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

39 Documents

ADMINISTRATIVE PROCEEDING
FILE NO. 3-12554

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
June 15, 2007

In the Matter of MICHAEL SASSANO, DOGAN BARUH, ROBERT OKIN, and R. SCOTT ABRY	ORDER GRANTING INTERIM STAY

On January 31, 2007, we instituted proceedings against Michael Sassano, Dogan Baruh, Robert Okin, and R. Scott Abry ("Respondents"). The Order Instituting Proceedings ("OIP") alleged that Respondents had engaged in deceptive market timing and late trading practices that resulted in numerous violations of the securities laws. The OIP authorized public administrative and cease-and-desist proceedings against Respondents pursuant to Section 8A of the Securities Act of 1933, Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Sections 9(b) and (f) of the Investment Company Act of 1940. 1/

By letter dated February 14, 2007, the Division of Enforcement ("Division") informed the administrative law judge that it "anticipated completing its obligations under Rule [of Practice] 230(a) by the end of next week." That Rule sets forth the Division's production obligations in administrative proceedings. Rule 230(a) states, in pertinent part: "Unless otherwise provided by this rule, or by order of the Commission or the hearing officer, the Division of Enforcement shall make available for inspection and copying by any party documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings." 2/

1/ 15 U.S.C. §§ 77h-1, 78(o)(b)(6), 78u-3, 80b-3(f), 80a-9(b) and (f).

2/ 17 C.F.R. § 201.230(a) (emphasis supplied).

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On February 15, 2007, the law judge ordered the Division to provide evidence that it had complied with Rule 230. Although the extent to which the Division made its files available to Respondents pursuant to Rule 230 is not clear from the pleadings, the law judge subsequently found, as indicated below, that "[i]t is now apparent that the Division has not yet completed its Rule 230 production responsibilities." In the same order, the law judge required the Division to prepare an itemized privilege log. On March 7, 2007, the Division filed a 240-item privilege log.

On May 29, 2007, Respondent Sassano moved for an order directing the Division to produce documents and transcripts relevant to this proceeding from the Division's nationwide, omnibus investigation of market timing and late trading in the mutual fund industry filed pursuant to a Formal Order of Investigation called In re Certain Mutual Fund Trading Practices, NY-7220, which the Commission issued on September 10, 2003. Sassano argued that NY-7220 was the investigation that led to the filing of the present OIP, and that, pursuant to Rule 230, he was entitled to inspect and copy all documents obtained by the Division during the course of NY-7220. 3/ Sassano argued further that the Division's refusal to provide access to those documents substantially prejudiced his ability to prepare for the hearing in this case, which is scheduled to begin on July 9, 2007.

On June 5, 2007, the Division filed its opposition to Sassano's motion. The Division asserted that its Northeast Regional Office, which is handling this proceeding, opened a "case number," NY-7273, on January 29, 2004, for an "ongoing" investigation of market timing and late trading at Canadian Imperial Bank of Commerce. The Division asserted further that when it requested the Commission to issue the present OIP, its Action Memorandum identified the relevant investigation as NY-7273, and not NY-7220. Nevertheless, the Division's opposition acknowledged that the Commission did not issue a formal order of investigation in NY-7273, other than NY-7220. The Division's opposition also acknowledged that the Division took testimony and subpoenaed documents relating to the present OIP under the authority of the Commission's Formal Order of Investigation in NY-7220.

On June 8, 2007, the law judge issued an Order Concerning the Division of Enforcement's Duty to Provide Access to Certain Non-Privileged Investigative Materials from NY-7220 ("Order"), granting Sassano's motion in part. As relevant here, the Order requires that within seven days, i.e., by June 15, 2007, the Division make available to Respondents all relevant, "non-privileged documents obtained by the Division in NY-7220 relating to any of the mutual funds, annuity funds, hedge funds, trading platforms, and individuals referenced in the OIP," as well as all relevant, "non-privileged documents obtained by the Division in any other investigations that were not part of the NY-7220 investigation, but yielded documents that may become Division exhibits in this proceeding." The Order also requires the Division, by June 15, 2007, to supplement its March 7, 2007, privilege log to "identify with particularity any additional documents from NY-7220 that it withholds from inspection and copying." The Order provides that "[i]f the Division is unable or unwilling to provide Respondents with access to the relevant,

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3/ Respondent Abry later joined in Sassano's motion.

non-privileged portions of its investigative file in NY-7220 by June 15, 2007, then it may not introduce at the July 9 hearing any evidence that it gathered pursuant to subpoenas authorized by NY-7220."

On June 12, 2007, the Division asked the law judge to certify the Order for interlocutory Commission review and to stay the proceedings pending that review. The law judge denied the Division's motion for certification and a stay.

Now pending before us is the Division's motion requesting the Commission to: (1) immediately stay the proceeding pursuant to Rule of Practice 401 4/ to permit interlocutory review of the Order, and (2) set a briefing schedule on whether the Order should be reversed. The Division argues that the Order presents "extraordinary circumstances" justifying interlocutory review under Rule of Practice 400(a). 5/ The Division asserts that the Order violates the plain language of Rule 230(a) because it "allow[s] Respondents access to vast files of documents [located throughout the country] that were not used, considered or gathered in the investigation leading to this proceeding." The Division also asserts that the Order imposes "monumental burdens" on the Division. The Division urges that a blanket stay be imposed because the deadline to comply with the Order is June 15, and the Order raises fundamental questions concerning the Division's obligations under Rule 230(a) that should be resolved before the proceeding advances.

Respondents have filed a letter dated June 14, 2007, indicating that they wish to be heard on the merits of the Division's motion. We therefore have determined under Rule of Practice 401 to order an interim stay to maintain the status quo ante pending our review of the pending motion and any responses thereto. 6/ In these circumstances, a brief, interim stay – which will permit us to consider and more fully evaluate the issues involved – would serve the public interest. 7/

4/ 17 C.F.R. § 201.401(consideration of stays).

5/ Rule 400(a) 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." 17 C.F.R. § 201.400(a).

6/ Rule 401(b) states that the Commission "may grant a stay in whole or in part, and may condition relief under this rule upon such terms, or upon the implementation of such procedures, as it deems appropriate." 17 C.F.R. § 201.401(b).

7/ We emphasize that our determination to grant this interim stay should not be interpreted as suggesting that we have decided any matter regarding the merits of the motions submitted by any party in this proceeding.

Accordingly, it is ORDERED that the administrative proceedings against Respondents and any discovery in connection with those proceedings be, and they hereby are, stayed pending our consideration of the motion by the Division of Enforcement to stay the proceeding pending interlocutory review of the law judge's June 8, 2007, Order Concerning the Division of Enforcement's Duty to Provide Access to Certain Non-Privileged Investigative Materials From NY-7220.

By the Commission.

Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 23, 2007

IN THE MATTER OF VISION AIRSHIPS, INC. File No. 500-1	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that the public interest and the protection of investors require a suspension of trading in the securities of Vision Airships, Inc. ("Vision Airships") because questions have arisen regarding the adequacy and accuracy of assertions made by Vision Airships in publicly disseminated press releases concerning among other things 1) the company's acquisition of blimps, 2) the existence of company negotiations with other entities for use of the blimps, 3) the company's funding for its global expansion, and 4) the potential annual revenues from airship use.

Vision Airships, a company traded in the Over-the-Counter market under the ticker symbol VPSN, has made no public filings with the Commission, and has recently been the subject of spam email touting the company's shares.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above listed company.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above listed company is suspended for the period from 9:30 a.m. EST July 23, 2007 through 11:59 p.m. EST, on August 3, 2007.

By the Commission.

Nancy M. Morris
Secretary

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

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Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56192 / August 2, 2007

INVESTMENT ADVISERS ACT OF 1940
Release No. 2627 / August 2, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12719

In the Matter of PATRICK PHILLIP DAVISON, Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND 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 proceeding be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Patrick Phillip Davison ("Davison" 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 Sections III.2 and III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and 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. From May 1988 through February 2003, Davison was employed as an investment adviser by UBS Financial Services and its predecessor entities. UBS Financial Services is an investment adviser and broker-dealer registered with the Commission. From May 15, 1988 through March 7, 2003, Respondent was also a registered representative associated with UBS Financial Services and its predecessor entities. In addition, from on or about March 7, 2003 until July 2006, Respondent offered and sold securities as an unlicensed investment adviser and unlicensed broker-dealer. Respondent, age 50, is a resident of Medford, Oregon.

2. On December 20, 2006, Davison pled guilty to two counts of securities fraud in violation of Title 15 United States Code, Section 80b-6(1), before the United States District Court for the District of Montana, in U.S. vs. Patrick P. Davison, CR 06-141-BLG-RFC. On June 8, 2007, a judgment in this criminal action was entered against Respondent. He was sentenced to a prison term of 120 months and ordered to restitution of $5,598,166.49.

3. The counts of the criminal information to which Davison pled guilty alleged, inter alia, that from June 1995 to July 2006, Respondent, acting knowingly and with intent to defraud investors, devised and engaged in a scheme in which he materially defrauded investors by selling non-existent securities and using the proceeds for his own personal use. In addition, Davison used the United States mails and interstate commerce to send statements, correspondence and other documents necessary for his scheme to defraud investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent be and hereby is barred from association with any broker, dealer or 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 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

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 200, 230, AND 239

[Release No. 33-8828; IC-27922; File No. S7-18-07]

RIN 3235-AJ88

Revisions of Limited Offering Exemptions in Regulation D

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules; Request for additional comments.

SUMMARY: We propose to revise Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the rules. We propose to create a new exemption from the registration provisions of the Securities Act of 1933 for offers and sales of securities to "large accredited investors." The exemption would permit limited advertising in an exempt offering where each purchaser meets the definition of "large accredited investor." We also propose to revise the term "accredited investor" in Regulation D to clarify the definition and reflect developments since its adoption. In addition, we propose to shorten the timing required by the integration safe harbor in Regulation D, and to apply uniform disqualification provisions to all offerings seeking to rely on Regulation D. We are soliciting comments on possible revisions to Rule 504. Finally, we also solicit additional comments on the definition of "accredited natural person" for certain pooled investment vehicles in Securities Act Rules 216 and 509 that we proposed in December 2006.

DATES: Comments should be received on or before [insert date that is 60 days after publication in the Federal Register].

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

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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 S7-18-07 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 S7-18-07. 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 also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Room 1580, 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: Gerald J. Laporte, Office Chief, or Anthony G. Barone, Special Counsel, Office of Small Business Policy, at (202) 551-3460, or Steven G. Hearne, Special Counsel, Office of Rulemaking, at (202) 551-3430, Division of Corporation Finance, or, in connection with the proposed definition of accredited natural person, Elizabeth G. Osterman, Assistant Chief Counsel, Division of Investment Management, at (202) 551-6825, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We propose to amend Rule 30-1,[1] Rule 144A,[2] Rule 146, [3] Rule 215,[4] and Form D[5], and revise Regulation D[6] under the Securities Act of 1933[7] by amending Rules 501,[8] 502,[9] 503,[10] 504,[11] 505,[12] 506[13] and 508,[14] and replacing Rule 507.[15] We also request further comment on proposed new Rules 216 and 509 under the Securities Act.[16]

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1 17 CFR 200.30-1.

2 17 CFR 230.144A.

3 17 CFR 230.146.

4 17 CFR 230.215.

5 17 CFR 239.500.

6 17 CFR 230.501 through 230.508.

7 15 U.S.C. 77a et seq.

8 17 CFR 230.501.

9 17 CFR 230.502.

10 17 CFR 230.503.

11 17 CFR 230.504.

12 17 CFR 230.505.

13 17 CFR 230.506.

14 17 CFR 230.508.

15 17 CFR 230.507.

16 See Release No. 33-8766 (Dec. 27, 2006) [72 FR 399] (the "Private Pooled Investment Vehicle Release").

Table of Contents

I. Background and Overview of Proposals

Regulation D, adopted in 1982, was designed to facilitate capital formation while protecting investors by simplifying and clarifying existing exemptions for private or limited offerings, expanding their availability, and providing more uniformity between federal and state exemptions.[17] Although Regulation D originated as an effort to assist small business capital formation and continues to play an important role in that arena, all sizes of companies use the registration exemptions in Regulation D.

Regulation D consists of eight rules. Rules 501 through 503 contain definitions, conditions, and other provisions that apply generally throughout Regulation D. Rules 504 through 506 detail specific exemptions from registration under the Securities Act. Rules 504 and 505 provide exemptions adopted pursuant to the Commission's authority under Section 3(b)[18] of the Securities Act. Rule 504 provides exemptions for companies that are not subject to reporting requirements under the Securities Exchange Act of 1934[19] for the offer and sale of up to $1,000,000 of securities in a 12-month period. Rule 505 exempts offers by companies of up to $5,000,000 of securities in a 12-month period, so long as offers are made without general solicitation or advertising. Rule 506 is a safe

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17 See Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251].

18 15 U.S.C. 77c(b).

19 15 U.S.C. 78a et seq.

harbor under Section 4(2)[20] of the Securities Act and provides an exemption without any limit on the offering amount, so long as offers are made without general solicitation or advertising and sales are made only to "accredited investors" and a limited number of non-accredited investors who satisfy an investment sophistication standard. Rules 507 and 508 were added in 1989.[21] Rule 507 disqualifies issuers from relying on Regulation D, under certain circumstances, for failure to file a Form D notice.[22] Rule 508 provides a safe harbor for certain insignificant deviations from a term, condition, or requirement of Regulation D.

Following our adoption in June 2005 of comprehensive amendments to our rules and forms relating to registered public offerings,[23] we believe it is appropriate to propose revisions to our rules applicable to private and limited offerings. Our objective in this effort is to clarify and modernize our rules to bring them into line with the realities of modern market practice and communications technologies without compromising investor protection.[24] Action in this area also is timely because our Advisory Committee on Smaller Public Companies made a number of recommendations relating to private and

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20 15 U.S.C. 77d(2).

21 See Release No. 33-6825 (Mar. 14, 1989) [54 FR 11369] (adding 17 CFR 230.507 and 230.508).

22 Rule 503 requires the filing of a Form D notice with the Commission no later than 15 days after the first sale of securities in an offering under Regulation D.

23 See Release No. 33-8591 (Jul. 19, 2005) [70 FR 44722].

24 The American Bar Association recently suggested that revisions in this area would be appropriate, in view of the implementation of the securities offering reform rules for registered offerings. See comment letter in Commission Rulemaking File No. S7-11-07 from American Bar Association (Mar. 22, 2007) (the "ABA Private Offering Letter"), available at http://www.sec.gov/comments/s7-11-07/s71107-4.pdf.

limited offerings in its final report dated April 23, 2006.[25] Several of the proposals in this release build on the Advisory Committee's recommendations.

As discussed in detail below, we propose to make changes in the following four principal areas involving Regulation D:

- Creating a new exemption from the registration provisions of the Securities Act for offers and sales to "large accredited investors";
- Revising the definition of the term "accredited investor" to clarify it and reflect developments since its adoption;
- Shortening the length of time required by the integration safe harbor for Regulation D offerings; and
- Providing uniform disqualification provisions throughout Regulation D.

We propose to create a new exemption to the registration requirements of the Securities Act under our general exemptive authority in Section 28 of that Act.[26] This exemption, set forth in proposed new Rule 507, would be limited to sales of securities to "large accredited investors," and would permit an issuer to publish a limited announcement of the offering. The proposed definition of large accredited investor would be based on the "accredited investor" definition, but with higher and somewhat different dollar-amount thresholds. Large accredited investors that participate in these

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25 See Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (April 23, 2006), at 74-81, 92-93, 94-96, 100-101 (the "Advisory Committee Final Report"), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

26 15 U.S.C. 77z-3. Section 28 states that the Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

exempt offerings would be considered "qualified purchasers" under Section 18(b)(3) of the Securities Act,[27] thereby providing "covered security" status and the resulting preemption of certain state securities regulation.

We also propose to update the "accredited investor" definition. First, we propose to add an alternative "investments-owned" standard for determining accredited investor and large accredited investor status. This standard would include definitions of "investments" and "joint investments" similar to those we proposed in December 2006 in our initiative to revise Regulation D as it relates to investments by individuals in certain private pooled investment vehicles relying on Rule 506.[28] In addition, we propose a mechanism to adjust the dollar-amount thresholds in the definition of "accredited investor" to reflect future inflation. We propose to add categories of entities to the list of permitted accredited investors. We also propose to shorten the time frame for the integration safe harbor for Regulation D offerings from six months to 90 days to help provide flexibility to issuers. Finally, we propose to establish uniform disqualification provisions for all offerings under Regulation D in order to prevent certain issuers from relying on Regulation D exemptions.

In addition to these proposals, we also are soliciting comment on whether Rule 504 of Regulation D, the "seed capital" exemption, should be amended so that securities sold pursuant to a state law exemption that permits sales only to accredited investors would be deemed "restricted securities" for purposes of Rule 144.[29]

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27 15 U.S.C. 77r(b)(3).

28 See Private Pooled Investment Vehicle Release. We are taking the opportunity to request additional comment on that proposal here. See II.B.5 below.

29 17 CFR 230.144.

Finally, in last year's Private Pooled Investment Vehicle Release, we solicited comment on two new rules that would establish a new category of accredited investor, "accredited natural person," that individuals would need to satisfy in order to invest in certain private pooled investment vehicles relying on Rule 506.[30] We received approximately 600 comments on that proposal, many of which generally disfavored our proposal, which would raise individual investor thresholds for such investments. We are continuing to consider those comments, and solicit further comment on the proposed definition of accredited natural person made in the Private Pooled Investment Vehicle Release. The Commission may act on the new proposals in this release and the December 2006 proposals at the same time.

II. Proposed Revisions of Regulation D

A. Proposed Rule 507 – Exemption for Limited Offers and Sales to Large Accredited Investors

We propose to create a new exemption to the registration requirements of the Securities Act for offers and sales of securities to a new category of investors called "large accredited investors."[31] The exemption would permit limited advertising of these offerings.[32] Large accredited investors would consist of the same categories of entities and individuals that qualify for accredited investor status under existing Rule 506, but with significantly higher dollar-amount thresholds for investors subject to such

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30 Proposed Rules 216 and 509 under the Securities Act.

31 We propose to move the current contents of Rule 507 into proposed Rule 502(e) and then include the new exemption in Rule 507.

32 The exemption would not, however, be available to offers and sales by pooled investment vehicles relying on Section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) or Section 3(c)(7) (15 U.S.C. 80a-3(c)(7)) of the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.). See II.A.4 below.

thresholds.[33] Legal entities that are considered accredited investors if their assets exceed $5 million would be required to have $10 million in investments to qualify as large accredited investors. Individuals generally would be required to own $2.5 million in investments or have annual income of $400,000 (or $600,000 with one's spouse) to qualify as large accredited investors, as compared to the current accredited investor standard of $1 million in net worth or annual income of $200,000 (or $300,000 with one's spouse). Legal entities that are not subject to dollar-amount thresholds to qualify as accredited investors, generally government-regulated entities, would not be subject to dollar-amount thresholds to qualify as large accredited investors.

We believe that we may exempt certain offers and sales that may involve limited advertising from the registration requirements of Section 5 of the Securities Act[34] without compromising investor protection, due to the general increased sophistication and financial literacy of investors in today's markets, coupled with the advantages of modern communication technologies. Our proposal is patterned generally after the Model Accredited Investor Exemption adopted by the North American Securities Administrators Association (NASAA) in 1997.[35] Like the Model Accredited Investor Exemption, our proposal does not eliminate the prohibition on general solicitation and general advertising from the conditions of the exemption. Both the Advisory Committee on Smaller Public Companies and the American Bar Association's Committee on Federal Regulation of

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33 In II.B below, we propose to make certain changes to other accredited investor qualifications. These changes would apply equally to accredited investors in Rule 505 and 506 transactions and to large accredited investors in Rule 507 transactions.

34 15 U.S.C. 77e.

