

¹¹² As discussed in Part V regarding the PRA, the Commission estimates that approximately 196,800 respondents file Form ID each year at an estimated burden of .15 hours per response, all of which is borne internally by the respondent, for a total annual burden of 29,520 hours. As also discussed in Part V, we expect that, if adopted, the proposed amendments would cause an additional 18,600 respondents to file a Form ID each year and, as a result, cause an additional annual burden of 2790 hours. Assuming a cost of \$175 per hour for in-house professional staff, we estimate the current Form ID burden cost at \$5,166,000 per year (29,520 hours per year x \$175 per hour), the additional Form ID burden cost that would result from adoption of the proposed amendments at \$488,250 per year (2790 hours per year x \$175 per hour) and the total Form ID burden cost that would result from adding the estimated additional Form ID burden cost to the estimated current Form ID burden cost would be \$5,654,250 per year ((29,520 hours per year + 2790 hours per year) = 32,310 hours per year; 32,310 hours per year x \$175 per hour = \$5,654,250 per year).

¹¹³ A person from an issuer that did not already own a computer with Internet access could, for example, go to a public library to use its computer and obtain Internet access.

D. Requests for Comments

We request comment on all aspects of the cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments. We also request that those submitting comments provide empirical data and other factual support for their views to the extent possible.

VII. CONSIDERATION OF IMPACT ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act¹¹⁴ requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, Section 2(b) of the Securities Act,¹¹⁵ Section 3(f) of the Exchange Act,¹¹⁶ and Section 2(c) of the Investment Company Act¹¹⁷ require us, when engaged in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

The proposed amendments, if adopted, would restructure and mandate the electronic filing of the information required by Form D. We believe the amendments, in general, would provide benefits by clarifying, simplifying and updating the information requirements of Form D and

¹¹⁴ 15 U.S.C. 78w(a)(2).

¹¹⁵ 15 U.S.C. 77b(b).

¹¹⁶ 15 U.S.C. 78c(f).

¹¹⁷ 15 U.S.C. 80a-2(c).

modernizing the related information capture process. In particular, as discussed in further detail above, the proposed amendments should

- ease filing burdens;
- result in better public availability of Form D information;
- enhance the utility of Form D as a means to promote federal and state uniformity and coordination; and
- improve collection of data for Commission enforcement and rulemaking efforts.

We understand that private sector businesses currently make Form D information available to the public for a fee. Although the ready accessibility of this information at no cost would affect these businesses, we believe that the interactive online system that would be used for Form D information would not discourage the development by private sector businesses of additional features that the new online system would not provide. Consequently, we believe that the proposed amendments would not have a burden on competition that is not necessary or appropriate and might promote competition in providing Form D information through additional features including those related to the tagged data aspect of the system.

Eased filing burdens and better public availability of information resulting from the proposed amendments would promote efficiency. For example, the expected online system would enable issuers to provide Form D information with modern, rapid and accurate methods and would enable users of the system to access Form D information more quickly and easily than through a review of paper documents.

Improved collection of data for Commission enforcement and rulemaking efforts resulting from the proposed amendments would create a Form D information database that would allow us to evaluate our exemptive schemes on a continuing basis in order to facilitate capital formation in a

manner consistent with investor protection and the evaluation could lead to improvements that would promote our capital markets. Similarly, the enhanced utility of Form D as a means to promote federal and state uniformity and coordination resulting from the proposed amendments could lead to improved coordination which would promote capital formation.

We request comment on whether the proposed amendments, if adopted, would impose a burden on competition. We also request comment on whether the proposed amendments, if adopted, would promote efficiency, competition and capital formation. Finally, we request commenters to provide empirical data and other factual support for their views if possible.

VIII. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments regarding the content and mandated electronic filing of information required by Form D.

A. Reasons for, and Objectives of, the Proposed Action

The main purpose of the proposed amendments is to address deficiencies in the Form D data collection process. Currently, much of the information required by Form D appears to be useful and justified in the interests of investor protection and capital formation. It also appears that some useful information that could be required by Form D currently is not required. On the other hand, Form D currently requires some information that may no longer be useful. Our staff receives many inquiries from market participants suggesting that Form D could be clarified and simplified. Moreover, the absence of an electronic system for filing Form D information prevents issuers from filing through efficient modern methods and limits the usefulness of the information collected on Form D. We believe the amendments, in general, would address the deficiencies in the Form D

data collection process by clarifying, simplifying and updating the information requirements of Form D and modernizing the related information capture process.

B. Legal Basis

We are proposing the amendments under the authority in Sections 2(a), 3(b), 4(2), 19(a), 19(d) and 28 of the Securities Act,¹¹⁸ Sections 3(b), 23(a) and 35A of the Exchange Act,¹¹⁹ Section 319(a) of the Trust Indenture Act,¹²⁰ and Section 38 of the Investment Company Act.¹²¹

C. Small Entities Subject to the Proposed Rules

The proposed amendments would affect issuers that are small entities. Exchange Act Rule 0-10(a)¹²² defines an issuer, other than an investment company, to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.¹²³ Investment Company Act Rule 0-10(a) defines an investment company as a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it, together with other investment companies in the same group of

¹¹⁸ 15 U.S.C. 77b(a), 77c(b), 77d(2), 77s(a), 77s(d) and 77z-3.

¹¹⁹ 15 U.S.C. 78c(b), 78w(a) and 78ll.

¹²⁰ 15 U.S.C. 77sss(a).

¹²¹ 15 U.S.C. 80a-37.

¹²² 17 CFR 240.0-10(a).

¹²³ Securities Act Rule 157(a) [17 CFR 230.157(a)] generally defines an issuer, other than an investment company, to be a “small business” or “small entity” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year and it is conducting or proposing to conduct a securities offering of \$5 million or less. For purposes of our analysis of issuers other than investment companies in this Part VIII of the release, however, we use the Exchange Act definition of “small business” or “small entity” because that definition includes more issuers than does the Securities Act definition and, as a result, assures that the definition we use would not itself lead to an understatement of the impact of the proposed amendments on small entities.

related investment companies, had net assets of \$50 million or less as of the end of its most recent fiscal year.¹²⁴ The proposed amendments would apply to all issuers that file Form D.

As previously noted, in 2006, 16,829 issuers filed a Form D. We believe that many of these issuers are small entities but we currently we do not collect information on total assets to determine if they are small entities for purposes of this analysis.¹²⁵

D. Reporting, Recordkeeping and Other Compliance Requirements

Currently, issuers must file Form D information in paper. The proposed amendments would require all issuers, including small entities, to submit somewhat different Form D information online using the Internet. These issuers also would need to file a Form ID electronically to obtain the access codes needed to use the Form D filing system if they did not already have the codes.¹²⁶ The only additional professional skills required would be those required to file electronically.¹²⁷

We expect that filing electronically would increase initial and ongoing costs incurred by some small entities. We also expect, however, that many small entities would not bear the full range of costs that would result from the amendments for the reasons described below.

Initial costs are those associated with filing a Form ID in order to obtain the access codes needed to file Form D information electronically and otherwise preparing to make an initial filing of Form D information. In order to file a Form ID, an issuer would need to learn the related electronic

¹²⁴ 17 CFR 270.0-10(a).

¹²⁵ We do, however, solicit comment in Part II on whether proposed Form D should require an issuer to disclose whether the value of its total assets was \$5 million or less on the last day of its most recently ended fiscal year.

¹²⁶ As further discussed in Part V, however, we assume that about 95% of Form D filers would not already have the codes.

¹²⁷ Although we believe it would be easier to respond to the revised information requirements of Form D, as discussed in Part V, we believe the overall collection of information burden of the form would remain approximately the same.

filing requirements, obtain access to a computer and the Internet, use the computer to access the Commission's EDGAR Filer Management Web site, respond to Form ID's information requirements and fax to the Commission a notarized authenticating document.¹²⁸ Similarly, in order otherwise to prepare to make an initial electronic filing of Form D information, an issuer would need to learn about the revised Form D information content and electronic filing requirements, obtain access to a computer and the Internet, use the computer to access the Form D filing system and respond to Form D's information requirements.

Ongoing costs are those associated with maintaining the framework developed through the initial costs (for example, updating information required by Form ID) and additional costs arising from each subsequent filing of Form D information.

We expect that the vast majority of small entities would need to incur few, if any, additional costs related to obtaining computer and Internet access. We believe that the vast majority of small entities already would have access to a computer and the Internet.¹²⁹

E. Duplicative, Overlapping or Conflicting Federal Rules

We believe that the proposed amendments would not duplicate, or overlap or conflict with, other federal rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities.