35 A copy of the Model Accredited Investor Exemption is available on the NASAA Web site at http://www.nasaa.org/content/Files/Model%5FAccredited%5FInvestor%5FExemption.pdf.

Securities recommended relaxing the ban on general solicitation for transactions with purchasers who do not need the protection of registration.[36] Our proposal attempts to ease restrictions on limited offerings of securities in a manner that is cognizant of the potential harm of offerings by unscrupulous issuers or promoters who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration. We believe easing the restriction on limited offerings of securities as we have proposed is appropriate, given the additional safeguards we have proposed.

The proposed Rule 507 exemption would share the following characteristics with the Rule 506 exemption:

- It would allow an issuer to sell an unlimited amount of its securities to an unlimited number of investors who meet specified criteria—accredited investors in the case of Rule 506 transactions and large accredited investors in the case of Rule 507 transactions;
- Its availability would focus on purchasers, and not depend on the characteristics of offerees;
- It would place no restrictions on the payment of commissions or similar transaction-related compensation;
- It would be non-exclusive, meaning that the issuer could choose to claim any other available exemption without the benefit of the rule;[37]

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36 See Advisory Committee Final Report at 74-81; ABA Private Offering Letter, n. 24 above, at 26.

37 An issuer engaging in the limited advertising permitted by Rule 507 may not be able to claim the Section 4(2) exemption if the activity has imparted a public character to the offering. See Release No. 33-7943 (Jan. 26, 2001) [66 FR 8881] (text accompanying n. 31), citing Release No. 33-4552 (Nov. 6, 1962) [27 FR 11316] (public advertising incompatible with claim of private offering).

- Securities acquired in a transaction under the rule would be subject to the limitations on resale under Rule 502(d)[38] and therefore would be treated as "restricted securities" as defined in Securities Act Rule 144(a)(3)(ii);[39]
- The issuer would be required to exercise reasonable care to assure that the purchasers of the securities are not underwriters;[40] and
- The issuer would have an obligation to file a notice of sales in the offering with the Commission on Form D.[41]

In addition, proposed Rule 507 would include the same disqualification provisions as we propose below for other Regulation D exemptions.[42] Currently, Rule 506 has no bad actor disqualification provisions.

Rule 507 would differ from Rule 506 in five ways:

- Large Accredited Investor Standard. Rule 507 would be premised on the concept of large accredited investors. Rule 506 would continue to be premised on the concept of accredited investors.
- Limited Advertising Permitted. Instead of a total ban on general solicitation and general advertising, as is the case in Rule 506 transactions, issuers in Rule 507 transactions could engage in limited advertising that satisfies the

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38 17 CFR 502(d).

39 17 CFR 230.144(a)(3)(ii). In a companion release, we have proposed changes to Rule 144. Release No. 33-8813 (June 22, 2007) [72 FR 36822].

40 Rule 502(d). The term "underwriter" is defined in Section 2(a)(11) of the Securities Act. 15 U.S.C. 77b(a)(11).

41 In a companion release, we are proposing changes to Form D to simplify and update it, as well as to require electronic filing. Release No. 33-8814 (June 29, 2007) [72 FR 37376].

42 See II.C.2 below.

requirements of the rule. All other general solicitation and advertising would be prohibited.

- No Sales to Persons Who Do Not Qualify as Large Accredited Investors. Issuers in Rule 507 transactions would not be allowed to sell securities to any investor who does not qualify as a large accredited investor. In Rule 506 transactions, issuers may sell securities to an unlimited number of accredited investors and up to 35 non-accredited investors.[43]

- Authority for Exemption. Rule 507 would be adopted as an exemption primarily under the Commission's general exemptive authority under Section 28 of the Securities Act, while Rule 506 was adopted as a safe harbor under Section 4(2) of the Securities Act.

- Covered Security Status. Securities sold in accordance with either of these rules would be considered "covered securities," but under different provisions of Section 18 of the Securities Act. Securities sold under Rule 507 would be covered securities because the purchasing large accredited investors would be defined as "qualified purchasers" under Section 18(b)(3) of the Securities Act. Securities sold under Rule 506 would continue to be covered securities under Section 18(b)(4)(D) of the Securities Act[44] because Rule 506 was issued under

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43. If an issuer sells to non-accredited investors in a Rule 506 transaction, the issuer must furnish them with the information specified in Rule 502(b), 17 CFR 230.502(b). The issuer also must assure that the non-accredited investors meet the investor sophistication requirements of Rule 506(b)(2)(ii), 17 CFR 230.506(b)(2)(ii). We are not proposing these kinds of requirements for Rule 507 transactions because issuers could not sell securities to any non-accredited investors in Rule 507-exempt transactions.

44. 15 U.S.C. 77r(b)(4)(D).

Section 4(2) of the Securities Act.[45]

We discuss these five areas of difference in the sections immediately below.

1. "Large Accredited Investor" Standard

We propose to define a new category of investors, called "large accredited investors,"[46] which we would use in Rule 507. The proposed definition of large accredited investor is based on the "accredited investor" definition, but with higher and somewhat different dollar-amount thresholds.[47] We have proposed higher thresholds due to what we perceive are increased investor protection risks relating to the limited advertising that would be allowed under Rule 507.[48] The higher thresholds would provide a cushion over the accredited investor standards for determining eligibility for the new exemption. The greater public access to investors that the new exemption would provide warrants increased assurance of the ability of investors in offerings under that exemption to fend for themselves. Further, the higher thresholds may provide such

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45 State securities regulation of covered securities generally is limited under Section 18(b) of the Securities Act to imposing notice filing requirements on offerings, requiring the filing of a consent to service of process, and assessing a filing fee. Securities sold in offerings that are exempt under Rule 506 are covered securities because Section 18(b)(4)(D) provides that securities sold in transactions exempt under Commission rules issued under Section 4(2), which includes Rule 506, are covered securities. Securities sold in offerings that are exempt under Rule 507 would be covered securities because our proposal provides for an amendment to Rule 146 under the Securities Act that would define the term "qualified purchaser" in Section 18(b)(3) of the Act to include large accredited investors with respect to offers or sales in compliance with Rule 507. Under Section 18(b)(3), qualified purchasers, as defined by the Commission under the Securities Act, purchase covered securities in transactions so designated by the Commission.

46 See Proposed Rule 501(a).

47 See the discussion of the accredited investor definition in II.B below.

48 While the Model Accredited Investor Exemption is limited to accredited investors, we propose to further limit the Rule 507 exemption to large accredited investors. NASAA, the organization of state securities administrators, recently supported a similar higher threshold for any new federal exemption that would relax the prohibitions against general solicitation and general advertising. See comment letter in Commission File No. 265-23 from NASAA to the Advisory Committee (Mar. 28, 2006) (the "NASAA Letter"), at 2, available at http://www.sec.gov/rules/other/265-23/rastaples1692.pdf.

assurance.

We propose that the entities or institutions that currently must have more than $5 million in assets to qualify for accredited investor status under Rule 501(a) would be required to have more than $10 million in investments to qualify as large accredited investors. Individuals, or "natural persons" as the rule calls them, would be able to qualify as large accredited investors if they own more than $2.5 million in investments or have had individual annual income of more than $400,000 (or $600,000 with one's spouse) in the last two years and expect to maintain the same income level in the current year.[49] We propose to have alternative investments and income tests for individuals because an investments test without an income test tends to favor investors who have had time to build investment portfolios.

Based on estimates from our Office of Economic Analysis, 1.64 percent of U.S. households would qualify as large accredited investors, compared with 8.47 percent that would qualify as accredited investors.[50] Our approach in selecting the dollar-amount thresholds for investors to qualify as large accredited investors reflects an attempt to approximate the standards adopted by the Commission in the 1980s for accredited investors in light of current knowledge and changed circumstances.[51]

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49 We discuss our proposed use of the term "aggregate income" instead of the term "joint income," which currently is used in Rule 501(a), 17 CFR 230.501(a), in II.B.2 below.

50 These estimates are based on Federal Reserve Board of Governors, Survey of Consumer Finances, 2004. This survey used year-end 2003 values. More information regarding the survey may be obtained at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

51 Our Office of Economic Analysis estimates that in 1982, when Regulation D was adopted, approximately 1.87 percent of U.S. households qualified for accredited investor status. This estimate is based on Federal Reserve Board of Governors, Survey of Consumer Finances, 1983. This survey used year-end 1982 values. More information regarding the survey may be obtained at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

We selected the $10 million amount for institutions for two additional reasons. First, in the interest of uniformity between federal and state securities regulation, we chose a standard similar to the standard in the Uniform Securities Act of 2002, as amended, that was approved by the National Conference of Commissioners of Uniform State Laws.[52] The model statute, which has been adopted by several states, requires that most non-regulated institutional investors have $10 million in assets to qualify as "institutional investors." In selecting a standard for large accredited investors, we chose to substitute a $10 million investments-owned standard for the $10 million assets-owned standard because, as discussed below, we believe that investments owned may be a more accurate and more easily administered standard than assets owned to determine whether an investor needs the protection of Securities Act registration. The $10 million amount also correlates closely with the inflation-indexed value of $5 million in 1982, when we adopted the $5 million assets-owned standard.[53]

We selected the $2.5 million investments-owned standard for individuals and spouses based on the $2.5 million investments-owned standard we proposed in December 2006 for individuals and spouses to invest in private pooled investment vehicles.[54] We selected the $400,000 in annual income standard for individuals because it is

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52 See Uniform Securities Act (2002), as amended, available at http://www.uniformsecuritiesact.org/usa/DesktopDefault.aspx?tabindex=2&tabid=48.

53 Our Office of Economic Analysis estimates that the financial thresholds used in Rule 501(a), adjusted for inflation as of July 1, 2006, would be as follows: the $5 million asset requirement for certain legal entities would have increased to approximately $9.5 million; the $1 million individual net worth test would have increased to approximately $1.9 million; and the $200,000 individual income test and $300,000 joint income test would have increased to approximately $388,000 and $582,000, respectively. Our Office of Economic Analysis estimated these levels using the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, available at www.bea.gov.

54 See Private Pooled Investment Vehicle Release.

approximately the inflation-indexed value of $200,000 in 1982, when the Commission first adopted the $200,000 in annual income standard for individual accredited investors. Similarly, we selected the $600,000 in aggregate income for spouses standard because it is approximately the inflation-indexed value of $300,000 in 1982. Although the $300,000 combined standard was not adopted until 1988, it was adopted to complement the $200,000 individual income standard adopted in 1982.[55]

Individuals and entities that currently are not subject to a dollar-amount threshold to qualify as accredited investors also would qualify as large accredited investors. As such, banks, registered investment companies, private business development companies, and other regulated entities identified in Rule 501(a)(1) and (2) that are not subject to an assets test to qualify for accredited investor status also would qualify for large accredited investor status without being subject to an income, assets, or investments requirement.[56] Further, directors and executive officers of the issuer would be considered large accredited investors in addition to being considered accredited investors, without being subject to an income, assets, or investments requirement.[57] As in the accredited investor standard, these entities and persons are generally deemed not to need the same level of protection under the Securities Act as other entities and non-affiliated persons.

Request for Comment

- Do the standards we propose for qualifying as a large accredited investor provide a reasonable basis for determining that, under the circumstances of Rule 507,

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55 See Release No. 33-6758 (Mar. 3, 1988) [53 FR 7866].

56 See 17 CFR 230.501(a)(1) and (2).

57 See 17 CFR 230.501(a)(4).

those investors do not need all of the protections of Securities Act registration? If not, what qualifications should we set? Are other levels more appropriate than \$10 million in investments for legal entities and \$2.5 million in investments for individuals and spouses, or annual income of \$400,000 for individuals and \$600,000 with one's spouse? Should these levels be lower? Should they be higher, especially because of the availability of limited advertising? For example, would \$7.5 million or \$15 million in investments for legal entities and \$1.5 million or \$3.5 million in investments for individuals and spouses, or annual income of \$300,000 or \$600,000 for individuals and \$400,000 or \$800,000 with one's spouse be more appropriate levels? Why? Should we adopt an eligible person threshold of \$1 million in investments for individuals, as suggested by NASAA?[58] If you propose thresholds, please provide the basis for your belief that those thresholds are more appropriate.

- Should we adopt a definition of "large accredited investor" that includes only an investments-owned test for individual investors, as we proposed in the Private Pooled Investment Vehicle Release for certain individual investors in private pooled investment vehicles, or should we adopt alternative investments and income tests as proposed? Please explain the reasons for your views.
- Should we retain the asset-based test instead of using an investment-based test for determining status as a large accredited investor for both individuals and legal entities? In this regard, should the standard for legal entities be \$10 million in assets—the same as the requirement for institutional investors in the Uniform

58 See n. 48.

Securities Act?

- Would it be appropriate to modify proposed Rule 507 to include any additional safeguards in the definition of large accredited investor?

2. Limited Advertising Permitted

Rule 507 would permit an issuer in an exempt transaction to publish a limited announcement of an offering.[59] The announcement would be required to state prominently that sales will be made to large accredited investors only, that no money or other consideration is being solicited or will be accepted through the announcement, and that the securities have not been registered with or approved by the Commission and are being offered and sold pursuant to an exemption.[60] At the issuer's option, the announcement also could contain the following additional information:

- The name and address of the issuer;
- A brief description of the business of the issuer in 25 or fewer words;[61]

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59 While the proposed statement is similar to the statement permitted under Rule 135c, 17 CFR 230.135c, the proposed exemption is substantially patterned after the Model Accredited Investor Exemption and differs from Rule 135c in that the advertisement is permitted and anticipated to be part of the offering process, whereas Rule 135c is limited to an announcement that is not to be used to condition the market or as part of the solicitation for the offering.

60 These statements are similar to statements required by the Model Accredited Investor Exemption, except that the proposed announcement is not required to contain a statement that the securities have not been registered with or approved by a state securities agency.

61 The Model Accredited Investor Exemption limits an issuer's description of the business to 25 or fewer words. We have retained the 25-word limitation in the proposal, but solicit comment below on whether such a limitation is appropriate. We already have one federal exemption from Securities Act registration that permits offerings involving select investors and a limited amount of general solicitation. Our Rule 1001, 17 CFR 230.1001, exempts offerings conducted under Section 25102(n) of the California Corporations Code's "Qualified Purchaser Exemption." Adopted in September 1994, the California provision permits offerings to specified classes of qualified purchasers that are similar to federal classes of accredited investors without state registration. The QPE allows for a general announcement of an offering, including a brief description of the issuer's business, without a word limit. California's QPE served as a prototype for the Model Accredited Investor Exemption.

- The name, type, number, price, and aggregate amount of securities being offered and a brief description of the securities;
- A description of what large accredited investor means;
- Any suitability standards and minimum investment requirements for prospective purchasers in the offering; and
- The name, postal or email address, and telephone number of a person to contact for additional information.[62]

Publication of such an announcement would not contravene the prohibition on general solicitation and advertising otherwise applicable to the offer and sale of securities in a Rule 507 transaction. The publication could only be "in written form"[63] but could occur in any written medium, such as in a newspaper or on the Internet. We have proposed to limit the publication to written form in an effort to limit aggressive selling efforts made through the announcement. As part of this limitation, radio or television broadcast spots or "infomercials" would be prohibited.[64]

Rule 507 also provides that an issuer or a person acting on an issuer's behalf may provide information in addition to the limited announcement only if the issuer reasonably

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62 The additional information permitted in the announcement is patterned after the Model Accredited Investor Exemption, but also permits a description of the meaning of the term "large accredited investor" and a discussion of suitability standards and minimum investment requirements. We propose to permit these latter statements to avoid confusion about the meaning of the term "large accredited investor" and to facilitate management of offerings under the exemption.

63 Proposed Rule 507 uses the term "in written form" to limit the term and differentiate the concept from "written communication" as defined in Rule 405. 17 CFR 230.405. The term "written communication" is defined in Rule 405 to include a radio or television broadcast. Publication of an announcement under Rule 507 would be substantially more limited.

64 Limiting the use of certain types of advertisements under Rule 507 would be consistent with our position in Rule 433, 17 CFR 230.433, relating to free writing prospectuses in the context of public offerings by non-reporting and unseasoned issuers.

believes that the prospective purchaser is a large accredited investor.[65] Additional information may be provided orally or in writing, such as in the form of sales material or an offering circular. Information also may be delivered to prospective purchasers through an electronic database that is restricted to large accredited investors.[66]

Request for Comment

- We propose to limit the information included in a Rule 507 announcement and require that the information be in written form. Should we require or permit any other information to be included in the limited announcement proposed in Rule 507 offerings? If so, what additional information would be appropriate? Should any of the optional information be required? Should we eliminate or expand the 25-word limit on the description of the issuer's business? If we did not impose a limit on the business description, would issuers be more or less likely to use inappropriately promotional and non-objective language to describe their businesses in the limited announcement? Should the rule require that any description of the issuer's business be fair and impartial?
- Should we eliminate the requirement that the Rule 507 announcement be in written form? If so, what limitations, if any, should we have on the form of the announcement? Should we define the phrase "in written form"? Should we limit permitted written announcements to publications, as opposed to, for example, flyers handed out on street corners? Should we allow radio or television

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65 For a related discussion of what measures an issuer could take to satisfy its obligation under Rule 501(a) to form a reasonable belief that a prospective purchaser satisfies the definition of accredited investor, see n. 99 and accompanying text.

66 For a discussion of on-line private offerings under Regulation D, see Release No. 33-7856 (Apr. 28, 2000) [65 FR 25843].

broadcast announcements? Should we follow the Model Accredited Investor Exemption and allow the announcement to be made by any means? Should we require issuers to retain copies of any advertisements or to submit copies of the script of any radio or television broadcast to the Commission staff? Should they be filed with the Commission, and if so, should the filing be confidential?

- Proposed Rule 507 would require issuers to include in any permitted public announcement a prominent statement that sales will be made only to large accredited investors, that no money is being solicited or will be accepted by way of the announcement, and that the securities have not been registered with or approved by the Commission and are being offered and sold pursuant to an exemption. Are these appropriate requirements for the announcement? Should we require additional statements? Do we need to require that the statement be prominent? If so, should we also specify format or font sizes? How would such a requirement operate for electronic communications? Does the requirement that the announcement prominently state that "no money or other consideration is being solicited or will be accepted through the announcement" make it clear that an investor should not respond to the announcement by sending a check to the issuer? Can you suggest alternative wording?
- Should we allow issuers, at their option, to include in a Rule 507 announcement a coupon, returnable to the issuer, indicating interest in the offering, containing the name, address and telephone number of the prospective purchaser, and stating

clearly and separately that the indication of interest is not binding and that no money should be sent?[67]

- The Model Accredited Investor Exemption does not permit telephone solicitation unless, before placing a telephone call, the issuer reasonably believes the prospective purchaser to be solicited is an accredited investor.[68] Should we include a similar limitation in Rule 507 with respect to large accredited investors?
- The rule provides that an issuer or any person acting on an issuer's behalf may provide additional information if the issuer reasonably believes the prospective purchaser is a large accredited investor. Does the proposal adequately acknowledge that the reasonable belief of an agent of the issuer may be attributable to the issuer and thereby permit the issuer to satisfy the standard? What requirements, if any, should apply to the delivery of information to prospective purchasers through an electronic database that is restricted to large accredited investors?[69] Should we provide additional guidance and if so, should the guidance be in the rule?
- Should the rule provide any guidance as to how an issuer may arrive at a reasonable belief that a prospective purchaser is a large accredited investor?

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67 This provision could be modeled after subparagraph (c) of Rule 254 of Regulation A, 17 CFR 254(c). Proposed Rule 135d, although never adopted, had a similar provision in subparagraph (b). See Release No. 33-7188 (June 27, 1995) [60 FR 35648].