¹²⁸ As discussed in Part V, the Commission has estimated the collection of information burden of Form ID as .15 hours per response, all of which is borne internally by the respondent.

¹²⁹ A person from a small entity that did not already own a computer with Internet access could, for example, go to a public library to use its computer and obtain Internet access.

In connection with the proposed amendments, we considered several alternatives, including the following:

- establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- further clarifying, consolidating or simplifying the proposed requirements;
- using performance rather than design standards; and
- providing an exemption from the proposed requirements, or any part of them, for small entities.

We believe that, as to small entities, differing compliance, reporting or timetable requirements, a partial or complete exemption from the proposed requirements or the use of performance rather than design standards would be inappropriate because these approaches would detract from the completeness and uniformity of the Form D database and, as a result, reduce the expected benefits of better public availability of Form D information, enhanced utility of Form D as a means to promote federal and state uniformity and improved collection of data for Commission enforcement and rulemaking efforts. Further, we believe the proposed Form D filing system would be relatively easy to use.¹³⁰ We solicit comment, however, on whether differing compliance, reporting or timetable requirements, a partial or complete exemption, or the use of performance rather than design standards would be consistent with our described main goal of addressing deficiencies in the Form D data collection process.¹³¹

¹³⁰ As discussed in Part III.C, we are considering a period during which we would permit voluntary electronic filing of Form D information using the new electronic filing system and form to enable issuers to become familiar with them. Small entities would be able to take advantage of any such period.

¹³¹ In this regard, in Part III of this release, we solicit comment on the availability of technology to complete Form D online and whether public companies should be phased in to mandated electronic Form D filing sooner than private companies (presumably, many of the small entities that would file Form D would be private companies).

We considered further clarifying, consolidating or simplifying the proposed Form D information and electronic filing requirements. During 2003, the Commission's Office of Small Business Policy ("OSBP") reviewed the types of errors, omissions, and misstatements more commonly found in Form D filings, as well as the types of questions typically received through phone calls from the public associated with the form. We also have considered the electronic filing requirements related to Exchange Act Forms 3, 4 and 5, the manner in which their online filing system has operated and the suitability of that system as a model for the expected online system for Form D information. Based in part on OSBP's review and our consideration of the electronic filing of Forms 3, 4 and 5, we believe that the proposed Form D information and electronic filing requirements are clear and straightforward (although, we seek comment on this).

G. Solicitation of Comment

We encourage comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- the number of small entities that may be affected by the proposed amendments;
- the existence or nature of the potential impact of the proposed amendments on small entities as discussed in this analysis; and
- how to quantify the impact of the proposed amendments.

We ask those submitting comments to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

IX. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,¹³² a rule is “major” if it has resulted, or is likely to result in:

- an annual effect on the economy of \$100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment or innovation.

In connection with this analysis, we solicit comment and empirical data on:

- the potential effect of the proposals on the U.S. economy on an annual basis;
- any potential increase in costs or prices for consumers or individual industries resulting from the proposals; and
- any potential effect of the proposals on competition, investment or innovation.

X. STATUTORY BASIS AND TEXT OF PROPOSED AMENDMENTS

We are proposing the amendments to Rules 100, 101, 104, 201, and 202 of Regulation S-T, Securities Act Rules 502 and 503 and the description and content of Securities Act Form D under the authority in sections 2(a), 3(b), 4(2), 19(a), 19(d), and 28 of the Securities Act,¹³³ sections 3(b), 23(a), and 35A of the Exchange Act,¹³⁴ section 319(a) of the Trust Indenture Act,¹³⁵ and section 38 of the Investment Company Act.¹³⁶

¹³² Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

¹³³ 15 U.S.C. 77b(a), 77c(b), 77d(2), 77s(a), 77s(d), and 77z-3.

¹³⁴ 15 U.S.C. 78c(b), 78w(a), and 78ll.

¹³⁵ 15 U.S.C. 77sss(a).

¹³⁶ 15 U.S.C. 80a-37.

List of Subjects

17 CFR Parts 230, 232 and 239

Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED AMENDMENTS

For the reasons set out in the preamble, we propose to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

PART 230 -- GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The general authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Amend § 230.502 by revising paragraph (c) to read as follows:

§ 230.502 General conditions to be met.

* * * * *

(c) Limitation on manner of offering. Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising; Provided, however, that publication by an issuer of a notice in accordance with § 230.135c or filing with the Commission by an issuer of a notice of sales on Form

D (17 CFR 239.500) in which the issuer has made a good faith and reasonable attempt to comply with the requirements of such form, shall not be deemed to constitute general solicitation or general advertising for purposes of this section; Provided further, that, if the requirements of § 230.135e are satisfied, providing any journalist with access to press conferences held outside of the United States, to meetings with issuer or selling security holder representatives conducted outside of the United States, or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, will not be deemed to constitute general solicitation or general advertising for purposes of this section.

* * * * *

3. Revise § 230.503 to read as follows:

§ 230.503 Filing of notice of sales.

(a) When notice of sales on Form D must be filed.

(1) An issuer offering or selling securities in reliance on § 230.504, § 230.505, or § 230.506 must file with the Commission a notice of sales on Form D (17 CFR 239.500) for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

(2) An issuer may file an amendment to a previously filed notice of sales on Form D at any time.

(3) An issuer must file an amendment to a previously filed notice of sales on Form D for an offering:

(i) To correct a mistake of fact in the previously filed notice of sales on Form D, as soon as practicable after discovery of the mistake;

(ii) To reflect a change in the information provided in the previously filed notice of sales on Form D, as soon as practicable after the change, except that no amendment is required to reflect a change that occurs after the offering terminates or a change that occurs in the following only:

(A) an issuer's revenues,

(B) the amount of securities sold in the offering,

(C) the total offering amount, if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%,

(D) the number of accredited investors who have invested in the offering,

(E) the number of non-accredited investors who have invested in the offering; as long as the change does not increase the number to more than 35, or

(F) in offerings that last more than a year, information on related persons if the change was due solely to the filling of a vacant position upon the death or departure in the ordinary course of business of the previous occupant of the position; and

(iii) in offerings that last more than a year, annually, between January 1 and February 14, to reflect information about the offering on or before its termination since the later of the filing of the notice of sales on Form D or the most recent amendment to the notice of sales on Form D.

(4) An issuer that files an amendment to a previously filed notice of sales on Form D must provide current information in response to all requirements of the notice of sales on Form D regardless of why the amendment is filed.

(b) How notice of sales on Form D must be filed and signed.

(1) A notice of sales on Form D must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering Analysis and Retrieval System (EDGAR) in accordance with EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(2) Every notice of sales on Form D must be signed by a person duly authorized by the issuer.

PART 232 – REGULATION S-T – GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

4. The general authority citation for Part 232 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 80a-8, 80a-29, 80a-30, and 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

5. Amend § 232.100 by revising paragraph (a) to read as follows:

§ 232.100 Persons and entities subject to mandated electronic filing.

(a) Registrants and other entities whose filings are subject to review by the Division of Corporation Finance;

* * * * *

6. Amend § 232.101 by:

- a. Removing the word “and” at the end of paragraph (a)(1)(xi);
- b. Removing the period and adding “and” at the end of paragraph (a)(1)(xii);
- c. Adding paragraph (a)(1)(xiii); and
- d. Removing “, Regulation D (§§ 230.501-230.506 of this chapter)” from paragraph (c)(6).

(§§ 239.65, 249.447, 269.10 and 274.404 of this chapter), in paper format no later than one business day after the date on which the filing was to be made.

* * * * *

9. Amend § 232.202 by revising paragraph (a) introductory text to read as follows:

§ 232.202 Continuing hardship exemption.

(a) An electronic filer may apply in writing for a continuing hardship exemption if all or part of a filing or group of filings, other than a Form ID (§§ 239.63, 249.446, 269.7 and 274.402 of this chapter) or a Form D (§ 239.500 of this chapter), otherwise to be filed in electronic format cannot be so filed without undue burden or expense. Such written application shall be made at least ten business days prior to the required due date of the filing(s) or the proposed filing date, as appropriate, or within such shorter period as may be permitted. The written application shall contain the information set forth in paragraph (b) of this section.

* * * * *

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

10. The general authority citation for Part 239 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78j, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

11. Revise § 239.500 to read as follows::

§ 239.500 Form D, notice of sales of securities under Regulation D and section 4(6) of the Securities Act of 1933.