68 Paragraph (G) of the Model Accredited Investor Exemption provides that no telephone solicitation is permitted unless the issuer reasonably believes that the person solicited is an accredited investor before making the telephone solicitation. Proposed Rule 507(b)(2)(iii) provides that any information beyond the announcement may be provided "only if the issuer reasonably believes that the prospective purchaser is a large accredited investor," but does not address telephone solicitation explicitly.

69 See n. 66.

Should it be permitted to form the belief entirely on the basis of responses to a questionnaire?

- Rule 508 provides that insignificant deviations from the requirements of Regulation D do not result in the loss of the exemption.[70] Rule 508(a)(2) provides, however, that failures with regard to limitations on the manner of offering are deemed to be significant. What should be the implications for failure to comply with the restrictions on permitted advertising in Rule 507 transactions? Should the issuer no longer be able to rely on the Rule 507 exemption? Are the provisions of Rule 508 sufficient to deal with situations that might arise?
- Should we adopt broader amendments to Rule 508 to address related issues that might arise under the Rule 507 exemption, as well as under other exemptions in Regulation D? For example, should we delete the current Rule 508 carve-out of manner of sale limitations in the list of insignificant deviations? This carve-out has been read to provide that an issuer's failure to comply with a ban on general solicitation applicable to a Regulation D offering never can constitute an insignificant deviation. As a result, legal practitioners have expressed concern that an insignificant deviation relating to general solicitation could result in total loss of the Rule 508 defense. If the carve-out were deleted, Rule 508 would treat insignificant failures to comply with an applicable ban on general solicitation like most other deviations from the requirements of Regulation D. One effect of such a rule amendment would be to clearly permit issuers to raise the Rule 508 defense with respect to complaining parties who were not generally solicited in an

70 We propose to amend Rule 508 to add a reference to proposed Rule 507.

offering structured to avoid general solicitation, while continuing to preclude the issuer from raising the defense with respect to a party who was generally solicited, depending upon whether it is able to satisfy the other conditions to availability of the defense.

3. No Sales to Persons Who Do Not Qualify as Large Accredited Investors

We propose that issuers relying on Rule 507 to exempt a transaction from Securities Act registration be permitted to sell securities only to investors who qualify as large accredited investors. This is a departure from the approach taken in Rule 506, where issuers are permitted to sell securities to up to 35 non-accredited investors, in addition to an unlimited number of accredited investors. Because limited advertising allows issuers to provide information about their offering to anyone, we believe it is appropriate to establish stricter limitations on sales to limit investors to those who do not need all of the protections of Securities Act registration.

A Rule 507 offering could only be conducted simultaneously or "side-by-side" with another Regulation D offering if the two offerings were considered as separate and distinct offerings under the five-factor integration test set forth in Rule 502(a) of Regulation D.[71] Since Rule 506 prohibits the use of general solicitation and advertising and Rule 507 is limited exclusively to sales to large accredited investors, neither of these two exemptions would be available if two offerings were considered as integrated where one offering used limited public advertising and the other offering was sold to persons

71 17 CFR 230.502(a). We are proposing a note to clarify that Rule 144A does not preclude an issuer or a person acting on the issuer's behalf from publishing a general announcement of an offering pursuant to Rule 507. See II.E.2 below.

who were not large accredited investors.[72]

Request for Comment

- Should we permit investors who do not qualify as large accredited investors to invest in Rule 507 offerings? If so, how should we limit the number of non-qualifying investors? Would permitting investors who do not qualify as large accredited investors to invest in Rule 507 offerings increase the potential for fraud in those offerings?
- To limit sales to large accredited investors, would it be appropriate to limit publication of the announcement to password-protected Web sites that are accessible only by large accredited investors? Should we provide other limitations to ensure that the exemption is not abused?

4. Authority for Exemption

We are proposing Rule 507 as an exemption from the registration provisions of Section 5 of the Securities Act under our general exemptive authority in Section 28 of that Act. Under Section 28, we may exempt any transaction from any provision of the Securities Act "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[73]

We believe proposed Rule 507 meets the standard set forth in Section 28 because it safeguards investor interests by limiting both the advertising permitted and the types of investors that may invest in an exempt offering. The proposal would impose strict

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72 We do not propose to provide an integration safe harbor for Rule 507 offerings as was done, for example, in Section 3(c)(7)(E) of the Investment Company Act, 15 U.S.C. 80a-3(c)(7)(E), and under 17 CFR 230.144A(e) and 17 CFR 230.701(f).

73 15 U.S.C. 77z-3.

controls on advertising and would be limited to offerings that are sold only to investors who meet high financial qualification standards designed to identify investors who have less need for the protections offered by Securities Act registration, as they can "fend for themselves" with regard to the transaction.[74]

Proposing Rule 507 under Section 28, rather than Section 4(2),[75] has certain consequences. Among these consequences is that pooled investment vehicles that rely on the exclusion from the definition of "investment company" provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act would not be able to take advantage of the limited advertising proposed to be permitted under Rule 507. This results because those vehicles are required to sell their securities in transactions not involving a public offering.[76] Such vehicles typically rely on Section 4(2) to meet this requirement, frequently through Rule 506, which expressly forbids general solicitation and general

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74 The conclusion that investors do not need all the protections that registration under the Securities Act would offer them and that they can fend for themselves is the determination that must be made under SEC v. Ralston Purina, 346 U.S. 119, 125 (1953), to establish that transactions are exempt under Section 4(2) of the Securities Act as transactions "not involving any public offering." We believe the Ralston Purina standard is informative in analyzing whether Rule 507, as proposed, would satisfy the Section 28 standard. As a practical matter, we believe that the use of high financial thresholds to qualify as a large accredited investor and the imposition of a ban on most general solicitation and advertising would tend to support a determination that Rule 507 is appropriate in the public interest and consistent with the protection of investors.

75 Because some advertising would be permitted in Rule 507 transactions, we have chosen not to propose the exemption under Section 4(2) of the Securities Act, which the Commission in the past has viewed as incompatible with a non-public offering under Section 4(2). See n. 37.

76 Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company an issuer the securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," as defined in the Investment Company Act, and that is not making or proposing to make a public offering of its securities. The term "qualified purchaser" is defined for purposes of the Investment Company Act in Section 2(a)(51) of the Investment Company Act, 15 U.S.C. 80a-2(a)(51). This definition applies in the context of the Investment Company Act; the term has a different meaning under the Securities Act, as provided in the proposed amendment to Rule 146(c).

advertising.[77] Accordingly, they would be precluded from selling their securities in reliance on Rule 507.

Request for Comment

- Are there other implications we should consider as a result of our proposed use of our exemptive authority under Section 28, rather than proposing Rule 507 under Section 4(2)?

5. Covered Security Status

Securities sold under Rule 506 are "covered securities" under Section 18(b)(4)(D) of the Securities Act.[78] To enhance the utility of proposed Rule 507, we propose that a large accredited investor that participates in a Rule 507 offering be defined in Rule 146 as a "qualified purchaser" under Section 18(b)(3) of the Securities Act. As such, securities sold in a Rule 507-exempt offering would be "covered securities," resulting in preemption from state securities regulation as provided under Section 18 of the Securities Act.[79] By providing "covered security" status to the securities, the securities would be primarily regulated on the federal level, with the goal of enhancing efficiency and reducing duplicative regulation without compromising investor protection. Because the dollar-amount thresholds for investors in Rule 507 transactions would be significantly

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77 Compliance with Rule 506 provides a safe harbor that a transaction does not involve "any public offering" within the meaning of Section 4(2) of the Securities Act. See 17 CFR 230.506(a).

78 The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996) ("NSMIA"), preempts the state registration and review of transactions involving "covered securities." It amended Section 18 of the Securities Act to establish classes of covered securities, including securities offered or sold to "qualified purchasers," as defined by Commission rule.

79 In 2001, we proposed to define the term "qualified purchaser" in the Securities Act to equate that term with our definition of the term "accredited investor" in Rule 501(a). See Release No. 33-8041 (Dec. 19, 2001) [66 FR 66839]. That proposal is no longer under consideration by the Commission.

higher than the dollar-amount thresholds in Rule 506 offerings, we believe the policy rationales for making securities in Rule 506 transactions "covered securities" also support making securities in Rule 507 transactions "covered securities."[80]

Request for Comment

- We propose to amend Rule 146 to define the term "large accredited investor" as a "qualified purchaser" for purposes of Section 18 of the Securities Act. Is defining a "large accredited investor" as a "qualified purchaser" under the Securities Act appropriate? Should the definition of "qualified purchaser" be narrower or broader?
- Proposed Rule 146(c) includes a provision that indicates clearly that states may continue to impose substantially similar notice filing requirements as those imposed by the Commission on transactions with qualified purchasers. Is this provision necessary? Should we define "substantially similar" more precisely? If so, please provide specific language. Would the proposed language preclude states from requiring that certain supplemental items be attached to notice filings?

B. Proposed Revisions Related to Definition of "Accredited Investor"

We propose revisions to the definition of the term "accredited investor" in Rule 501(a) of Regulation D, which sets forth the standards to qualify as an accredited investor. The current definition provides that a person who comes within, or who the issuer reasonably believes comes within, one of eight enumerated categories at the time of sale is an accredited investor. Currently, the Rule 501(a) categories include:

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[80] These policy rationales are contained in the legislative history of NSMIA, especially H.R. Rep. No. 104-622, at 159-165 (1996).

- Institutional investors;[81]
- Private business development companies;
- Corporations, partnerships and tax exempt organizations with total assets in excess of $5 million;
- Directors, executive officers and general partners of the issuer;
- Individuals with a net worth exceeding $1 million, either alone or with their spouses;
- Individuals with income in excess of $200,000 in each of the two most recent years or joint income with the individual's spouse in excess of $300,000 in each of those years;
- Trusts with total assets in excess of $5 million; and
- Entities in which all of the equity owners are accredited investors.

The revisions we propose to the Rule 501(a) "accredited investor" qualification standards would affect Rules 504 through 506 and, to the extent that the standards to qualify as a "large accredited investor" are based on the standards to qualify as an "accredited investor," Rule 507.[82] We believe our proposed revisions of the qualification standards for accredited investors will result in those standards, together with the

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[81] This category includes banks, savings and loan associations, registered brokers and dealers, insurance companies, registered investment companies, business development companies, and small business investment companies. The category also includes certain employee benefit plans within the meaning of the Employee Retirement Income Security Act (codified primarily at 29 U.S.C. ch. 18), with total assets in excess of $5 million. See Rule 501(a)(1).

[82] The revisions may affect offerings made by pooled investment vehicles under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, as those offerings must qualify as non-public offerings under Section 4(2) of the Securities Act and many such offerings are structured to take advantage of the Rule 506 safe harbor for the Section 4(2) exemption. We recently proposed revisions to our accredited investor qualification standards for individuals investing in certain pooled investment vehicles. See II.B.5 below.

substantive provisions of the exemptions in Regulation D, better determining who meets the requirements for reliance on the exemptions. Our proposed revisions would:

- add an alternative "investments-owned" standard to Rule 501(a);
- define the term "joint investments";
- establish a mechanism to adjust the dollar-amount thresholds in the definitions in the future to reflect inflation; and
- add several categories of permitted entities to the list of accredited and large accredited investors.

In addition, in the Private Pooled Investment Vehicle Release, we proposed to revise Regulation D to establish a new category of accredited investor, "accredited natural person," that individuals would need to satisfy in order to invest in certain private pooled investment vehicles relying on Rule 506.[83] We are continuing to consider the comments received on that proposal. We also are taking the opportunity to solicit further comment on the questions we asked in December 2006 when we issued that proposal, especially in light of the new proposals in this release, and to solicit comment on additional questions on the proposal, as discussed below.

1. Adding Alternative Investments-Owned Standards to Accredited Investor Standards

Rule 501(a) currently provides generally that certain legal entities must have total assets in excess of $5 million to qualify as accredited investors, that individuals and spouses may qualify if they have a net worth above $1 million, that individuals also may qualify if they have annual income above $200,000, and that spouses also may qualify if they have annual income above $300,000. We propose to add alternative standards for these entities and for individuals and spouses in Rule 501(a) that reflect investments owned by the prospective investor as an additional and alternative method of establishing accredited investor status.[84] We believe an investments-owned standard will add another, potentially more accurate method to assess an investor's need for the protections of registration under the Securities Act. We also believe an investments-owned standard may reduce and simplify compliance burdens for companies by providing an alternative standard that may be assessed more easily than the current assets or net worth or annual income standards.

a. Proposed Definition of "Investments"

We propose a definition of "investments" for purposes of qualifying for accredited investor and large accredited investor status that is substantively the same as the definition we proposed in December 2006 in the Private Pooled Investment Vehicle Release.[85] However, in order to establish a uniform definition that applies throughout Regulation D, the newly proposed definition contains slight differences. The Private Pooled Investment Vehicle Release proposed separate definitions for the terms "prospective accredited natural person," "related person," "investment purposes,"

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83 Proposed Rules 216 and 509 under the Securities Act.

84 As explained above with respect to large accredited investors, an investments-owned standard would be an alternative to the income standards for establishing large accredited investor status for individuals and spouses and the sole method for establishing large accredited investor status for entities that must satisfy a dollar-amount threshold.

85 The standard proposed in December 2006 would require investors to satisfy a two-part test—they would be required to be an accredited investor, as defined in Rule 501(a)(5) or (6) for transactions offered under Rule 506 or Rule 215(e) or (f) for transactions under Section 4(6) of the Securities Act (15 U.S.C. 77d(6)), and to own at least $2.5 million in "investments," as that term would be defined in Rule 509 as proposed in the Private Pooled Investment Vehicle Release.

"valuation," and "deductions."[86] Our current proposal replaces the term "prospective accredited natural person" with the term "purchaser." In addition, the concepts underlying the terms "related person," "investment purposes," "valuation," and "deductions" are discussed in the notes to the definition of "investments" in our current proposal rather than as separate definitions, as was done in the Private Pooled Investment Vehicle Release.[87] We believe including these concepts as notes to the definition of "investments" in proposed Rule 501(h) will provide greater clarity and ease use of the definition.

b. Amount of Investments Required

For legal entities required to satisfy a $5 million assets test, the proposed amendment would add an alternative investments standard of $5 million. For individuals and spouses, the proposed amendment would provide a new alternative standard of $750,000 in investments that could be used instead of the current net worth standard of $1 million or annual income standards of $200,000 (or $300,000 with one's spouse).[88] We proposed an investments-owned standard as part of our December 2006 proposal for a new category of accredited investor, the "accredited natural person," which was

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86 Unlike in the Private Pooled Investment Vehicle Release, we have not here proposed a definition of "certain retirement plans and trusts" for use in our proposed definition of "investments." We assume that investments held in retirement plans and trusts would be included in our proposed definition of investments.

87 In order to simplify the definition of "investments," we included the concepts of "related person" and "deduction" in the notes as they relate to "investment purposes" and "valuation," respectively. See proposed notes 1 through 3 to paragraph (h) of Rule 501.

88 We are proposing the $750,000 investments-owned standard because the dollar-amount threshold is the same as the dollar-amount threshold initially proposed in Regulation D for the assets test, which, as initially proposed, excluded certain assets, including personal residences. The assets threshold was increased to $1 million and adopted for the sake of simplicity and reflected a $250,000 increase in large part to account for the value of the primary residence. See Release No. 33-6389, at 11255.

developed to address eligibility for individuals to invest in private pooled investment vehicles that rely on the exclusion from the definition of the term "investment company" provided by Section 3(c)(1) of the Investment Company Act.[89]

Unlike the December 2006 proposed definition, the proposed alternative standards would not result in a reduction in the number of investors eligible for accredited investor status; rather, the standard is intended to ease issuers' threshold determinations and provide a possibly more logical basis for them.[90] In determining whether an investor meets the threshold under the investments-owned standard, the value of personal residences and places of business would not be included. Although we recognize that we have historically included (and may continue to include) personal residences and places of business as assets in calculating total assets for legal entities and net worth for individuals, we believe, consistent with our December 2006 proposed definition, that an accurate method of assessing an investor's need for the protections of registration under the Securities Act when based on an investments test is to exclude these real estate assets from the definition of investments, since they are not held for investment purposes.[91]

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89 See n. 76.

90 As proposed, there would be no changes to the current standards for accredited investors in Regulation D that would decrease the existing pool of potential investors. We do not believe these amendments would substantially change the number of investors now eligible for accredited investor status. Based on the 2004 Federal Reserve survey cited in n. 50, our Office of Economic Analysis estimates that adding an alternative $750,000 investments standard to the current accredited investor standard for natural persons (net worth in excess of $1 million or individual income in excess of $200,000 (or $300,000 with the person's spouse)) would result in 8.69 percent of households qualifying for accredited investor status in 2003, as opposed to 8.47 percent of households qualifying for accredited investor status without the proposed alternative.

91 This approach follows the proposed approach in the Private Pooled Investment Vehicle Release. Commenters generally preferred including the primary residence in the valuation of investments. We continue to consider those comments, but are again proposing to exclude the primary residence when determining the value of investments, as the value of an individual's primary residence may have little relevance with regard to the individual's need for the protections of Securities Act registration.

Accordingly, real estate would not be considered to be held for "investment purposes" if the real estate is used by the person or certain related persons for personal purposes (e.g., as a personal residence).[92] The term "personal purposes" is derived from the Internal Revenue Code provision that addresses circumstances under which a taxpayer is allowed deductions with respect to certain "dwelling units."[93] The proposed definition refers to the Internal Revenue Code because it would allow determinations of whether residential real estate is an investment based on the same provisions that would apply in determining whether certain expenses related to the property are deductible for purposes of completing tax returns. Similarly, property that has been used as a place of business or in connection with the conduct of a trade or business also would not be considered to be held for investment purposes.[94]

Request for Comment[95]

- Are the dollar-amount thresholds for the proposed investments-owned standard appropriate? Are other levels more appropriate than the $5 million in investments for legal entities and $750,000 in investments for individuals and spouses? Should these levels be higher or lower? For example, would $4 million in investments for legal entities and $500,000 in investments for individuals and

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92 See proposed Note 1 to Rule 501(h).

93 The proposed rule would treat residential real estate as an investment if it is not treated as a dwelling unit used as a residence in determining whether deductions for depreciation and other items are allowable under the IRC. Section 280A of the IRC provides, among other things, that a taxpayer uses a dwelling unit during the taxable year as a residence if he or she uses such unit for personal purposes for a number of days that exceeds the greater of 14 days or 10 percent of the number days during which the unit is rented at a fair rental. 26 U.S.C. 280A.

94 See proposed Note 1 to Rule 501(h).

95 We intend to consider comments we receive in response to this request for comment along with the comments on the Private Pooled Investment Vehicle Release.

spouses be more appropriate levels? Why?

- Is there a better way to define "investments" to meet the goals of the standard in Regulation D? Is our proposed definition of investments too complicated? Should we specifically include additional types of investment asset classes in the definition of investments? Should we exclude or limit any of the investment asset classes we have proposed for inclusion?
- We are proposing a definition of "investments" in proposed paragraph (h) of Rule 501 that is substantially similar to the definition in proposed Securities Act Rule 509(b)(3)[96] and existing Investment Company Act Rule 2a51-1(b).[97] Should we adopt a less technical, more principles-based definition of "investments"? Would a more principles-based definition be more appropriate for the many smaller companies and small businesses with limited resources that commonly use Regulation D, sometimes operating without sophisticated legal counsel? If a more principles-based definition would be more appropriate, should the rule define "investments" as meaning cash and cash equivalents, securities, real estate, commodities, and commodity interests held for investment purposes, provide that the value of investments be calculated "net of investment indebtedness," and provide that investment purposes would not include use of real estate by a prospective purchaser as a primary or secondary residence or primary place of business?
- Should we specifically exclude from the definition of investments real estate used

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96 See the Private Pooled Investment Vehicle Release.