(a) When notice of sales on Form D must be filed.

(1) An issuer offering or selling securities in reliance on § 230.504, § 230.505, or

§ 230.506 of this chapter or section 4(6) of the Securities Act of 1933 must file with the Commission a notice of sales on Form D (17 CFR 239.500) for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

(2) An issuer may file an amendment to a previously filed notice of sales on Form D at any time.

(3) An issuer must file an amendment to a previously filed notice of sales on Form D for an offering:

(i) To correct a mistake of fact in the previously filed notice of sales on Form D, as soon as practicable after discovery of the mistake;

(ii) To reflect a change in the information provided in the previously filed notice of sales on Form D, as soon as practicable after the change, except that no amendment is required to reflect a change that occurs after the offering terminates or a change that occurs in the following only:

(A) an issuer's revenues,

(B) the amount of securities sold in the offering,

(C) the total offering amount, if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%,

(D) the number of accredited investors who have invested in the offering,

(E) the number of non-accredited investors who have invested in the offering, as long as the change does not increase the number to more than 35, or

(F) in offerings that last more than a year, information on related persons if the change was due solely to the filling of a vacant position upon the death or departure in the ordinary course of business of the previous occupant of the position; and

(iii) in offerings that last more than a year, annually, between January 1 and February 14, to reflect information about the offering on or before its termination date since the later of the filing of the notice of sales on Form D or the most recent amendment to the notice of sales on Form D.

(4) An issuer that files an amendment to a previously filed notice of sales on Form D must provide current information in response to all requirements of the notice of sales on Form D regardless of why the amendment is filed.

(b) How notice of sales on Form D must be filed and signed.

(1) A notice of sales on Form D must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering Analysis and Retrieval System (EDGAR) in accordance with EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(2) Every notice of sales on Form D must be signed by a person duly authorized by the issuer.

12. Revise Form D (referenced in § 239.500) to read as follows:

Note – The text of Form D does not and this amendment will not appear in the Code of Federal Regulations.

Form D Notice of Exempt Offering of Securities

Form D

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM D

NOTICE OF EXEMPT OFFERING OF SECURITIES

Intentional misstatements or omissions of fact constitute federal criminal violations. See 18 U.S.C. 1001.

You must follow the accompanying instructions in submitting this notice.

1. Issuer's Identity

Name of Issuer _____

Previous Name(s) _____ None

Jurisdiction of Incorporation/Organization (dropdown)

Entity Type (dropdown)

Year of Incorporation/Organization (dropdown giving last five years and "Before 2002")

SEC File No. _____ None

Add Issuer

(for each additional issuer, a signature block will appear)

2. Principal Place of Business and Contact Information

Street Address _____

City _____ **State/Province** ___ (dropdown)

Zip/Postal Code _____ **Country** U.S. Canada Other
(dropdown of countries if answer is "Other" than U.S. or Canada) _____

9. **Type(s) of Securities Offered** (select all that apply)

- Equity
- Debt
- Option, Warrant or Other Right to Acquire Another Security
- Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security
- Pooled Investment Fund Interests
- Tenant-in-Common Securities
- Mineral Property Securities
- Other (Describe: _____)

10. **Business Combination Transaction**

Is this offering being made in connection with a business combination transaction, such as a merger, acquisition or exchange offer? Yes No

11. **Minimum Investment**

Minimum investment accepted from any investor \$ _____

12. **Sales Compensation**

Individual Recipient	CRD Number	Associated Broker or Dealer	Street Address	State(s) of Solicitation (dropdown)

Add Recipient

13. **Offering and Sales Amounts**

Total Offering Amount \$ _____ or Indefinite
 Total Amount Sold \$ _____
 Total Remaining to be Sold \$[auto subtract] _____ or Indefinite

14. **Investors**

Select if securities in the offering have been or may be sold to persons who do not qualify as accredited investors and enter the number of such non-accredited investors who already have invested in the offering: _____²

Enter the number of accredited investors who already have invested: _____

Signature and Submission

Terms of Submission: Please verify the information you have entered and review the Terms of Submission below before signing and clicking SUBMIT below to file this notice.

² If the filer selects Rule 505 or Rule 506 in Item 6 above and enters a number above 35 in this field, a pop-up will warn that only 35 non-accredited investors are permitted in this type of offering and require the filer to select "OK" before proceeding.

[Material in this box will be placed in scrollbox online.]

In submitting this notice, each issuer named above is :

- Notifying the SEC and/or each State in which this notice is filed of the offering of securities described and undertaking to furnish them, upon written request, the information furnished to offerees.
- Irrevocably appointing each of the Secretary of the SEC and, the Securities Administrator or other legally designated officer of the State in which the issuer maintains its principal place of business and any State in which this notice is filed, as its agents for service of process, and agreeing that these persons may accept service on its behalf, of any notice, process or pleading, and further agreeing that such service may be made by registered or certified mail, in any Federal or state action, administrative proceeding, or arbitration brought against it in any place subject to the jurisdiction of the United States, if the action, proceeding or arbitration (a) arises out of any activity in connection with the offering of securities that is the subject of this notice, and (b) is founded, directly or indirectly, upon the provisions of: (i) the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, or any rule or regulation under any of these statutes, or (ii) the laws of the State in which the issuer maintains its principal place of business or any State in which this notice is filed.
- Certifying that the issuer is not disqualified from relying on any Regulation D exemption it has identified in Item 6 above for one of the reasons stated in Rule 502(e).

Each issuer identified above has read this notice, knows the contents to be true, and has duly caused this notice to be signed on its behalf by the undersigned duly authorized person.

Signature

Signature: _____ Title: _____ Date: _____

By clicking on SUBMIT below, you are agreeing to the Terms of Submission above.

SUBMIT

OMB Approval

OMB No. 3235-0076

Expires: _____, 20

Estimated Average Burden Hours per Response: 4.00

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

Instructions for Submitting Notice

General Instructions

- **Who must file:**
 - Each issuer of securities that sells its securities in reliance on an exemption provided in Regulation D or Section 4(6) of the Securities Act of 1933 must file this notice containing the information requested with the U.S. Securities and Exchange Commission (SEC) and with the state(s) requiring it. If more than one issuer has sold its securities in the same transaction, all issuers should be identified in one filing with the SEC, but some states may require a separate filing for each issuer or security sold.
- **When to file:**
 - An issuer must file a new notice with the SEC for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. An issuer may file the notice at any time before that if it has determined to make the offering. An issuer must file a new notice with each state that requires it at the time set by the state. For state filing requirements, go to www.NASAA.org. A mandatory capital commitment call does not constitute a new offering, but is made under the original offering, so no new Form D filing is required.
 - An issuer may file an amendment to a previously filed notice at any time.
 - An issuer must file an amendment to a previously filed notice for an offering:
 - to correct a mistake of fact in the previously filed notice, as soon as practicable after discovery of the mistake;
 - to reflect a change in the information provided in the previously filed notice, except as provided below, as soon as practicable after the change; and
 - in offerings that last more than a year, annually, between January 1 and February 14, to reflect information about the offering on or before its termination since the later of the filing of the Form D or the latest amendment to the Form D.
- **When filing is not required:** An issuer is not required to file an amendment to a previously filed notice to reflect a change in an offering that occurs after the offering terminates or a change that occurs in the following only:
 - an issuer's revenues,
 - the amount of securities sold in the offering,
 - the total offering amount, if the change, together with all other changes in that amount since the previously filed notice, does not result in an increase of more than 10%,
 - the number of accredited investors who have invested in the offering,
 - the number of non-accredited investors who have invested in the offering, as long as the change does not increase the number to more than 35, or
 - in offerings that last more than a year, information on related persons if the change was due solely to the filling of a vacant position upon the death or departure in the ordinary course of business of the previous occupant of the position.

- **Amendment Content:** An issuer that files an amendment to a previously filed Form D must provide current information in response to all items of Form D regardless of why the amendment is filed.
- **How to File:** Issuers must file this notice with the SEC using the process made available at [insert linked Web address for filing]. For state filing requirements, go to www.NASAA.org.
- **Filing Fee:** There is no federal filing fee. For information on state filing fees, go to www.NASAA.org.
- **Confirmation of Filing:** The SEC will send an e-mail message confirming receipt of this notice to the e-mail address associated with the password used to submit the notice.
- **Definitions of Terms:** Terms used but not defined in this form that are defined in Regulation D or Rule 405 under the Securities Act of 1933, 17 C.F.R. §§ 230.501 et seq. and 230.405, have the meanings given to them in Regulation D and Rule 405.