97 17 CFR 270.2a51-1(b).

as a primary residence or primary place of business? Should we exclude secondary residences? Is it appropriate to include secondary residences that are not held for investment purposes? Would it be appropriate to specify in the rule that residential real estate that currently qualifies for the home mortgage interest deduction under the Internal Revenue Code is the type of residential real estate that would be excluded for purposes of determining investments owned? Commenters are asked to discuss why they believe that real estate of the kind excluded should or should not be counted as an investment under the rules and why.

- Our proposed definition of "investments" excludes securities that constitute a "control interest" in an issuer. Limiting the definition in this manner is designed to exclude, among other things, controlling ownership interests in family-owned and other closely-held businesses.[98] Such holdings may not demonstrate the lack of need for protection of the Securities Act registration provisions. Proposed Rule 501(h) and proposed Rule 509(b)(3) and the underlying existing rule upon which these two proposals are based, Rule 2a51-1(b)(1), all contain the same exceptions from the control interest exclusion – interests in "investment vehicles," "public companies" and "large private companies" – all of which are defined in Rule 2a51-1. Should these three exceptions be omitted from the definition of investments or referred to in Rule 501(h) in a shorter, more principles-based definition so as to be easier to comprehend?

98 For a more in-depth discussion of the concept of investments as used in proposed Rule 501(h), proposed Rule 509(b)(3) and Rule 2a51-1(b)(1), see the adopting release for Rule 2a51-1, Release No. IC-22597 (Apr. 3, 1997) [62 FR 17511].

- Note 3 to proposed Rule 501(h) indicates that the value of investments is the fair market value on the most recent practicable date or their cost and that the determination is made net of any outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments. Would it be appropriate to provide that the test be the higher or lower of fair market value or cost, or solely fair market value? Should we simply use the concept of net of investment indebtedness or is it more helpful to have a more detailed explanation of the deductions?
- Does an investments-owned standard serve as a better proxy than a net worth or total assets standard for determining whether an investor is among those investors who do not need the protections of Securities Act registration? Would an investments-owned standard be a more appropriate determinant of accredited investor status than the current net worth standard?
- Our experience indicates that some issuers may not have taken appropriate measures to satisfy their obligation under Rule 501(a) to form a reasonable belief that a prospective purchaser satisfied the definition of accredited investor. What additional measures could and should we take to improve issuers' understanding and practices in this area? Should we create a safe harbor in Regulation D that sets forth the type of investigation required for an issuer to reach a reasonable belief? Would it be appropriate to set forth in the safe harbor that an issuer must conduct a reasonable investigation in order to come to a reasonable belief? Are there other modifications to the existing requirements under Regulation D that would improve issuers' practices in forming a reasonable belief that prospective

purchasers satisfy the definition of accredited investor? Should we provide specific details as to what kind of investigation an issuer can rely upon to form a reasonable belief, as we did in Rule 144A(d)(1)?[99] What other criteria or methods could be used by issuers to form a reasonable belief that an investor is accredited? Or would any of the foregoing render the rule less usable for capital formation?

2. Proposed Definition of "Joint Investments"

Our rules currently allow issuers to count all of the assets that an individual owns jointly with a spouse or that are part of a shared community interest in the calculation of whether the individual is an accredited investor under Rule 501(a)(5) because the individual has a "joint net worth" with the spouse of more than $1 million. In the Private Pooled Investment Vehicle Release, we proposed to take a different approach to determining eligibility for accredited investor status by reason of assets owned by a spouse or as part of a shared community interest in calculating "joint investments."[100] We propose to take that same approach in calculating "joint investments" to apply throughout Regulation D. We propose a simplified definition of the term "joint investments" to apply throughout Regulation D that retains the substantive meaning of the definition proposed in the Private Pooled Investment Vehicle Release.

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99 17 CFR 230.144A(d)(1). In determining whether a prospective purchaser is a qualified institutional buyer, Rule 144A(d) provides that a seller and any person acting on its behalf are entitled to rely upon the following non-exclusive methods of establishing the prospective purchaser's ownership and discretionary investment of securities: (i) the prospective purchaser's most recent publicly available financial statements; (ii) the most recent publicly available information appearing in documents filed by the prospective purchaser with the Commission or another U.S. federal, state, or local government agency or self regulatory organization, or with a foreign governmental agency or self-regulatory organization; (iii) the most recent publicly available information appearing in a recognized securities manual; or (iv) a certification by the chief financial officer, a person fulfilling an equivalent function, or other executive officer of the purchaser, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser's most recent fiscal year.

100 Private Pooled Investment Vehicle Release at 407.

The definition of "joint investments" that we propose provides that investments of an individual seeking to make an investment in a Regulation D-exempt offering without obtaining the signature and binding commitment of his or her spouse may include only 50 percent of:

- any investments held jointly with the individual's spouse; and
- any investments in which the individual shares a community property or similar shared ownership interest with the individual's spouse.

Where spouses both sign and are bound by the investment documentation, the full amount of their investments (whether made jointly or separately) may be included for purposes of determining whether the investors are either accredited or large accredited investors.[101]

To avoid confusion and clarify language in other parts of Rule 501 in connection with the "joint investments" proposal, we propose to change the words used to describe the threshold for spouses to qualify for accredited investor status on the basis of net worth under Rule 501(a)(5) from "joint net worth" to "aggregate net worth" and to change the words used to describe the income threshold for spouses to qualify as accredited investors under Rule 501(a)(6) from "joint income" to "aggregate income." We also would use the "aggregate income" terminology in the definition of large accredited investor. We believe these changes are advisable to avoid confusion between the interpretation of the word "joint" in the context of the term "joint investments" and in the context of the terms

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101 We received substantial comment on this issue in response to the Private Pooled Investment Vehicle Release, urging that we permit a spouse's assets to be included in any calculation for determining an investor's accreditation. See, e.g., comment letters in Commission Rulemaking File No. S7-25-06 from American Bar Association (Mar. 12, 2007) (the "ABA Private Pooled Investment Vehicle Letter"), available at http://www.sec.gov/comments/s7-25-06/s72506-584.pdf, and New York State Bar Association (Mar. 14, 2007), available at http://www.sec.gov/comments/s7-25-06/s72506-597.pdf. We continue to consider this issue.

"joint net worth" and "joint income." Our previous releases and staff interpretations in this area have used the terms "joint net worth" and "joint income" to mean aggregate net worth and aggregate income, and we do not intend for these changes to alter the meaning of the rules.[102]

Request for Comment

- Does the proposed joint investments approach properly address the application of the accredited investor standard to marital assets? Should we base the determination as to whether marital assets may be considered in determining the accredited investor status of individual spouses on something other than whether both spouses sign and are bound by the investment documentation?
- Under Rule 501(a)(5) as we propose to amend it, an issuer could count 100 percent of the assets held jointly with an individual's spouse or as part of a shared community interest in determining, on the basis of net worth, the eligibility for accredited investor status of an individual investing without his or her spouse but only 50 percent of those same assets (if they are investments) in determining eligibility on the basis of investments owned. Is this approach workable? Should we treat assets of a spouse the same regardless of whether an individual investor is qualifying on the basis of net worth or investments owned? For instance, should we permit an issuer to include only 50 percent of an individual investor's marital assets in calculating both net worth and investments owned? Or should we permit the issuer to include 100 percent or some other part of the marital

[102] For a discussion of "joint net worth," see Release No. 33-6389, at n. 14 (Mar. 8, 1982) [47 FR 11251]. For a discussion of "joint income," see Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015] and Release No. 33-6758 (Mar. 3, 1988) [53 FR 7866].

assets?

- We believe that the definition of joint investments proposed today does not reflect any material change in substance from the definition of joint investments proposed in the Private Pooled Investment Vehicle Release. Would adopting both definitions, with their immaterial differences, create confusion, and why? Would it create less confusion and be more appropriate to modify the definition of joint investments in proposed Rule 216 and proposed Rule 509 to mirror the definition we propose today?

3. Future Inflation Adjustments

Our staff recently indicated that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor standard.'"[103] By not adjusting these dollar-amount thresholds upward for inflation, we have effectively lowered the thresholds in terms of real purchasing power.[104] We recognize, however, that raising the accredited investor standards of Regulation D too high may result in some issuers returning to pre-1982 practices of effecting private placements under the statutory exemption in Section 4(2) and forgoing the Regulation D safe harbor. This result may not be desirable for issuers or for the health of our private capital markets because issuers would be required to incur the expenses and complications of multi-state securities law compliance and the uncertainty of case law interpretations of the Section 4(2) exemption, as was the case

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103 See Implication of the Growth of Hedge Funds, Staff Report to the U.S. Securities and Exchange Commission (Sept. 2003) available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

104 See n. 53 and the discussion in II.A.1.

before the adoption of Regulation D.[105] In addition, regulators and investors would no longer be provided with Form D filings, which help in monitoring private placement activity.[106] Accordingly, we are reluctant at this time to immediately adjust upward for inflation the current income requirements and investment thresholds in Rule 501(a).

Instead, at this time we propose to adjust for inflation all dollar-amount thresholds set forth in Rule 501 of Regulation D on a going forward basis, starting on July 1, 2012, and every five years thereafter, to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, from December 31, 2006.[107] We propose to round the adjusted dollar amounts to the nearest multiple of $10,000. By adjusting the thresholds for inflation in the future, we intend to retain the income, assets, and investments requirements in real terms so that the accredited investor standards will not erode over time.[108]

Request for Comment

- We have noted the effects of inflation on the total assets, net worth, and income thresholds currently used in the accredited investor qualification standards.

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105 For transactions that are exempt under Rule 506, the federal preemption of most state securities regulation under Section 18(b)(4)(D) of the Securities Act would apply.

106 The current version of Form D was developed by the Commission and NASAA as a uniform form to be filed with both the Commission and the States. See Release No. 33-6663 (Oct. 2, 1986) [51 FR 36385]. Form D continues to be accepted and used by many states to monitor private placement activity.

107 This index was selected based on discussions with the Federal Reserve Bank and wide use of the index as an indicator of inflation in the U.S. economy. Adjusting thresholds every five years ensures that the thresholds stay current while limiting the disruption caused by changing the threshold.

108 This is the same method we have proposed to apply to the accredited natural person standards we proposed for private pooled investment vehicles. See the Private Pooled Investment Vehicle Release, at 406.

Should we make a one-time adjustment now to the thresholds to increase them to take into account the effects of inflation?

- Is our proposal to adjust the dollar-amount thresholds in Regulation D every five years in the future and the methodology that we have proposed for this purpose appropriate? Should the time period between adjustments be longer or shorter than five years? Should the adjusted dollar amounts be rounded to the nearest multiple of $10,000, as proposed, or to a different nearest multiple, such as $50,000 or $100,000? What would the impact of this inflation adjustment be on the ability of companies to raise capital, particularly small businesses?
- Is there more appropriate data to use that would support different conclusions as to our proposal to adjust Regulation D dollar-amount thresholds for inflation? Is there a more appropriate way to interpret the data that we have provided?
- Is another index more appropriate for our purposes than the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce?

4. Adding Categories of Entities to List of Accredited and Large Accredited Investors

The definition of accredited investor in Rule 501(a)(3) currently includes a list of legal entities that may qualify as accredited investors, assuming they satisfy other conditions. The list includes organizations described in Section 501(c)(3) of the Internal Revenue Code,[109] corporations, Massachusetts or similar business trusts, and partnerships. It does not include limited liability companies, Indian tribes, labor unions, governmental bodies, and similar legal entities, leading to some degree of uncertainty as to whether these types of entities may qualify as accredited investors.

Accordingly, we propose to amend the Rule 501(a)(3) list of legal entities so that it includes any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body or other legal entity with substantially similar legal attributes. We also would add a definition of the term "governmental body" to Rule 501(a), similar to the definition of that term that appears commonly in transactional financing documents.[110] Our staff is regularly asked questions about which entities may qualify as accredited investors, and has provided guidance that limited liability companies and certain governmental units may so qualify.[111] We hope these changes will reduce uncertainty and legal costs and promote more efficient private capital formation.

Requests for Comment

- Should we add or delete types of legal entities from the list in paragraph (a)(3) of Rule 501? For example, should we specifically include "joint venture" or "college or university endowment" in the list, or is it clear that they would be covered by the proposed language of the rule?[112] Should we delete the list

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109 26 U.S.C. 501(c)(3).

110 See, e.g., Section of Business Law, American Bar Association, Model Stock Purchase Agreement with Commentary, at 15-16 (1995). Our proposed definition of "governmental body" would apply only to the definition of "accredited investor" in Rule 215 and Rule 501(a), which apply only in the context of exempt offerings under Section 4(6) and Regulation D.

111 In this regard, see Division of Corporation Finance no-action letter to Wolf, Block, Schorr and Solis-Cohen (Dec. 11, 1996) (limited liability companies), and Release No. 33-6455 (Mar. 4, 1983) [48 FR 10045] at Q & A 19, citing Division of Corporation Finance no-action letter to Voluntary Hospitals of America, Inc. (Dec. 30, 1982) (governmental unit that falls within the substantive description of 26 U.S.C. 501(c)(3)).

112 As originally proposed, the definition of "accredited investor" in Regulation D specifically included college or university endowment funds. See Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791]. Upon adoption, college or university endowment funds were intended to be included

entirely and simply say that any legal entity that can sue or be sued in the United States, assuming it meets the other standards for becoming an accredited investor, can qualify as an accredited investor?

- Should we define the terms "Indian tribe" and "labor union" and, if so, how? For example, should we define "Indian tribe" in terms of a tribe, band, nation, pueblo, village, or community that the Secretary of the Interior acknowledges to exist as an Indian tribe under the Federally Recognized Indian Tribe List Act of 1994?[113] Should we include state-recognized Indian tribes? Should we make any special provision for labor union pension funds?
- When we first proposed Rule 144A, we noted that the type of "qualified institutional buyers" contemplated under that rule would generally include "very large institutions, long involved in the resale market for restricted securities, as to which there has been little concern with respect to Section 5 implications."[114] As a result, we looked to the list of institutional accredited investors contained in Rule 501(a)(3) to develop the Rule 144A(a)(1)(i)(H) list of qualified institutional buyers. Because we are now proposing to amend Rule 501(a)(3) by expanding the list of institutional accredited investors, we are seeking comment on whether the Rule 144A(a)(1)(i)(H) list of qualified institutional buyers should be expanded in a similar manner. Is it appropriate to consider all institutions that would come

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within the category "organization[s] described in Section 501(c)(3) of the Internal Revenue Code." See Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251]. Since we now propose to replace the phrase "organization described in Section 501(c)(3) of the Internal Revenue Code" with a reference to non-profit corporations, we seek to assure that college and university endowment funds will still be considered accredited investors if they satisfy the applicable financial standard.

113 25 U.S.C. 479a.

114 See Release No. 33-6806 (Oct. 25, 1988) [53 FR 33147].

under Rule 501(a)(3) and that meet the $100 million investment size threshold under Rule 144A as having sufficient experience with the resale market for restricted securities? Should any or all of the categories of institutional accredited investors contained in Rule 501(a)(3) be included in the Rule 144A(a)(1)(H) list of qualified institutional buyers? Are there any categories of institutions included in proposed Rule 501(a)(3) that should not be included in the definition of qualified institutional buyer under Rule 144A?

- Rule 144A contains few procedural restrictions relating to the transferability of restricted securities sold under Rule 144A. Do we need to make any modifications in light of the possibility that, if we were to expand the definition of qualified institutional buyer under Rule 144A, these restrictions would lead to a greater likelihood of restricted securities flowing into the public market?

5. Proposed Definition of Accredited Natural Person

In the Private Pooled Investment Vehicle Release, we expressed our concerns about the increased number of individual investors who may today be eligible as accredited investors to make investments in pooled investment vehicles relying on Section 3(c)(1) of the Investment Company Act. We noted that the existing $1 million net worth and $200,000 ($300,000 with one's spouse) income tests provide some investor protection for individuals seeking to invest in pooled investment vehicles relying on Section 3(c)(1) of the Investment Company Act, but expressed our concern that some further level of protection may be necessary to safeguard investors seeking to make an investment in such vehicles in light of their unique risks, including risks with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such vehicles' anticipated returns. Accordingly, we proposed for comment a standard that would require individual investors to satisfy a two-part test to qualify as accredited investors for purposes of investing in certain private pooled investment vehicles—they would be required to satisfy the current standard to qualify as accredited investors, as defined in (i) Rule 501(a)(5) or (6) for transactions under Rule 506 or (ii) Rule 215(e) or (f) for transactions under Section 4(6) of the Securities Act, and also to own at least $2.5 million in "investments," as that term would be defined in proposed Rule 509 or proposed Rule 216, as applicable.

We recognize that if we adopt the alternative investments-owned standard for individuals in the definition of accredited investor in proposed Rule 215(e) and Rule 501(a)(5) ($750,000) and the investments-owned standard for the definition of accredited natural person in proposed Rule 216 and Rule 509 ($2.5 million), an individual who meets the investment test as an accredited natural person would also meet the investments test as an accredited investor. We believe that the different amounts applicable under the definitions are targeted to address concerns about the nature of different types of offerings. As noted, the alternative investments-owned standards proposed under the definition of accredited investor are designed to add another method to assess an investor's need for the protections of registration under the Securities Act. The additional and higher investments-owned standard proposed in the definition of accredited natural person is intended to provide a more objective and clearer standard to use in ascertaining whether an individual is likely to have sufficient knowledge and experience in financial and business matters to enable that investor to evaluate the merits and risks of a prospective investment in certain private pooled investment vehicles, or to be able to hire someone with such knowledge and experience who may help the individual to make such an evaluation.

We received numerous comments disagreeing with the proposed definition of accredited natural person. Most of those submitting comments argued that the proposal limits investor access to private pooled investment vehicles and questioned the dollar amount of the investments standard. In light of those comments, we are soliciting additional comments on the following points.

Requests for Comment

- We request comment on whether we should revise the proposed definition of accredited natural person to include alternative income and investment standards similar to those used in the definition of "large accredited investor" in proposed Rule 507 (income of $400,000 (or $600,000 with one's spouse) or investments of $2.5 million). Would such a revision address some of the concerns noted by those who submitted comments on the Private Pooled Investment Vehicle Release? Would a higher (e.g., $500,000 (or $700,000 with one's spouse)) or lower (e.g., $300,000 (or $400,000 with one's spouse)) income standard be more appropriate, and why? Would a higher (e.g. $3 million) or lower (e.g. $2 million) investments standard be more appropriate, and why? In responding to this request for comment, please also comment on any concerns you might have if any final definition that we may adopt includes an inflation adjustment provision. For example, some comment letters on the December 2006 proposal raised a concern that the proposed inflation adjustment could result in the proposed standard for accredited natural persons ultimately being higher than the existing $5 million investments-owned requirement for private investment pools that rely on Section 3(c)(7) of the Investment Company Act.[115] How would you propose to address this concern? Should we set a dollar limit above which the dollar amount of investments included in proposed Rule 216 and proposed Rule 509 may not rise (for example, should we cap the investments amount at $4.9 million), and why?

- We believe that the changes we propose to make in the definition of "investments" proposed today do not reflect any material change from the definition of "investments" proposed in the Private Pooled Investment Vehicle Release. Would adopting both definitions, with their immaterial differences, create confusion, and why? Would it create less confusion and be more appropriate to modify the definition of "investments" in proposed Rule 216 and proposed Rule 509 to mirror the definition we propose today?
- Would a more principles-based definition of the term "investments," like the one we have suggested as an alternative to the definition we are proposing for Rule 501(h), also be appropriate in the context of proposed Rule 509 and Rule 216? Is there any reason to have a definition of "investments" in Rule 501(h) that is different from the definition used in proposed Rule 509 and Rule 216, and why?
- Earlier in this release, we request specific comment on the treatment of real estate as an investment, the treatment of securities that constitute a "control interest" in

115 See, e.g., comment letters in Commission Rulemaking File No. S7-25-06 from Schulte, Roth & Zabel LLP (Mar. 9, 2007), available at http://www.sec.gov/comments/s7-25-06/s72506-549.pdf, and ABA Private Pooled Investment Vehicle Letter, n. 101 above.

An individual that invests in 3(c)(7) pools must be a qualified person, defined in Section 2(a)(51)(A)(1) of the Investment Company Act as an individual who owns not less than $5 million in investments. Rule 2a51-1(b) under the Investment Company Act defines investments, and is the basis for the definition we proposed in December 2006 and today.

an issuer as an investment, and how investments are proposed to be valued under the definition of "investments" proposed in this release. We solicit comment with respect to those points in connection with the definition of the term "investments" as proposed for use with the term "accredited natural person." Is there any reason to have a definition of the term "investments" under proposed Rules 216 and 509 that is different from the one proposed in this release? Please explain why or why not.

- As we have explained, we modeled the definition of "investments" in proposed Rule 216 and proposed Rule 509 on the definition included in Rule 2a51-1(b) under the Investment Company Act. Would a more principles-based definition of the term "investments," like the one we have suggested as an alternative to the definition we are proposing for Rule 501(h), also be appropriate in the context of Rule 2a51-1, and why? Should we adopt coordinated definitions of "investments" for purposes of proposed Rule 501(h), proposed Rule 216, proposed Rule 509 and Rule 2a51-1, or should there be different definitions applicable to these rules, and why?

C. Proposed Revisions to General Conditions of Regulation D

Rule 502 of Regulation D sets forth conditions that are applicable to offers and sales made under Regulation D. We propose to make changes to those conditions, including shortening the amount of time issuers are required to wait to make offers and sales in order to rely on the integration safe harbor provided in Rule 502(a) and adding disqualification provisions for certain issuers seeking to rely on the exemptions in Regulation D. We also are providing guidance regarding the integration of concurrent public and private offerings.

Our Advisory Committee on Smaller Public Companies advised that the six-month safe harbor period from integration provided in Rule 502(a) "represents an unnecessary restriction on companies that may very well be subject to changing financial circumstances, and weighs too heavily in favor of investor protection, at the expense of capital formation."[116] The Committee supported "clearer guidance concerning the circumstances under which two or more apparently separate offerings will or will not be integrated."[117] The Advisory Committee acknowledged the difficulty, however, of modifying the five-factor test contained in Rule 502(a) and concluded that the issue could be more readily addressed through a shortening of the six-month period. Based on their analysis of the issue, the Advisory Committee recommended that we shorten the integration safe harbor from six months to 30 days.[118]

In making recommendations with respect to the integration doctrine, the Advisory Committee recommended, in addition to decreasing the time period of the integration safe harbor in Regulation D, that the Commission clarify the interpretation of or amend Securities Act Rule 152[119] in order to permit companies to conduct a valid private placement immediately before the filing of a registration statement without concern that

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116 Advisory Committee Final Report at 96.

117 Id. at 95.

118 Id. at 94.

119 17 CFR 230.152. Rule 152 specifies that "[t]he phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transaction although subsequently thereto the issuer decides to make a public offering and/or files a registration statement."

the two offerings would be integrated.[120] The Advisory Committee also noted in making this recommendation that, in addition to the concerns that companies may not be able to raise capital privately in the time shortly before the filing of a registration statement, there also are continuing integration considerations when conducting concurrent private placements while a registration statement is pending with the Commission.[121] This recommendation and commentary demonstrate that questions continue to arise in the capital raising process concerning the ability of issuers to conduct a private placement before a Securities Act registration statement is filed with the Commission, or in the period between the filing and effectiveness of the registration statement.

We understand that capital raising around the time of a public offering, in particular an initial public offering, often is critical if companies are to have sufficient funds to continue to operate while the public offering process is ongoing. For this reason, we are providing guidance so that companies and their counsel may have a better framework for evaluating their particular circumstances.[122]

Consistent with Securities Act Rule 152, the staff of the Division of Corporation Finance, in its review of Securities Act registration statements, will not take the view that a completed private placement that was exempt from registration under Securities Act Section 4(2) should be integrated with a public offering of securities that is registered on

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120 Advisory Committee Final Report at 100-101.

121 Advisory Committee Final Report at n. 207.

122 This guidance does not affect the risk that the Commission or a court could find a violation of Section 5 where a company begins an offering as a private placement and seeks to complete that offering pursuant to a registration statement, or where a company commences a registered offering and seeks to complete that offering through a private placement, except in those circumstances specified in Securities Act Rule 155. See Integration of Abandoned Offerings, Release No. 33-7943 (Jan. 26, 2001) [66 FR 8887].

a subsequently filed registration statement.[123] Consistent with the staff's approach to this issue, we are of the view that, pursuant to Securities Act Rule 152, a company's contemplation of filing a Securities Act registration statement for a public offering at the same time that it is conducting a Section 4(2)-exempt private placement would not cause the Section 4(2) exemption to be unavailable for that private placement.[124]

We recognize that a company's financing needs do not end with the filing of a registration statement. As a general matter, however, the filing of a registration statement has been viewed as a general solicitation of investors.[125] Today, upon the filing of a registration statement, information about a company and its prospects is available immediately through our EDGAR filing system. The staff of the Division of Corporation Finance has issued interpretive letters to the effect that, notwithstanding the availability of the information in the registration statement, companies may continue to conduct concurrent private placements without those offerings necessarily being integrated with the ongoing public offering.[126] Concerns remain, however, with the ability to complete such concurrent private placements in factual situations that were not considered previously by the Division staff in interpretive letters. The Division staff has not applied any per se approach in addressing these circumstances in its review of filings, but rather

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123 See, e.g., Division of Corporation Finance no-action letter to Verticom, Inc. (Feb. 12, 1986).

124 In these circumstances, companies should be careful to avoid any pre-filing communications regarding the contemplated public offering that could render the Section 4(2) exemption unavailable for what would be an otherwise exempt private placement.

125 See, e.g., Division of Corporation Finance no-action letter to Michael Bradfield, General Counsel, Board of Governors of the Federal Reserve System (Mar. 16, 1984).

126 See, e.g., Division of Corporation Finance no-action letters to Black Box Incorporated (June 26, 1990) and Squadron Ellenoff, Pleasant & Lehrer (Feb. 28, 1992). The guidance in this release does not affect the ability of issuers to continue to rely on the views expressed by the Division staff in these letters.

has requested a discussion of the relevant facts and in some cases an opinion of counsel when concerns arose as to the potential integration of the concurrent private offering and public offering and the availability of the Section 4(2) exemption after the filing of the registration statement.[127]

Our view is that, while there are many situations in which the filing of a registration statement could serve as a general solicitation or general advertising for a concurrent private offering, the filing of a registration statement does not, per se, eliminate a company's ability to conduct a concurrent private offering, whether it is commenced before or after the filing of the registration statement. Further, it is our view that the determination as to whether the filing of the registration statement should be considered to be a general solicitation or general advertising that would affect the availability of the Section 4(2) exemption for such a concurrent unregistered offering should be based on a consideration of whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of the Section 4(2) exemption. This analysis should not focus exclusively on the nature of the investors, such as whether they are "qualified institutional buyers" as defined in Securities Act Rule 144A or institutional accredited investors, or the number of such investors participating in the offering; instead, companies and their counsel should analyze whether the offering is exempt under Section 4(2) on its own, including whether securities were offered and sold to the private

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127 The guidance that follows applies in the context of private placements conducted under existing exemptions from registration. If we adopt proposed Rule 507 of Regulation D, we may provide additional interpretive guidance on any potential integration issues unique to that exemption. In this regard, we note that, as proposed, offers and sales exempt under Rule 507 would be subject to a ban on general solicitation except as permitted under the rule and would be considered "limited," rather than "private," offerings.

placement investors through the means of a general solicitation in the form of the registration statement. For example, if a company files a registration statement and then seeks to offer and sell securities without registration to an investor that became interested in the purportedly private offering by means of the registration statement, then the Section 4(2) exemption would not be available for that offering. On the other hand, if the prospective private placement investor became interested in the concurrent private placement through some means other than the registration statement that did not involve a general solicitation and otherwise was consistent with Section 4(2), such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents outside of the public offering effort, then the prior filing of the registration statement generally would not impact the potential availability of the Section 4(2) exemption for that private placement and the private placement could be conducted while the registration statement for the public offering was on file with the Commission. Similarly, if the company is able to solicit interest in a concurrent private placement by contacting prospective investors who (1) were not identified or contacted through the marketing of the public offering and (2) did not independently contact the issuer as a result of the general solicitation by means of the registration statement, then the private placement could be conducted in accordance with Section 4(2) while the registration statement for a separate public offering was pending. While these are only examples, we believe they demonstrate the framework for analyzing these issues that companies and their counsel should apply and that the staff will consider when reviewing registration statements.

1. Proposed Revisions to Regulation D Integration Safe Harbor

The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to the multiple offerings that would not be available for the combined offering. The integration concept was first articulated in 1933[128] and was further developed in two interpretive releases issued in the 1960s.[129] The interpretive releases clarified that determining whether a particular securities offering should be integrated with another offering requires an analysis of the specific facts and circumstances of the offerings. In our guidance, we identified five factors to consider in making the determination of whether the offerings should be integrated.[130] In 1982, we included the five factors and established an integration safe harbor in Rule 502(a). We stated that the five factors relevant to the question of integration are:

> Whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, and (5) the offerings are made for the same general purpose.[131]

Under the safe harbor, offers and sales more than six months before a Regulation D offering or more than six months after the completion of a Regulation D offering will not

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[128] Release No. 33-97 (Dec. 28, 1933).

[129] Release No. 33-4434 (Dec. 6, 1961) [26 FR 11896] and Release No. 33-4552 (Nov. 6, 1962) [27 FR 11316].

[130] Release No. 33-4552 (Nov. 6, 1962) [27 FR 11316].

[131] Id.

be considered part of the same offering. This provides issuers with a bright-line test upon which they can rely to avoid integration of multiple offerings.

In making its recommendation that the integration safe harbor be shortened, the Advisory Committee noted that smaller companies' financing needs often are unpredictable, making the six-month waiting period for use of the safe harbor problematic for issuers in need of capital. Other commenters have made similar recommendations to decrease the waiting period in the safe harbor.[132] While we recognize the burdens that the integration doctrine places on capital formation, improper reliance on exemptions from registration harms investors by depriving them of the benefits of full and fair disclosure and the civil remedies that flow from registration. Any changes that we make to the integration doctrine must continue to provide that issuers are aware of their obligation to analyze the exemptions upon which they rely and whether any offers and sales are, in reality, part of a single plan of financing.

The current six-month time frame of the safe harbor in Rule 502(a) provides a substantial time period that has worked well to clearly differentiate two similar offerings and provide time for the market to assimilate the effects of the prior offering. The Advisory Committee has expressed concern, however, that such a long delay could inhibit companies, particularly smaller companies, from meeting their capital needs.[133] We recognize that increased volatility in the capital markets and advances in information technology have changed the landscape of private offerings. We remain concerned,

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132 See ABA Private Offering Letter, n. 24 above, at 33. The ABA letter also suggested expanding the factors to consider when making the determination of whether an offering should be integrated.

133 See Advisory Committee Final Report at 96.

however, that an inappropriately short time frame could allow issuers to undertake serial Rule 506-exempt offerings each month to up to 35 non-accredited investors in reliance on the safe harbor, resulting in unregistered sales to hundreds of non-accredited investors in a year. Such sales could result in large numbers of non-accredited investors failing to receive the protections of Securities Act registration. Our proposal seeks to strike an appropriate balance between the number of non-accredited investors allowed in an offering relying on the integration safe harbor and the non-public nature of that offering. It would be an anomalous result that an issuer could make an offering to hundreds of non-accredited investors in reliance on the integration safe harbor, triggering reporting requirements under the Exchange Act, without a public offering. We propose, therefore, to lower the safe harbor time frame to 90 days rather than the 30 days recommended by the Advisory Committee.[134] We believe 90 days is appropriate, as it would permit an issuer to rely on the safe harbor once every fiscal quarter.[135] This reduction in time should provide additional flexibility to issuers, while still requiring them to wait a sufficient period of time before initiating a substantially similar offer in reliance on the safe harbor.[136]

The same integration analysis as applies to other Regulation D offerings would apply to offerings made under proposed Rule 507. Accordingly, an issuer would not be

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134 Both the Advisory Committee and the ABA recommended reducing the time frame for the integration safe harbor to 30 days. Their proposals do not address our concerns that such a short time frame could result in public offerings conducted under the guise of private offerings. See ABA Private Offering Letter, n. 24 above, at 33 and Advisory Committee Final Report at 94.

135 For issuers that provide quarterly reports, the 90-day requirement would provide time and transparency for investors and the market to take into account the offering and its results.

136 The five-factor test would continue to apply, providing issuers with flexibility where they are making separate offerings within the 90-day time frame.

able to take advantage of the safe harbor in Rule 502(a) for any sales to investors that are not large accredited investors within the safe harbor period after the publication of a general announcement as permitted by Rule 507. The new 90-day safe harbor would apply to Rule 507 offerings, allowing issuers to make offerings without integration concerns after waiting the requisite period of time.

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- As proposed, we would reduce the time frame for the integration safe harbor from six months to 90 days. Is 90 days an appropriate time frame for the safe harbor? Is 90 days still too long a delay for issuers seeking capital in reliance on the integration safe harbor? Would this reduction increase the possibility that issuers will use the safe harbor and undertake serial offerings?
- Some commentators have suggested that a 30-day integration safe harbor would be appropriate. We are concerned that such a short time period could encourage serial private offerings that would otherwise be integrated and effectively allow unregistered public offerings. If we were to reduce the time period of the safe harbor, should we limit the total number of non-accredited investors to whom an issuer may sell over the course of the year? If so, how many non-accredited investors would be an appropriate limitation per year—100, 140, 210 or some other number?
- The five-factor test provides issuers with an analytical framework to differentiate offers so that they need not be integrated. Does the five-factor test provide sufficient guidance for issuers to make their analysis? If not, how could we improve the factors to provide clearer guidance? Should we provide additional

factors? Would the proposed 90-day time frame obviate the need to revise the test?

- Would the interaction between the general announcement permitted by proposed Rule 507 and the proposed 90-day integration safe harbor present opportunities for abuse? Could issuers use the general announcement permitted by proposed Rule 507 to test the waters before deciding whether to undertake either a registered public offering or unregistered exempt offering under Regulation D? Should we permit this use of a Rule 507 general announcement? Should we modify proposed Rule 507 to prohibit such a practice?

2. Disqualification Provisions

In conjunction with the proposed revisions to Regulation D, we have considered the need for general "bad actor" disqualification provisions for all offerings under Regulation D. Our concern arises from the number of recidivists we see in problematic Regulation D offerings. Before the National Securities Markets Improvement Act of 1996,[137] recidivists were excluded from most Rule 506 offerings by state disqualification provisions. The National Securities Markets Improvement Act preempts the states from enforcing those provisions in favor of federal regulation, raising the question whether federal disqualification provisions should be adopted to replace them.

We propose that availability of all Regulation D exemptions be conditioned on the application of bad actor disqualification provisions. By deterring recidivists from participating in our primary private and limited offering marketplaces, we intend to improve the effectiveness of Regulation D offerings for a significant majority of

137 Pub. L. No. 104-290.

companies, especially smaller companies, that do not have bad actors associated with their securities offerings and will not be disqualified under the proposed provisions.

Currently, in Regulation D, only Rule 505 provides disqualification provisions.[138] Rule 505 refers issuers to the substantive disqualification provisions of Rule 262[139] under Regulation A,[140] essentially incorporating those provisions by reference. Under those provisions, issuers are barred from relying on the exemption where the issuer, any of its predecessors, any affiliated issuers, any director, officer or general partner of the issuer, any beneficial owner of 10 percent or more of any class of its equity securities, any promoter of the issuer presently connected with the issuer, any underwriter of the securities to be offered, or any partner, director or officer of the underwriter have committed relevant violations of laws and regulations. The Model Accredited Investor Exemption[141] and the Uniform Securities Act of 2002[142] also provide for similar disqualification provisions for these types of issuers and associated persons.

The exemption in proposed Rule 507 and the proposal to reduce the time that issuers must wait to rely on the integration safe harbor would provide issuers with greater

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138 17 CFR 230.505(b)(2)(iii).

139 17 CFR 230.262.

140 17 CFR 230.251 through 230.263. Regulation A is an exemption from Securities Act registration, promulgated under Section 3(b) of the Securities Act, 15 U.S.C. 77c(b), for public offerings not exceeding $5 million in any 12-month period.

141 According to NASAA, as of 1999, 33 states plus the District of Columbia and Puerto Rico had adopted a form of this exemption and seven more states had bills pending in their legislatures. See North American Securities Administrators Association, Written Statement before the House Small Business Committee, Government Programs and Oversight Subcommittee (Oct. 14, 1999).

142 See www.uniformsecuritiesact.org. According to the drafting committee, as of April 27, 2007, the Act had been enacted in 11 states and the U.S. Virgin Islands and is endorsed by NASAA, the Securities Industry and Financial Markets Association (formerly known as the Securities Industry Association) and the American Bar Association.

flexibility in preparing and conducting private offerings. Given this proposed increase in flexibility, as well as enforcement issues we have confronted with recidivists involved in purported Regulation D offerings,[143] we believe it is appropriate to propose that certain issuers be precluded from relying on any of the Regulation D exemptions if they or the persons designated in proposed Rule 502(e) have violated the law. We are proposing a rule that is based generally on the provisions in Regulation A, the Model Accredited Investor Exemption and the Uniform Securities Act of 2002.[144] In the interests of coordination and uniformity, we drew extensively from the Model Accredited Investor Exemption, but have modified some of the provisions, taking into account provisions of the Uniform Securities Act. The proposed disqualification provisions all relate to determinations by regulators and courts of problematic behavior or wrongdoing. It is our intent that the Commission's adoption of disqualification provisions based on provisions in use in many states will lead to increased uniformity in federal and state securities regulation.[145]

Exempt private and limited offerings under Regulation D do not provide the protections that registration would afford. We believe that registration, with its incumbent rights for investors and duties of the issuer, is more appropriate for offerings by issuers and persons that have been subject to determinations of violations of law or

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143 See, e.g., SEC v. Calvo, 378 F.2d 1211, 1216 (11th Cir. 2004).

144 In response to the Advisory Committee's proposed recommendations, NASAA commented that any new exemption in Regulation D should "contain at least disqualification provisions like those contained in Rule 505(b)(2)(iii), Rule 1.B of the NASAA Uniform Limited Offering Exemption (1983), and Section D of the Model Accredited Investor Exemption." See NASAA Letter, n. 48 above.

145 Several provisions of the federal securities laws call for greater uniformity in federal and state securities regulation. See, e.g., Securities Act § 19(d), 15 U.S.C. 77s(d).

wrongdoing than offerings relying on Regulation D exemptions. Thus, we believe it would be prudent to preclude certain persons who have been shown to have acted improperly from relying on Regulation D to make or be involved with unregistered offers and sales of securities.

As proposed, the disqualification provisions in new Rule 502(e) would apply to all offerings made in reliance on Regulation D, precluding reliance by the issuer on Regulation D if the issuer itself is disqualified or the presence of any of the enumerated persons disqualifies the issuer.[146] The disqualification provisions under proposed Rule 502(e) would apply to:

- the issuer, any predecessor of the issuer, and any affiliated issuer;
- any director, executive officer, general partner, or managing member of the issuer;
- any beneficial owner of 20 percent or more of any class of the issuer's equity securities; and
- any promoter connected with the issuer.

The persons and entities we propose to subject to the disqualification provisions are substantially similar to those in Regulation A and the Model Accredited Investor Exemption, except that we do not propose to include underwriters.[147] Both Regulation A

146 In conjunction with this proposal, we also propose to delete the current disqualification provisions in Rule 505(b)(2)(iii).