Item-by-Item Instructions

1. **Issuer's Identity.** Identify each legal entity issuing any securities being reported as being offered by entering its full name, any previous name used within the past five years, its jurisdiction and year of incorporation or other organization, its type of legal entity, and its SEC file number if a reporting company under the Securities Exchange Act of 1934. If more than one entity is issuing the securities, identify a primary issuer in the fields shown and add additional issuers by clicking on "Add Issuer."
2. **Principal Place of Business and Contact Information.** Enter a full street address of the issuer's principal place of business. Post office box numbers and "In care of" addresses are not acceptable. Enter a contact telephone number for the issuer. Where more than one issuer is named, enter information only for one primary issuer.
3. **Related Persons.** Enter the full name and address of each person having the specified relationships with any issuer and identify each relationship:
 - Each executive officer and director of the issuer and person performing similar functions for the issuer, such as general and managing partners of partnerships and managing members of limited liability companies; and
 - Each person who has functioned as a promoter of the issuer within the past five years of the later of the first sale of securities or the date upon which the Form D filing was required to be made.
4. **Industry Group.** Select the issuer's industry group. If the issuer or issuers can be categorized in more than one industry group, select the industry group that most accurately reflects the use of the bulk of the proceeds of the offering. For purposes of this filing, use the ordinary dictionary and commonly understood meanings of the terms identifying the industry group.
5. **Revenue Range.** Enter the revenue range of the issuer or of all the issuers for the most recently completed fiscal year available, or, if not in existence for a fiscal year, revenue range to date. Domestic SEC reporting companies should state revenues in accordance with Regulation S-X under the Securities Exchange Act of 1934. Domestic non-

reporting companies should state revenues in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Foreign issuers should calculate revenues in U.S. dollars and state them in accordance with U.S. Generally Accepted Accounting Principles, home country GAAP or International Financial Reporting Standards. If the issuer(s) declines to disclose its revenue range, enter "Decline to Disclose." If the business is intended to produce revenue but did not, enter "No Revenues." If the business is not intended to produce revenue (for example, the business seeks asset appreciation), enter "Not Applicable."

6. **Federal Exemption(s) and Exclusion(s) Claimed.** Select the appropriate checkbox(es) to designate the provision(s) being claimed to exempt the offering and resulting sales from the federal registration requirements under the Securities Act of 1933 and, if applicable, to exclude the issuer from the definition of "investment company" under the Investment Company Act of 1940. Select "Rule 504(b)(1) (not (i), (ii) or (iii))" only if the issuer is relying on the exemption in the introductory sentence of Rule 504 for offers and sales that satisfy all the terms and conditions of Rules 501 and 502(a), (c) and (d).
7. **Type of Filing/Choosing Notice Recipient.** Indicate whether the issuer is filing a new notice and/or an amendment to a notice that was filed previously. Also select the appropriate checkbox(es) to choose whether you are directing the notice to the SEC only or to the SEC and the State(s) you select. If this is a new notice to the SEC or any recipient State, enter the date of the first sale of securities in the offering with respect to that recipient or indicate that the first sale has "Yet to Occur" in the pop-up checkbox(es) that appear. The person submitting this notice is responsible for confirming State requirements [link to NASAA Web site] to determine whether choosing to direct this notice to a State by selecting a checkbox in this item satisfies any applicable filing requirements of that State and whether a separate State filing or payment of a State filing fee is required.
8. **Duration of Offering.** Indicate whether the issuer intends the offering to last for more than one year.
9. **Type(s) of Securities Offered.** Select the appropriate checkbox(es) for each of the types of securities offered the offering of which is the subject of one or more exemptions specified in Item 6 and as to which this Form D is filed (if, however, such a security is debt convertible into another security, the issuer should check the box(es) for "Debt" and any other appropriate types of securities except for "Equity"). If, for example, an issuer specified an exemption in Item 6 and filed this Form D as to the offering of both immediately exercisable options and their underlying common stock, the issuer should check the boxes for "Option, Warrant or Other Right to Acquire Another Security" and "Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security." If, however, the issuer specified an exemption in Item 6 and filed this Form D as to the offering of options exercisable over a year after purchase but not the offering of the underlying common stock, the issuer should check only the box for "Option, Warrant or Other Right to Acquire Another Security." For purposes of this filing, use the ordinary dictionary and commonly understood meanings of these categories. For instance, equity securities would be securities that represent proportional ownership in an issuer, such as ordinary common and preferred stock of corporations and partnership and limited