147 We propose to add managing members to the traditional list of directors, officers, and general partners to indicate clearly that managing members of limited liability companies are intended to be included in the provision. We also propose to limit the provisions to "executive officers" rather than "officers" and to 20 percent beneficial owners rather than 10 percent beneficial owners as provided in Rule 262 of Regulation A. We believe that limiting the scope of these provisions to executive officers and 20 percent beneficial owners would be appropriate, given their greater influence on the policies of the issuer as compared to officers and 10 percent beneficial owners.

and the Model Accredited Investor Exemption include underwriters among the classes of persons to whom disqualification provisions apply.[148] Underwriters generally do not directly control the issuer or determine for an issuer whether to conduct an offering. In weighing the balance of adding the disqualification provisions, we determined that adding provisions throughout Regulation D would have positive effects on the private and limited offering equity markets. In order to limit the burden of expanding these provisions, we propose to limit the application, and therefore the due diligence burden, to the issuer and those persons whom we regard as having substantial influence over the issuer.[149]

Proposed Rule 502(e) provides six disqualification provisions that would preclude an issuer from relying on Regulation D. Each of the disqualification provisions requires a determination by a government official or agency or self-regulatory organization that the relevant person has violated the law or engaged in other wrongdoing. These provisions apply where the issuer or the covered persons:

- filed a registration statement within the last five years that is the subject of a currently effective permanent or temporary injunction or an administrative stop order;[150]

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148 The term "underwriters" is used in both Regulation A and the Model Accredited Investor Exemption. The term underwriters includes selling broker-dealers, who are commonly called underwriters in Regulation A offerings and placement agents in private offerings.

149 We have chosen not to use in this context the concept of "affiliate," which we use in other rules under the Securities Act to designate certain persons with control relationships with issuers. Rule 505 of Regulation D currently refers issuers to the disqualification provisions of Rule 262 of Regulation A. Under the proposed disqualification provisions, Rule 505 would refer to Rule 502(e) and not to the disqualification provisions in Regulation A.

150 Rule 262(a)(1) provides that the issuer, any of its predecessors or any affiliated issuer "has filed a registration statement which is the subject of any pending proceeding or examination under Section 8 of the Act, or has been the subject of any refusal order or stop order thereunder within five years prior to the filing of the offering statement required by Rule 252." As proposed, the

- was convicted of a criminal offense in the last 10 years that was in connection with the offer, purchase or sale of a security or involved the making of a false filing with the Commission;[151]
- has been subject to an adjudication or determination within the last five years by a federal or state regulator that the person violated federal or state securities or commodities law or a law under which a business involving investments, insurance, banking or finance is regulated;[152]
- is subject to an order, judgment or decree by a court entered within the last five years that restrains or enjoins the issuer or a person from engaging in any conduct or practice involving securities and other similar businesses, including an order

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provision would not be limited to the issuer and the language of the provision would apply more generally to court injunctions and stop orders or similar orders by the Commission or state securities agencies. The proposed language tracks Section 306(a)(3) of the Uniform Securities Act.

151 Rule 262 provides disqualification provisions for "any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission." Under Rule 262, the disqualification of issuers, predecessors and affiliated issuers is for five years, while for any director, officer or general partner of the issuer, beneficial owner of 10 percent or more of any class of its equity securities, any promoter of the issuer presently connected with it in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of any such underwriter the disqualification is for 10 years. The proposed provision tracks Rule 262 instead of the Model Accredited Investor Exemption or Uniform Securities Act, because the language focuses on securities-related offenses while the other models use broader language. The proposal uses the term "criminal offense" instead of specifying "felony or misdemeanor" as used in Rule 262 and uniformly applies a 10-year disqualification for these more egregious acts. This provision would substantially cover situations addressed in Rule 262(a)(3) and Rule 262(b)(3).

152 This provision is based on Section 412(d)(6) of the Uniform Securities Act, but more generally includes "federal or state regulator" and "federal or state securities or commodities laws or a law under which a business involving investments, insurance, banking, or finance is regulated" instead of providing a specific list of relevant statutes. The Model Accredited Investor Exemption contains a similar, but more limited provision that disqualifies a person if they are "currently subject to any state or federal administrative enforcement order or judgment . . . finding fraud or deceit in connection with the purchase or sale of any security."

for failure to comply with Rule 503 (the filing of Form D);[153]

- is subject to a cease and desist order entered within the last five years issued under federal or state securities or similar laws;[154] or
- is subject to a suspension or expulsion from membership in or association with a member of a national securities exchange or national securities association for an act or omission constituting conduct inconsistent with just and equitable principles of trade.[155]

The length of disqualification from reliance on Regulation D in the proposal is generally five years. For more egregious conduct resulting in a criminal conviction, we propose disqualification for 10 years.[156] We believe that these disqualification provisions would provide a deterrent effect, as well as offer protection to investors from recidivists who have violated securities and related laws and rules in the past.

Proposed subparagraphs (i), (iii), (iv), and (v) of Rule 502(e)(1) enumerate the various administrative and civil orders, judgments, and determinations that would trigger disqualification for an issuer. Proposed subparagraph (ii) provides a similar

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153 We sought to simplify the provisions in Rule 262(a)(2) and (b)(2) of Regulation A by following the Model Accredited Investor Exemption provision (D)(1)(d). Rather than refer to "involving fraud or deceit in connection with the purchase or sale of any security," we broadened the application to a business "involving securities, commodities, investments, insurance, banking, or finance" as suggested by the Uniform Securities Act. We did not, however, include a business involving franchises as in the Uniform Securities Act list. We also added a specific reference to Rule 503, which is being moved from current Rule 507, as discussed below.

154 This provision, while similar to the provisions in Rule 502(e)(1)(iii) and (iv), is based on Section 412(12) of the Uniform Securities Act.

155 This provision is substantially similar to Rule 262(b)(4) and seeks to bar similar persons to those covered by Uniform Securities Act Section 412(13).

156 The period of disqualification generally follows the periods provided in Regulation A. The disqualification period for issuers convicted of a criminal offense would be increased from five to 10 years to conform with the disqualification for other criminal offenders and to better conform with the Uniform Securities Act.

disqualification provision for criminal convictions and proposed subparagraph (vi) provides a disqualification provisions that relates to decisions of self-regulatory organizations. Each disqualification provision relates to a failure to comply with laws or regulations, raising concerns that the person may continue to disregard laws and regulations relating to the offering of securities. For this reason, we believe an issuer should not be allowed to rely on Regulation D if the issuer or one of the covered persons meets the disqualification provisions in proposed Rule 502(e).

In order to combine all of the disqualification provisions in the same rule, we propose to remove the disqualification provision relating to failure to comply with Rule 503 (the filing of Form D) that is found in current Rule 507 and replace the substance of that provision with a clause in proposed Rule 502(e)(1)(iv). Proposed Rule 502(e)(1)(iv) would specifically indicate that an order for failure to comply with Rule 503 of Regulation D would trigger the disqualification provision. Proposed Rule 502(e)(2) would expand upon the concept in current Rule 507 and allow the Commission, upon a showing of good cause, to waive any of the enumerated disqualification provisions in proposed Rule 502(e)(1).[157] Proposed Rule 502(e)(2) also would provide a safe harbor for an offering by an issuer, if that issuer establishes that it did not know and reasonably could not have known that the disqualification existed.[158]

157 The waiver provision tracks the preliminary language in Rule 262 and provides flexibility for the Commission. The Commission staff has, and would continue to have, delegated authority to act on waiver requests under Rule 262 of Regulation A and Rule 505, and we are proposing a similar delegation for all other Regulation D disqualification waiver requests. See II.E.3 below.

158 The Model Accredited Investor Exemption provides exemptions from disqualification where a waiver is provided or where the issuer establishes that it did not know and in the exercise of reasonable care, based on a factual inquiry, could not have known of the disqualification. Regulation A does not include the exemption where an issuer reasonably could not have known. Due to the broad application of the proposed Rule, we have proposed similar exemptions to those in the Model Accredited Investor Exemption providing for waiver and for an issuer that

Request for Comment

- Should we limit the disqualification provisions to Rule 505 exemptions only, as is currently the case, rather than applying these provisions to all Regulation D exemptions? Are there any current disqualifications not included in the proposed rule that we should include? Are any persons not covered who should be?
- What would be the effects on disqualified issuers? How many issuers would be affected?
- Unlike the Regulation A, Regulation E[159] and current Rule 505 disqualification provisions, proposed Rule 502(e) excludes selling broker-dealers, underwriters, and placement agents from the disqualification provisions. Should selling broker-dealers, underwriters, and placement agents be covered in the disqualification provisions? Would including selling broker-dealers, underwriters, and placement agents give issuers an incentive to check their backgrounds before engaging them for an offering? If they were included, should there be an exemption for persons who continue to be licensed or registered to conduct securities related business in the jurisdiction where the order, judgment, or decree creating the disqualification was entered, as is the case in the Model Accredited Investor Exemption?
- Does the proposed rule adequately cover the disqualification provisions of Regulation A, which currently apply to Rule 505? For example, proposed Rule 502(e)(1)(iii) would disqualify persons subject to an adjudication or determination

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reasonably could not have known. We have not included the requirement for a factual inquiry to establish the reasonable basis as in the Model Accredited Investor Exemption.

159 17 CFR 230.601 through 230.610a. Regulation E is an exemption from Securities Act registration, promulgated under Section 3(c) of the Securities Act, 15 U.S.C. 77c(c), for securities of small business investment companies.

by a federal or state regulator that the person violated securities or commodities laws or a law under which a business involving investments, insurance, banking, or finance is regulated. Under Rule 262(a)(5), a United States Postal Service false representation order and certain other orders and injunctions are specifically enumerated. Does the proposed rule adequately cover these and other related orders and injunctions? If not, should we revise the proposed rule to specifically cover United States Postal Service orders and injunctions or other specific circumstances?

- Should the disqualification provisions for being currently subject to an order, judgment, decree, or cease and desist order apply as long as the person is subject to the order, no matter when the order was entered into, or should the provisions apply only to orders entered into within the last five years, as proposed?
- The length of disqualification in the proposed rules generally is consistent with our current Rule 262 provisions in Regulation A. The proposal increases the length of disqualification for criminally convicted issuers from 5 years to 10 years. Under the Uniform Securities Act of 2002, a person convicted of a felony involving the business of securities is permanently barred from relying on the exemption. Should such felony convictions permanently disqualify a person? Is 10 years an appropriate disqualification period? Is 5 years an appropriate length of time to protect investors adequately from persons who have been determined to have violated or have been sanctioned for violations of securities-related and similar laws and regulations?
- How should the Commission phase in the new disqualification provisions, if

adopted? Should we "grandfather" individuals and entities from the consequences of the new disqualification provisions if an issuer commences an offering before the effectiveness of proposed Rule 502(e)? With respect to offerings commenced before the effectiveness of proposed Rule 502(e), should we subject individuals and entities that become newly associated with the issuer after effectiveness to all the consequences of the new disqualification provisions? In these cases, should we provide any special waiver provisions and/or condition any waiver on providing disclosure in the offering document regarding any past disqualifying events?

- Would mandatory disclosure of the adverse orders, judgments, and determinations be an adequate substitute for disqualification?[160] If so, how should disclosure be mandated and enforced?
- The proposed rule provides an exemption from the disqualification provisions if, in the exercise of reasonable care, the issuer could not have known that a disqualification existed. Is this appropriate? If so, should an issuer be required to establish that reasonable care was based on a factual inquiry, as required in the Model Accredited Investor Exemption? Are there circumstances where no factual inquiry would be necessary? Would the requirement for a factual inquiry be burdensome?
- Should we revise the disqualification provisions in Regulation A and Regulation E to conform with proposed Rule 502(e)? What changes specific to Regulation A

160 We recently proposed changes to Form D, the form required of issuers relying on Regulation D, that would include requiring each issuer submitting the form to certify that it is not disqualified from relying on Regulation D for one of the reasons stated in proposed Rule 502(e). See Release No. 33-8814 (June 29, 2007) [72 FR 37376].

or Regulation E should we make to the proposed disqualification provisions?

D. Possible Revisions to Rule 504

Rule 504 of Regulation D is known as the "seed capital" exemption. It is limited to offerings by non-reporting companies that do not exceed an aggregate annual amount of $1 million. Rule 504 places substantial reliance upon state securities laws, because the size and local nature of these offerings has not appeared to warrant imposing significant federal regulation.

Rule 504 sets forth the requirements for four separate exemptions from the registration requirements of the Securities Act. Among these is Rule 504(b)(1)(iii),[161] which provides an exemption from registration for offers and sales of securities that are conducted "according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to 'accredited investors' as defined in [Rule 501(a)]."[162] Securities sold without registration in reliance on this provision are not subject to the limitations on resale established in Rule 502(d) and, as such, are not "restricted securities" for purposes of Rule 144(a)(3)(ii).

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161 17 CFR 230.504(b)(1)(iii).

162 Rule 501(a) has been discussed at length at various places above. The other three Rule 504 exemptions, which would not be affected by the possible revisions we are discussing here, are contained in:

(a) the introductory clause of Rule 504(b)(1), 17 CFR 230.504(b)(1) (exemption for offers and sales of restricted securities that do not involve general solicitation and advertising); and

(b) Rules 504(b)(1)(i) and 504(b)(1)(ii), 17 CFR 230.504(b)(1)(i) and 230.504(b)(1)(ii) (exemptions for offers and sales of unrestricted securities that may involve general solicitation and advertising if the offering is registered under appropriate state securities laws that require the public filing and delivery of a disclosure document to investors before sale).

In a companion release, we have proposed to amend Form D, the notice that must be filed with us when an issuer sells securities in a Regulation D offering, to require issuers relying on Rule 504 to specify the precise Rule 504 exemption on which they are relying. See Release No. 33-8814 (June 29, 2007) [72 FR 37376]. One of the purposes of this change is to provide us with better information on the extent of use of the different types of Rule 504 offerings.

We added Rule 504(b)(1)(iii) as a new exemption to Rule 504 in 1999.[163] It was an attempt to apply the appropriate federal securities law treatment to offerings made under state registration exemptions that satisfied its conditions. As an example of these exemptions, we cited the Model Accredited Investor Exemption, which was a model exemption developed in 1997 by the North American Securities Administrators Association.[164] It was our understanding at the time that securities issued under Rule 504(b)(1)(iii) generally could not be transferred under state law, and that immediate resale generally would not be possible.[165]

The addition of Rule 504(b)(1)(iii) in 1999 was part of a series of changes designed to deter abusive practices in Rule 504 offerings while not impeding legitimate "seed capital" offerings. The Commission had been concerned for some time with abusive practices in Rule 504 offerings, many of which involved "pump and dump" schemes for securities of non-reporting companies that traded over the counter. At the time, we stated that we would monitor the use of Rule 504 as revised and contact state securities regulators regarding their experience with these offerings. We further stated that if abusive practices involving Rule 504 continued, we would consider stronger measures in the future.[166]

In recent years, the Commission has taken enforcement action against numerous

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163 See Release No. 33-7644 (Feb. 25, 1999) [64 FR 11090]. Previously, securities sold under Rule 504 were not deemed restricted securities.

164 Id. A copy of the Model Accredited Investor Exemption is available on the NASAA Web site at http://www.nasaa.org/content/Files/Model%5FAccredited%5FInvestor%5FExemption.pdf.

165 See Release No. 33-7644, n. 38.

166 Id. Other suggested measures included the expansion of disqualification provisions similar to those in Rule 505(b)(2)(iii) and Rule 262. We propose to expand such disqualification provisions to all Regulation D offerings in this release. See II.C.2 above.

"pump and dump" schemes, most of which involve the securities of small companies without large market capitalization or significant market following.[167] Several of these cases have involved claims of purported compliance with Rule 504(b)(1)(iii) and state securities laws that are submitted to transfer agents as the basis for the issuance of securities without restrictive legends to permit immediate resale. In informal discussions, state securities regulators also have raised concerns about abusive practices involving Rule 504(b)(1)(iii) offerings. These factors lead us to question whether we should amend Rule 504(b)(1) to provide that the limitations on resale set forth in Rule 502(d) would apply to securities sold in a Rule 504(b)(1)(iii) transaction. Such an amendment would result in those securities being "restricted securities" for purposes of Rule 144.

In a companion release, we have proposed to amend Rule 144 to provide that non-affiliates receiving restricted securities of non-reporting companies would be eligible to resell those securities after 12 months without any restrictions.[168] A 12-month holding period would be consistent with the Model Accredited Investor Exemption. If we adopt the Rule 144 proposal and revise Rule 504(b)(1) to provide that securities sold in a Rule 504(b)(1)(iii) transaction are "restricted securities," the resale restrictions will be less stringent than under current Rule 144.[169]

Request for Comment

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167 See, e.g., SEC v. Integrated Services Group Inc., Lit. Release No. 19476 (Nov. 29, 2005) (reporting complaint filed in S.D. Tex.); SEC v. Custom Designed Compressor Systems, Inc., Lit. Release No. 19101 (Feb. 28, 2005) (reporting complaint filed in D. N.M.).

168 See Release No. 33-8813 (June 22, 2007) [72 FR 36822].

169 For resales of securities by non-affiliates of the issuer, current Rule 144 requires a one-year holding period followed by an additional year when resales are subject to manner of sale restrictions, volume limitations, current public information requirements, and notice requirements. Unlimited resales may occur after the second year.

- The Commission seeks comment as to whether Regulation D should be amended so that securities sold in reliance on Rule 504(b)(1)(iii) pursuant to a state law exemption that permits sales only to accredited investors would be subject to the limitations on resale in Rule 502(d) and, as such, be deemed "restricted securities" for purposes of Rule 144.[170]
- If Regulation D were amended to make securities issued under Rule 504(b)(1)(iii) "restricted securities," would the amendment impose a significant burden on start-up and other smaller companies? If you believe so, please explain your reasons, given the resale restrictions typically required under state securities law exemptions. Do any states have resale restrictions that are narrower than would apply to "restricted securities"?

E. Other Proposed Conforming Revisions

1. Proposed Amendments to Rule 215

We propose to amend Rule 215 to conform the definition of "accredited investor" in Rule 215 with the definition in Rule 501(a) of Regulation D. Rule 215 defines accredited investor under Section 2(a)(15) of the Securities Act[171] for purposes of Section 4(6) of the Securities Act and would track the proposed definition in Rule 501(a) of Regulation D.

2. Proposed Amendment to Rule 144A

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170 We envision that any such amendment would not affect the resale status of securities sold under the exemptions in Rules 504(b)(1)(i) and 504(b)(1)(ii), which exempt certain offerings of securities that are registered under a state securities law that requires the public filing and delivery of a disclosure document to investors before sale. As such, the resale limitations of Rule 502(d) would continue not to apply to securities sold in transactions that are exempted by those rules and those securities would not be "restricted securities" for purposes of Rule 144.

171 15 U.S.C. 77b(a)(15).

Rule 144A currently provides a safe harbor under Section 5 of the Securities Act for offers and resales of securities to a qualified institutional buyer or to an offeree or purchaser that the seller and any person acting on the seller's behalf reasonably believe is a qualified institutional buyer. A general announcement of an offering published by an issuer in accordance with Rule 507 may be deemed inconsistent with the requirement under Rule 144A that offers be made solely to such persons. As a result, we propose to add a Preliminary Note 8 to Rule 144A to clarify that publication of a general announcement of an offering in accordance with Rule 507 would not preclude resales pursuant to Rule 144A.

Request for Comment

- As proposed, Preliminary Note 8 to Rule 144A would not make any distinctions based on the type of security that is being offered pursuant to Rule 507. Should the Preliminary Note only apply to debt securities, as opposed to equity, because debt securities are more likely to be sold to institutional investors?

3. Delegated Authority

Under Rule 30-1,[172] the Commission has delegated to the Director of the Division of Corporation Finance the authority to grant applications for exemptions to the disqualification provisions under Regulation A and Rule 505. As we are proposing to include disqualification provisions for all Regulation D offerings, we propose to revise Rule 30-1(c) to delegate authority to the Director of the Division of Corporation Finance to grant applications for exemptions to the disqualification provisions of Regulation D.

III. General Request for Comment

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172 17 CFR 200.30-1(b)(1), 200.30-1(c).

The Commission is proposing these revisions. We welcome your comments. We solicit comment, both specific and general, on 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 revisions to Regulation D; and
- other matters that may have an effect on the proposals contained in this release.

In December 2006, the Commission proposed to add a new category of accredited investor, defined as accredited natural person, under the Securities Act.[173] We are taking the opportunity to solicit further comment on the questions we asked in connection with that proposal, especially in light of the new proposals in this release. Are there any differences in the regulation of operating and private pooled investment vehicles that we should consider in crafting harmonious rules for limited offerings? Finally, we solicit comment on whether any additional conforming amendments are necessary.

Comment is solicited from the point of view of both issuers and investors, as well as of capital formation facilitators, such as broker-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.

IV. Paperwork Reduction Act

The proposals contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[174] The title of these requirements is:

- "Form D" (OMB Control No. 3235-0076).[175]

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[173] See Private Pooled Investment Vehicle Release.

[174] 44 U.S.C. 3501 et seq.

We adopted Regulation D and Form D as part of the establishment of a series of exemptions for offerings and sales of securities under the Securities Act.[176] We are submitting these requirements to the Office of Management and Budget ("OMB") for review and approval in accordance with the Paperwork Reduction Act and its implementing regulations.[177]

We propose to make changes in four principal areas involving Regulation D, as well as to make other conforming changes, relating to:

- Creating a new exemption from the registration provisions of the Securities Act for offers and sales of covered securities to "large accredited investors";
- Revising the definition of the term "accredited investor" to clarify it and reflect developments since its adoption;
- Shortening the timing required by the integration safe harbor for Regulation D offerings; and
- Providing uniform disqualification provisions to apply throughout Regulation D.[178]

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175 Form D was adopted pursuant to Sections 2(a)(15), 3(b), 4(2), 19(a) and 19(c)(3) of the Securities Act (15 U.S.C. 77b(15), 77c(b), 77d(2), 77s(a) and 77s(c)(3)).

176 In a companion release, Release No. 33-8814, we are proposing changes to Form D that would require that Form D be filed electronically. If Form D is required to be filed electronically, filers will be required to file Form ID in order to be able to file electronically. If the proposal to require electronic Form D is adopted, any increase in the number of companies filing Form D will result in an increase in the number of Form ID filings.

177 44 U.S.C. 3507(d); 5 CFR 1320.11.

178 Currently under Regulation D, only Rule 505 offerings are subject to disqualification provisions. The proposal would subject issuers making any offering in reliance on Regulation D to similar disqualification provisions.

We also are soliciting comment on whether to amend Rule 504 of Regulation D so that securities sold pursuant to a state law exemption that permits sales only to accredited investors would be deemed "restricted securities" for purposes of Rule 144.

The information collection requirements related to the filing with the Commission of Form D are mandatory to the extent that an issuer elects to make an offering of securities in reliance on the relevant exemption. Responses are not confidential. The hours and costs associated with preparing and filing forms and retaining records constitute reporting and cost burdens imposed by the collection of information requirements. 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 OMB control number.

A. Summary of Information Collections

Form D contains collection of information requirements, requiring an issuer to file a notice of sale of securities pursuant to Regulation D or Section 4(6) of the Securities Act. The Form D is required to include basic information about the type of filing, the issuer, certain related persons, and the offering. Form D is filed by issuers as a notice of sales without registration under the Securities Act based on a claim of exemption under Regulation D or Section 4(6) of the Securities Act. The information is needed for implementing the exemptions and monitoring their use.

We propose to amend Form D to add a check box to indicate an offering relying on the proposed Rule 507 exemption. We do not believe the proposed change will have any effect on the paperwork burden of the form. However, we believe the overall effect of the proposals will be to increase the number of forms that are filed with the

Commission. While we anticipate an increase in the number of filings, we believe that most issuers that are seeking capital in the private equity markets would do so even without the proposed amendments. We believe the following proposals are likely to increase the number of exempt offerings and therefore the number of forms filed:

- The proposal to create a new exemption from the registration provisions of the Securities Act for offers and sales to large accredited investors permitting limited advertising, providing issuers a new option for offering securities;
- The proposals to clarify the definition of accredited investor will slightly increase the pool of accredited investors and, due to the increased pool of investors, is likely to marginally increase the number of offerings to those investors;[179] and
- The proposal to shorten the timing of the integration safe harbor will allow issuers to conduct more frequent offerings using the safe harbor.[180]

On the other hand, some of our proposals are likely to decrease the number of exempt offerings and therefore the number of forms filed:

- The proposal to revise the disqualification provisions applicable to Rule 505 and apply those provisions to all offerings relying on Regulation D may have the effect of reducing the number of forms filed.[181]

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179 We propose to add an "investments-owned" standard to the current standards under accredited investor. We anticipate that will increase the pool of accredited investors from 8.47 percent of U.S. households to 8.69 percent of U.S. households. See n. 90. Most of the additional clarification supports current staff positions on who may qualify as an accredited investor and should not significantly affect the size of the investor pool, though it may increase awareness among those groups of their ability to qualify.

180 We anticipate the reduction in the safe harbor waiting period will increase the number of Forms D filed, but do not believe it will increase the number of Forms ID filed, as any increase in Forms D will be from repeat filers.

181 We believe that very few issuers will be subject to the disqualification provisions and expect the number of Forms D filed will be minimally affected. We believe the revisions are necessary in

- The proposal to require for the determination of accredited investors status that an individual may count only 50 percent of any joint investments with their spouse unless both persons sign the investment documentation may reduce the pool of accredited investors where spouses decide not to invest together.
- To the extent that an amendment to revise Rule 504 to treat securities sold pursuant to a state law exemption that permits sales only to accredited investors as "restricted securities" for purposes of Rule 144 may result in potentially greater limitation on resale than may exist under state securities laws, this could have the effect of slightly reducing the number of forms filed.

B. Paperwork Reduction Act Burden Estimates

According to our Office of Filings and Information Services, in 2006, 16,829 companies made 25,329 Form D filings. The annual number of Form D filings rose from 17,390 in 2002 to 25,239 in 2006 for an average increase of approximately 2,000 Form D filings per year. Assuming the number of Form D filings continues to increase by 2,000 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.[182]

As described above, we estimate that our proposals, if adopted, would have mixed effects on the number of Forms D filed with the Commission. Use of the new exemption, the shortened delay for the Regulation D safe harbor, and the slight increase

order to exclude a small number of recidivists who have been found by regulators and courts to have violated applicable laws and regulations.

182 Our current OMB information collection estimate indicates that we expect 17,480 Form D filings per year. In conjunction with the Private Pooled Investment Vehicle Release, OMB revised the Form D information collection estimates to reflect an expected decrease in responses from 17,500 Form D filings to 17,480. However, based on the new data, we are increasing our estimated number of Form D filings.

in the pool of accredited investors due to the revised accredited investor definition likely would raise the number of Forms D filed. The utility of the established exemptions, particularly Rule 506, makes large numbers of Regulation D-exempt offerings that otherwise would not have been filed unlikely. In addition, the new disqualification provisions, some aspects of the revised definition of accredited investor, and the possible revisions to Rule 504 may slightly lower the number of filings.

We estimate that if the proposed rules are adopted, the burden for responding to the collection of information in Form D would not increase for most companies because the information required in the form would not change. Balancing the increasing and decreasing effects of the proposals, for purposes of the Paperwork Reduction Act, we estimate an annual increase in the number of Form D filings of five percent, or approximately 1,500 filings.[183]

For purposes of the Paperwork Reduction Act, we estimate that, over a three-year period, the average burden estimate will be four hours per Form D. This burden is reflected as a one-hour burden of preparation on the company and a cost of $1,200 per filing. Our burden estimates represent the average burden for all issuers. We expect that the burden and costs could be greater for larger issuers and lower for smaller issuers. For Form D notices, we estimate that 25 percent of the burden of preparation is carried by the company internally and that 75 percent of the burden of preparation is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[184] The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the

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183 To arrive at this estimate, we multiplied the number of Form D filings estimated per year (29,300) by 5 percent and rounded up to the nearest 100.

burden carried by the company internally is reflected in hours. We estimate the proposals will incrementally increase the number of Form D filings and therefore the filing burden by 1,500 hours of company personnel time and $1,800,000. Based on this increase, we estimate that the annual compliance burden in the proposed collection of information requirements in hours for issuers making Form D filings will be an aggregate 30,800 hours of company personnel time and $36,960,000 for the services of outside professionals per year.

We request comment on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) 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 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

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[184] The hourly cost estimate is based on our consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing with the Commission.

20549-1090, with reference to File No. [S7-18-07]. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. [S7-18-07], and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 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 assured of having its full effect if OMB receives it within 30 days of publication.

C. Paperwork Reduction Act – Accredited Natural Person

In December 2006, the Commission proposed to add a new category of accredited investor, defined as accredited natural person, under the Securities Act.[185] We do not believe that the additional questions regarding that proposal on which we solicit comment in this release change our analysis under the Paperwork Reduction Act provided in the Private Pooled Investment Vehicle Release. We solicit comment on that conclusion and on whether our estimates continue to be accurate.

V. Cost-Benefit Analysis

A. Background and Summary of Proposals

Adopted in 1982, Regulation D was designed as a comprehensive scheme for exemptions from the registration provisions of the Securities Act for smaller companies attempting to sell securities in private or limited offerings. We are proposing revisions to Regulation D in order to clarify certain rules and definitions and to add a new exemption. The proposed changes include:

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185 See Private Pooled Investment Vehicle Release.

- Providing issuers a more flexible exemption in proposed Rule 507 that would allow limited advertising in offerings of covered securities made exclusively to large accredited investors, a new category of investor proposed in Rule 501(a);
- Revising the definition of the term "accredited investor" to clarify it and reflect developments since its adoption, including adding alternative investments-owned standards to the definition, accounting for future inflation, clarifying the list of legal entities that may qualify as accredited investors and clarifying the meaning of "joint investments";
- Shortening the timing required by the integration safe harbor for Regulation D offerings from six months to 90 days; and
- Providing uniform disqualification provisions to apply throughout Regulation D.

We also are soliciting comment on whether to amend Rule 504 of Regulation D so that securities sold pursuant to a state law exemption that permits sales only to accredited investors would be deemed "restricted securities" for purposes of Rule 144.

We have identified certain costs and benefits that may result from the proposals. We encourage commenters to identify, discuss, analyze and supply relevant data regarding these or any additional costs and benefits.

B. Benefits

We believe the proposals will benefit investors by providing a new offering exemption to issuers, clarifying our existing rules and barring certain recidivists from offering securities in Regulation D exempt offerings. The benefits discussed are difficult to quantify and value. Generally, we believe the proposals will reduce the cost of Regulation D exempt offerings and thereby encourage issuers to substitute this form of offering for more costly alternatives, thereby lowering the cost of capital generally. The benefits of the proposals may include the following:

- Proposed Rule 507 would allow for limited advertising in offerings made exclusively to large accredited investors. Permitting limited advertising in an exempt offering would provide issuers more efficient access to the pool of potential investors and capital. This may reduce the cost of capital formation by allowing issuers to contact investors directly, and avoid the need for financial intermediaries to provide unnecessary costly assistance in the effort to raise capital. Finally, offerings of covered securities are preempted from state registration requirements permitting issuers to more readily offer their securities nationally.
- The proposal to revise the definition of accredited investor would add alternative investments-owned standards to the current accredited investor standards. We believe an investments-owned standard is both easier to establish and a more accurate indicator of whether an investor needs the protections afforded by registration, providing issuers a potentially better way of identifying accredited investors.[186] We believe the proposed standards would decrease the cost of establishing accredited investor qualification and slightly expand the number of accredited investors, thereby increasing the pool of potential investors and thus potentially benefiting investors by decreasing the cost of capital.

[186] If the criteria to determine accredited investor status are easier to apply, the cost of determining accredited investor status and the risk of sales to non-accredited investors would decrease. This would also lower the risk that the issuer may need to make a rescission offer or that an investor may inappropriately invest in an offering.

- The proposal would revise the accredited investor thresholds to account for future inflation, to clarify the meaning of "joint investments" and to clarify the list of legal entities that may qualify as accredited investors. Greater clarity in the rule would generally benefit investors by making the rule easier to apply and easing regulatory burdens on issuers.
- The proposal to shorten the Regulation D integration safe harbor from six months to 90 days would provide issuers greater flexibility to conduct more frequent offerings to meet unpredictable financing needs. Greater flexibility would allow issuers to better time their offerings, benefiting investors by potentially lowering the cost of capital.
- The proposal to establish uniform bad actor disqualification provisions to apply throughout Regulation D would preclude certain issuers from relying on Regulation D exemptions. We believe these disqualification provisions will help to keep recidivists out of the limited and private offering market. By deterring bad actors from conducting exempt offerings under Regulation D, we believe we may reduce fraud in the market, thereby ultimately lowering the cost of capital.
- An amendment to revise Rule 504 to treat securities sold pursuant to a state law exemption that permits sales only to accredited investors as "restricted securities" for purposes of Rule 144 would likely have a deterrent affect on abusive practices, such as "pump and dump" schemes for securities of non-reporting companies that trade over the counter.

C. Costs

Our proposals may impose some costs on investors by placing additional regulatory burdens on issuers. We have estimated for our Paperwork Reduction Act analysis that the proposals will increase the number of Form D filings by 1,500, resulting in $2,062,500 in additional costs relating to the filing of additional Forms D.[187] Many of the costs are dependent on a number of factors, but may include:

- Proposed Rule 507 would allow limited advertising in an exempt offering to large accredited investors. If the proposed rule is successful, issuers may substitute Rule 507 offerings for registered offerings, resulting in investors losing some of the informational and enforcement benefits of federal securities registration. Investors in the covered securities to be offered under Rule 507 in lieu of registered offerings also may incur costs due to the lost benefits of state registration and oversight.
- We expect that the majority of Rule 507 offerings would be undertaken by issuers in lieu of Rule 506 offerings, since all large accredited investors eligible to participate in Rule 507 offerings also would be eligible to participate in Rule 506 offerings. We believe the informational, enforcement and state registration and oversight benefits of Rule 507 would be the same as those of Rule 506, with no difference in costs to investors.
- Proposed Rule 507 may also cause certain issuers to undertake an offering of securities that they otherwise may not have undertaken in the absence of the new

187 We estimate that the burden of preparation for the 1,500 additional Form D filings carried by outside professionals will cost $1,800,000 and an additional 1,500 hours of company personnel time which we estimate to be valued at $175 per hour.

rule. The costs to conduct a Rule 507 offering, including attorney and accountant fees, as well as the costs related to limited advertising permissible in Rule 507 offerings, would be in lieu of the costs of other traditional financing methods, such as bank loans or the costs of not raising additional capital.

- If there is an increase in fraudulent activity through the limited advertising and solicitation allowed under proposed Rule 507, such activity could discourage the use of the exemption and other Regulation D exemptions generally, and thereby have the unintended consequences of increasing the cost of capital formation above what would occur in the absence of the rule amendment.
- The proposal to account for future inflation in the definition of accredited investor would limit the growth and could shrink the pool of accredited investors, imposing costs on investors by increasing issuers' cost of capital relative to what would occur in the absence of the rule amendment.
- The proposal to establish uniform disqualification provisions to apply throughout Regulation D may disqualify certain issuers from undertaking Regulation D exempt offerings relative to what would occur without the rule amendment. The application of the proposed disqualification provisions would add an additional cost to offerings for investigations in order to determine whether any of the participants in the offering will cause the issuer to be disqualified.[188] In addition,

[188] Under the current rules, disqualification provisions are included in Rule 505, but do not apply to Rule 504 or Rule 506. As proposed, the new disqualification provisions would apply to all Regulation D exemptions. Therefore, new costs would apply to offerings under Rules 504, 506 and 507. Costs would likely decrease for Rule 505 offerings, since the proposed disqualification provisions would not include "underwriters," which are currently included in the Rule 505 disqualification provisions.

a disqualified issuer would not have access to Regulation D, which would likely impose costs on investors by increasing the cost of raising capital for the issuer.

- An amendment to revise Rule 504 to treat securities sold pursuant to a state law exemption that permits sales only to accredited investors as "restricted securities" for purposes of Rule 144 could result in potentially greater limitations on resale than may exist under state securities laws.

D. Request for Comment

We solicit comments on the costs and benefits of the proposed revisions. We request your views on the costs and benefits described above, as well as on any other costs and benefits that could result from the adoption of these proposals. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits. Specifically, we ask the following:

- What are the costs and benefits of limited advertising and greater flexibility in the proposed Rule 507 exemption?
- What are the nature and extent of the costs and benefits to investors that would result from amending the accredited investor standards as proposed? Are there costs to accredited investors relating to the application of the investments-owned standard?
- What are the costs and benefits of the shortened 90-day integration safe harbor?
- What are the costs and benefits of the disqualification provisions we propose for Regulation D?

- What would be the costs and benefits if we revised Rule 504 to treat securities sold pursuant to a state law exemption that permits sales only to accredited investors as "restricted securities" for purposes of Rule 144?

In general, we request comment on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposals not already defined, that may result from the adoption of these proposed amendments and rules. We generally request comment on the competitive benefits or anticompetitive effects that may impact any market participants if the proposals are adopted as proposed. We also request comment on what impact the proposals, if adopted, would have on efficiency and capital formation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

E. Accredited Natural Person

In December 2006, the Commission proposed to add a new category of accredited investor, defined as accredited natural person, under the Securities Act.[189] We do not believe that the additional questions regarding that proposal on which we solicit comment in this release change the cost-benefit analysis we provided in connection with that proposal. We solicit comment on that conclusion. For example, would changing the thresholds on who can invest materially affect investors in or issuers of pooled investment vehicles? We also welcome further comments on all aspects of that analysis.

VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

A. General

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189 See Private Pooled Investment Vehicle Release.

Section 2(b) of the Securities Act[190] 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. The proposals are intended to modernize and streamline Regulation D without compromising investor protection.

We do not believe most of the proposals will place a significant burden on or otherwise affect competition. The proposed Rule 507 exemption, the revisions to the definition of accredited investor and the Regulation D safe harbor would apply equally to all issuers and should encourage additional Regulation D offerings. The limited advertising permitted in the proposed Rule 507 exemption may provide issuers with a competitive alternative to using finders and private placement agents to locate prospective investors in exempt offerings. This may help to reduce an issuer's costs of raising capital. The proposed disqualification provisions may provide a competitive disadvantage for issuers subject to them, as such issuers would be required to take appropriate actions to no longer be subject to the disqualification, seek a waiver or raise capital through a registered offering rather than use Regulation D. We believe any disadvantage would be tempered by an issuer's ability to avoid disqualification by dissociating from the disqualified person or seeking a waiver.

We believe our proposals may positively affect efficiency and capital formation. The proposals to provide a new exemption that allows limited advertising in offerings made exclusively to large accredited investors and to shorten the time frame of the

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190 15 U.S.C. 77b(b).

Regulation D integration safe harbor should both promote more efficient allocation of resources and increase capital formation, by allowing issuers greater flexibility in their choice of the method and timing of their offerings. We believe the proposals to add alternative investments-owned standards and to clarify the definition of accredited investors would promote efficiency by providing clearer guidance on the application of the accredited investor standard. The proposal to account for future inflation may reduce the number of accredited investors and add complications when calculating new accredited investor thresholds in the future, but also would limit the erosion of the accredited investor threshold over time. Finally, the application of bad actor disqualification provisions to all offerings under Regulation D would require issuers to determine whether executive officers and other related parties would subject the issuer to the disqualification provisions. Issuers subject to the disqualification provisions would be able to seek capital through registered offerings, with their heightened protections for investors. Although this would add costs to an issuer's capital formation, we believe this provision would serve more generally to promote capital formation by providing additional investor protection and inspiring greater confidence in the private equity markets.