liability company interests; debt securities would be securities representing money loaned to an issuer that must be repaid to the investor at a later date; pooled investment fund interests would be securities that represent ownership interests in a pooled or collective investment vehicle; tenant-in-common securities would be securities that include an undivided fractional interest in real property other than a mineral property; and mineral property securities would be securities that include an undivided interest in an oil, gas or other mineral property.

10. **Business Combination Transaction.** Indicate whether or not the offering is being made in connection with a business combination, such as a merger, acquisition, exchange offer or other transaction of the type described in paragraph (a)(1), (2) or (3) of Rule 145 under the Securities Act of 1933. Do not include an exchange (tender) offer for a class of the issuer's own securities.
11. **Minimum Investment.** Enter the minimum dollar amount of investment that will be accepted from any investor. If the offering provides a minimum investment amount that can be waived, provide the lowest amount below which a waiver will not be granted for any person. If there is no minimum investment amount, enter "0."
12. **Sales Compensation.** Enter the requested information for each individual who has been or will be paid directly or indirectly any commission or other similar compensation in connection with sales of securities in the offering, including finders. In addition, in the last column, enter the State(s) in which the individual has solicited or intends to solicit investors. If more than five individuals to be listed are associated persons of the same broker or dealer, enter only the name of the broker or dealer, its street address, and the State(s) in which its associated persons have solicited or intend to solicit investors.
13. **Offering and Sales Amounts.** Enter the dollar amount of securities being offered under a claim of federal exemption identified in Item 6 above. Also enter the dollar amount of securities sold in the offering as of the filing date. Select the "Indefinite" box if the amount being offered is undetermined or cannot be calculated at the present time, such as if the offering includes securities to be acquired upon the exercise or exchange of other securities or property and the exercise price or exchange value is not currently known or knowable. If an amount is definite but difficult to calculate without unreasonable effort or expense, provide a good faith estimate. The total offering and sold amounts should include all cash and other consideration to be received for the securities, including cash to be paid in the future under mandatory capital commitments. In offerings for consideration other than cash, the amounts entered should be based on the issuer's good faith valuation of the consideration.
14. **Investors.** Indicate whether securities in the offering have been or may be sold to persons who do not qualify as accredited investors as defined in Rule 501(a) and provide the number of such investors who have already invested in the offering and the number of accredited investors who have already invested.

Signature and Submission. An individual who is a duly authorized representative of each issuer identified must sign, date and submit this notice for the issuer. The capacity in which the individual signed should be set forth in the "Title" space.

Entity Type (for Item 1)

- Corporation
- Limited Partnership
- Limited Liability Company
- General Partnership
- Business Trust
- Other (Specify)

Industry Groups (for Item 4)

Agriculture

Banking & Financial Services

- Commercial Banking
- Insurance
- Investing
- Investment Banking
- Pooled Investment Fund*
 - Hedge Fund
 - Private Equity Fund
 - Venture Capital Fund
 - Other Investment Fund
- Other

Business Services

- Accounting & Consulting
- Advertising
- Employee Benefits & Compensation
- Environmental Services
- Human Resources
- Legal Services
- Marketing
- Public Relations
- Other

Energy

- Electric Utilities
- Energy Conservation
- Oil & Gas
- Other

* If the Pooled Investment Fund checkbox is selected, pop-ups also will require the filer to select one of the lower level checkboxes designating a specific type of investment fund and select a "yes" or "no" checkbox as to whether the filer is registered as an investment company under the Investment Company Act of 1940.

Health Care

- Biotechnology
- Health Insurance
- Hospitals & Physicians
- Pharmaceuticals
- Other

- Manufacturing

Real Estate

- Commercial
- Construction
- REITS & Finance
- Residential
- Other

Retailing

Restaurants

Technology

Computers

Telecommunications

Other

Travel

Airlines & Airports

Lodging & Conventions

Tourism & Travel Services

Other

Other

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

Dated: June 29, 2007