We are soliciting comment on whether to amend Rule 504 so that securities sold pursuant to a state law exemption that permits sales only to accredited investors would be deemed "restricted securities" for purposes of Rule 144. Given the resale restrictions typically required under state securities law exemptions, if this amendment were adopted, we do not believe it would have a material affect on issuers' ability to raise capital.

We request comment on whether the proposed amendments, if adopted, would promote or burden efficiency, competition and capital formation. Finally, we request commenters to provide empirical data and other factual support for their views if possible. We believe adoption of the proposed revisions to Regulation D would have a minor impact on competition, and would have a positive impact on the efficiency of raising capital and on capital formation.

B. Accredited Natural Person

In December 2006, the Commission proposed to add a new category of accredited investor, defined as accredited natural person, under the Securities Act.[191] We do not believe that the additional questions regarding that proposal on which we solicit comment in this release change our analysis under Section 2(b) of the Securities Act with respect to that proposal. We solicit comment on that conclusion. For example, would harmonized definitions increase the efficiency of limited offerings? Would different investment thresholds affect capital formation? We also welcome further comments on all aspects of that analysis.

VII. 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 revisions to Regulation D under the Securities Act.

A. Reasons for the Proposed Action

Our objective in this effort is to clarify and modernize our rules to bring them into line with the realities of modern market practice and communications technologies without compromising investor protection. Action in this area also is timely because our Advisory Committee on Smaller Public Companies made a number of recommendations

[191] See Private Pooled Investment Vehicle Release.

relating to private and limited offerings in its final report dated April 23, 2006. We propose to revise Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the rules through:

- Creating a new exemption from the registration provisions of the Securities Act for offers and sales of covered securities to "large accredited investors";
- Revising the definition of the term "accredited investor" to clarify it and reflect developments since its adoption;
- Shortening the timing required by the integration safe harbor for Regulation D offerings; and
- Providing uniform disqualification provisions to apply throughout Regulation D.

B. Objectives

The goal of Regulation D was to facilitate capital formation consistent with the protection of investors through simplification and clarification of existing exemptions, expansion of their availability and greater uniformity between federal and state exemptions. Our proposals offer revisions that would continue to simplify and clarify the exemptions and facilitate capital formation for smaller issuers, while protecting investors.

We propose to provide issuers with a more flexible safe harbor exemption in Rule 507 that would allow limited advertising in offerings made exclusively to large accredited investors. Proposed Rule 507 would permit issuers to publish a limited announcement of their offering, thereby providing issuers with greater access to potential investors and reducing their costs of raising capital. We also propose to adjust the definition of accredited investor:

- To add alternative investments-owned standards along with the current total asset and net worth standards, because an investments-owned standard may be easier to use and may provide a more accurate method to assess an investor's need for the protections of registration under the Securities Act;
- To adjust the dollar-amount thresholds in Rule 501 to account for inflation so that the thresholds will not erode over time;
- To clarify the list of legal entities that may qualify as accredited investors to eliminate existing uncertainty regarding the list;
- To clarify under the definition of "joint investments" that only 50 percent of the assets held jointly by spouses should be used in determining an individual's accredited investor status.

In addition, we propose to shorten the Regulation D integration safe harbor from six months to 90 days to provide flexibility to issuers to meet financing needs, which often are unpredictable. Finally, we propose that certain issuers be precluded from relying on Regulation D if they are subject to the disqualification provisions in proposed Rule 502(e). We believe these disqualification provisions will serve to guard against fraud in exempt offerings and improve the market's perceptions of these offerings, thereby reducing the cost of capital.

We are soliciting comment on whether to amend Rule 504 so that securities sold pursuant to a state law exemption that permits sales only to accredited investors would be deemed "restricted securities" for purposes of Rule 144. Given that Rule 504 issuers tend to be small entities, this amendment would affect small entities, to the extent that Rule 144 restrictions would be greater than current state law restrictions.

C. Legal Basis

The amendments are being proposed under the authority set forth in Sections 2(a)(15), 3(b), 4(2), 4(6), 18, 19, and 28 of the Securities Act.

D. Small Entities Subject to the Proposed Rules

The proposals would affect issuers that are small entities. For purposes of the Regulatory Flexibility Act under our rules, an issuer is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year.[192] For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. The proposed amendments would apply to all issuers that rely on Regulation D for an exemption to Securities Act registration.

All issuers that offer securities in reliance on Regulation D must file a Form D with the Commission. However, the vast majority of companies filing Form D are not required to provide financial reports to the Commission. As previously noted, in 2006, 16,829 issuers filed Form D. We believe that many of these issuers are small entities, but we currently do not collect information on total assets to determine if they are small entities for purposes of this analysis.

E. Reporting, Recordkeeping and Other Compliance Requirements

None of our proposed revisions to Regulation D would increase in any material way the information or time required to complete the Form D that must be filed with the Commission in connection with a Regulation D transaction. Our proposed revisions

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192 17 CFR 230.157.

would also not require any further disclosure than is currently required in offerings made in reliance on Regulation D, other than requiring each issuer submitting a Form D to certify that it is not disqualified from relying on Regulation D for one of the reasons stated in proposed Rule 502(e).[193]

Proposed Rule 507 would permit an issuer to publish a limited advertisement and to solicit large accredited investors. The limitations of the advertisement are detailed in Rule 507(b)(2)(ii). The exemption builds on the accredited investor definition in Regulation D, requiring that an issuer evaluate whether investors meet the large accredited investor eligibility requirements. The same systems and procedures an issuer would use to determine accredited investor eligibility would be required to determine large accredited investor eligibility. Issuers may need to establish new procedures if they intend to make an offering on their own and relied on financial intermediaries to establish the procedures in the past.

Proposed Rule 502(e), establishing uniform disqualification provisions throughout Regulation D, would require issuers to determine whether the issuer, any predecessor of the issuer, any affiliated issuer, any director, executive officer, general partner or managing member of the issuer, any beneficial owner of 20 percent or more of any class of its equity securities, or any promoter currently connected with the issuer is subject to any of the disqualification provisions.

F. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no rules that conflict with or duplicate the proposed rules.

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193 In a companion release, we are proposing this change to Form D. See Release No. 33-8814 (June 29, 2007) [72 FR 37376].

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective of our proposals, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments and rules, we considered the following alternatives:

- the establishment of different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- the clarification, consolidation, or simplification of the rule's compliance and reporting requirements for small entities;
- the use of performance rather than design standards; and
- an exemption from coverage of the proposed rules, or any part thereof, for small entities.

Regulation D provides exemptions to the registration requirements under the Securities Act. The proposed amendments to Regulation D would apply equally to all issuers that rely upon these exemptions. The regulation is designed to facilitate access to capital by providing exemptions to registration under the Securities Act. These exemptions allow issuers to raise capital without having to expend the time and resources necessary to undertake a registered public offering. Our proposals are intended to further the goals of Regulation D through simplification and clarification of the exemptions, expansion of their availability and by providing greater uniformity between federal and state exemptions.

With respect to the establishment of special compliance requirements or timetables under the proposals for small entities, we do not think this is feasible or appropriate. Our proposals are designed to further facilitate issuers' access to capital for both large and small issuers. Excepting small entities from our proposals would increase, rather than decrease, their regulatory burden. Nevertheless, we request comment on whether it is feasible or appropriate for small entities to have special requirements or timetables for compliance with our proposals.

With respect to clarification, consolidation and simplification of Regulation D's compliance and reporting requirements for small entities, we believe our proposals are designed to streamline and modernize Regulation D for all issuers, both large and small. Nevertheless, we request comment on ways to clarify, consolidate, or simplify any part of the proposed amendments and rules.

With respect to the use of performance or design standards, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context. Because the proposed rules seek compliance with specific standards without seeking to achieve pre-determined levels of capital formation or offering activity, design standards are necessary to achieve the objective of the proposals. Nevertheless, we request comment on these matters.

With respect to exempting small entities from coverage of these proposed rules, we believe such changes would be impracticable. These proposed rules are designed to facilitate an issuer's access to capital, regardless of the size of the issuer. We have endeavored throughout these proposed amendments and rules to minimize the regulatory burden on all issuers, including small entities, while meeting our regulatory objectives. Nevertheless, we request comment on ways in which we could exempt small entities from coverage of any unduly onerous aspects of our proposed amendments and rules.

H. Request for 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 proposals;
- The existence or nature of the potential impact of the proposals on small entities discussed in the analysis; and
- How to quantify the impact of the proposed rules.

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 proposals are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

I. Accredited Natural Person

In December 2006, the Commission proposed to add a new category of accredited investor, defined as accredited natural person, under the Securities Act.[194] We do not believe that the additional questions regarding that proposal on which we solicit comment in this release change our Initial Regulatory Flexibility Analysis provided on that proposal. We solicit comment on that conclusion and welcome further comments on all aspects of that analysis.

VIII. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[195] a rule is "major" if it has resulted, or is likely to result in:

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194 See Private Pooled Investment Vehicle Release.

195 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

- 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.

IX. Statutory Basis and Text of Proposed Amendments

The amendments are being proposed under the authority set forth in Sections 2(a)(15), 3(b), 4(2), 4(6), 18, 19 and 28 of the Securities Act, as amended.

TEXT OF PROPOSED AMENDMENTS

List of Subjects

17 CFR Part 200

Authority delegations (Government agencies).

17 CFR Part 230 and 239

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 200 – ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The authority citation for Part 200, Subpart A, continues to read, in part, as follows:

Authority: 15 U.S.C. 77o, 77s, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 80a-37, 80b-11, and 7202, unless otherwise noted.

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2. Amend § 200.30-1 by revising paragraph (c) to read as follows:

§ 200.30-1 Delegation of authority to Director of Division of Corporation Finance.

* * * * *

(c) With respect to the Securities Act of 1933 (15 U.S.C. 77a et seq.) and Regulation D thereunder (§ 230.501 et seq. of this chapter), to authorize the granting of applications under Rule 502(e)(2)(ii) (§ 230.502(e)(2)(ii) of this chapter) upon the showing of good cause that it is not necessary under the circumstances that the exemption under Regulation D be denied.

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PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

3. The 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.

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4. Amend § 230.144A by adding Preliminary Note 8 to read as follows:

§ 230.144A Priv esales of securities to institutions.

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he publication of a general announcement of an offering in accordance

(17 CFR § 230.507) would not preclude resales pursuant to Rule 144A.

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5. Amend § 230.146 by adding paragraph (c) to read as follows:

0.146 Rules under section 18 of the Act.

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(c) Definition of Qualified Purchaser. For purposes of Section 18(b)(3) of the Act (15 U.S.C. 77r(b)(3)), the term "qualified purchaser" shall mean any large accredited investor as defined in § 230.501(k) with respect to an offer or sale in compliance with § 230.507, but this paragraph does not prohibit a state from imposing notice filing requirements that are substantially similar to those imposed by the Commission for transactions with such investors.

6. Amend § 230.215 by revising it to read as follows:

§ 230.215 Accredited Investor.

The term accredited investor as used in section 2(a)(15)(ii) of the Securities Act of 1933 (15 U.S.C. 77b(a)(15)(ii)) shall include the following persons:

(a) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act, whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company

Act of 1940 or business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to this § 230.215); or any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such statute, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to this § 230.215) or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(b) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(c) Any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body, or other legal entity with substantially similar legal attributes, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to this § 230.215);

(d) Any director, executive officer, general partner, or managing member of the issuer of the securities being offered or sold, or any director, executive officer, general partner, or managing member of a general partner or managing member of that issuer;

(e) Any natural person whose individual net worth, or aggregate net worth with that person's spouse, at the time of purchase exceeds $1,000,000 or whose individual investments, or joint investments with that person's spouse, at the time of purchase exceeds $750,000 (each as adjusted for inflation in accordance with the Note to this § 230.215);

(f) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or aggregate income with that person's spouse in excess of $300,000 in each of those years (each as adjusted for inflation in accordance with the Note to this § 230.215) and has a reasonable expectation of reaching the same income level in the current year;

(g) Any trust, with total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to this § 230.215), not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and

(h) Any entity in which all of the equity owners are accredited investors.

Note to § 230.215: The dollar amounts of the accredited investor thresholds as set forth in paragraphs (a), (c), (e), (f) and (g) of this section shall be adjusted for inflation every five years, with the first adjustments effective July 1, 2012, by appropriate publication by the Commission in the Federal Register. The inflation adjustments shall be computed by: Dividing the annual value of the Personal Consumption Expenditures

Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and Multiplying the dollar amounts by the quotient obtained. The adjusted dollar amounts shall be rounded to the nearest multiple of $10,000.

Instruction to § 230.215: All terms used in the definition of "accredited investor" shall have the meaning indicated in § 230.501.

7. The general authority citation for Part 230, Regulation D – Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933 is revised to read as follows:

Authority: Section 230.501 to 230.508 issued under 15 U.S.C. 77c, 77d, 77r, 77s, and 77z-3.

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8. Amend Preliminary Note 2 to Regulation D, §§ 230.501 through 230.508 by revising the reference to "19(c)" to read "19(d)".

9. Amend § 230.501 by:

a. Revising paragraph (a).

b. Redesignating paragraphs (g) and (h) as paragraphs (i) and (l).

c. Revising the reference in newly redesignated paragraph (l)(1)(ii) that reads "(h)(1)(i) or (h)(1)(iii)" to read "(l)(1)(i) or (l)(1)(iii)".

d. Revising the reference in newly redesignated paragraph (l)(1)(iii) that reads "(h)(1)(i) or (h)(1)(ii)" to read "(l)(1)(i) or (l)(1)(ii)".

e. Revising the reference in Note 2 to newly redesignated paragraph (l) that reads "paragraph (h)(3) and the disclosure required by paragraph (h)(4)" to read "paragraph (l)(3) and the disclosure required by paragraph (l)(4)".

f. Adding new paragraphs (g), (h), (j) and (k).

The revisions and additions read as follows:

§ 230.501 Definitions and terms used in Regulation D.

* * * * *

(a) Accredited investor. "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act, whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to paragraph (a)); or any

employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such statute, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to paragraph (a)) or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body, or other legal entity with substantially similar legal attributes, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to paragraph (a));

(4) Any director, executive officer, general partner, or managing member of the issuer of the securities being offered or sold, or any director, executive officer, general partner, or managing member of a general partner or managing member of that issuer;

(5) Any natural person whose individual net worth, or aggregate net worth with that person's spouse, at the time of purchase exceeds $1,000,000 or whose individual investments, or joint investments with that person's spouse, at the time of purchase exceeds $750,000 (each as adjusted for inflation in accordance with the Note to paragraph (a));

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or aggregate income with that person's spouse in excess of $300,000 in each of those years (each as adjusted for inflation in accordance with the Note to paragraph (a)) and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000 or investments in excess of $5,000,000 (each as adjusted for inflation in accordance with the Note to paragraph (a)), not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and

(8) Any entity in which all of the equity owners are accredited investors.

Note to paragraph (a): The dollar amounts of the accredited investor thresholds as set forth in paragraphs (a)(1), (a)(3), (a)(5), (a)(6) and (a)(7) of this section and the large accredited investor thresholds as set forth in paragraphs (k)(1) through (k)(3) of this section shall be adjusted for inflation every five years, with the first adjustments effective July 1, 2012, by appropriate publication by the Commission in the Federal Register. The inflation adjustments shall be computed by: Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and Multiplying the dollar amounts by the quotient obtained. The adjusted dollar amounts shall be rounded to the nearest multiple of $10,000.

* * * * *

(g) Governmental body. "Governmental body" shall mean any:

(1) Nation, state, county, town, village, district or other jurisdiction of any nature;

(2) Federal, state, local, municipal, foreign or other government;

(3) Governmental or quasi-governmental authority of any nature (including any governmental agency, branch, department, official or entity and any court or other tribunal);

(4) Multi-national organization or body; or

(5) Body exercising, or entitled to exercise, any administrative, executive, judicial, legislative, police, regulatory or taxing authority or power of any nature.

(h) Investments. "Investments" shall mean:

(1) Securities (as defined by section 2(a)(1) of the Act), other than securities issued by an issuer that is controlled by the prospective purchaser that owns such securities, unless such issuer is:

(i) An investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), or a company that would be an investment company under section 3(a) but for the exclusions from that definition provided by sections 3(c)(1) through 3(c)(9) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) through 3(c)(9)), or the exclusions provided by § 270.3a-6 or § 270.3a-7 of this chapter, or a commodity pool;

(ii) A company that:

(A) Files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); or

(B) Has a class of securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Act (§§ 230.901 through 230.904); or

(iii) A company with shareholders' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective purchaser acquires the offered securities;

(2) Real estate held for investment purposes;

(3) Commodity interests held for investment purposes. For purposes of this section, commodity interests means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(i) Any contract market designated for trading such transactions under the Commodity Exchange Act (7 U.S.C. 1 et seq.) and the rules thereunder (17 CFR 1.1 through 190.10); or

(ii) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act (17 CFR 30.1 through 30.12);

(4) Physical commodities held for investment purposes. For purposes of this paragraph, physical commodities means any physical commodity with respect to which a commodity interest is traded on a market specified in paragraph (h)(3)(iii) of this section;

(5) To the extent not securities, financial contracts (as such term is defined in section 3(c)(2)(B)(ii) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(2)(B)(ii))) entered into for investment purposes; and

(6) Cash and cash equivalents (including foreign currencies) held for investment purposes. For purposes of this section, cash and cash equivalents include:

(i) Bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and

(ii) The net cash surrender value of an insurance policy.

Note 1 to paragraph (h): Solely for the purpose of determining "investment purposes" in this paragraph (h), real estate shall not be considered to be held for investment purposes by a prospective purchaser if it is used by the prospective purchaser, a sibling, spouse or former spouse, a direct lineal descendant by birth or adoption, or spouse of such lineal descendant or ancestor for personal purposes or as a place of business, or in connection with the conduct of the trade or business of the prospective purchaser or such related person, provided that real estate owned by a prospective purchaser who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code (26 U.S.C. 280A).

Note 2 to paragraph (h): Solely for the purpose of determining "investment purposes" in this paragraph (h), a commodity interest or physical commodity owned, or a financial contract entered into, by the prospective purchaser who is engaged primarily in the business of investing, reinvesting, or trading in commodity interests, physical commodities or financial contracts in connection with such business may be deemed to be held for investment purposes.

Note 3 to paragraph (h): Solely for the purpose of determining whether a prospective purchaser meets the dollar-amount investor thresholds in Regulation D, the aggregate amount of investments owned and invested on a discretionary basis shall be the investments' fair market value on the most recent practicable date or their cost provided that in the case of commodity interests, the amount of investments shall be the value of the initial margin or option premium deposited in connection with such commodity interests. There shall be deducted from the amount of such investor's investments the amount of any outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments owned by such person.

* * * * *

(j) Joint investments. "Joint investments" shall mean:

(1) In the case of a purchase binding on both spouses and where both spouses sign the investment documentation, the aggregate of their investments held individually and their investments held jointly or as community property or similar shared ownership interest; or

(2) In the case of a purchase made by an individual spouse or where only an individual spouse signs the investment documentation, the aggregate of the investments held individually by the purchaser and 50 percent of any investments held jointly with the individual's spouse or as community property or similar shared ownership interest.

(k) Large accredited investor. "Large accredited investor" shall mean an accredited investor as defined in paragraph (a) of this section, except that:

(1) Any person described in paragraph (a)(1), (a)(3), or (a)(7) of this section required to have a dollar amount of assets shall instead be required to have investments in excess of $10,000,000 (as adjusted for inflation in accordance with the Note to paragraph (a) of this section);

(2) Any person described in paragraph (a)(5) of this section shall be required to have investments, or joint investments with that person's spouse, in excess of $2,500,000 (as adjusted for inflation in accordance with the Note to paragraph (a) of this section);

(3) Any person described in paragraph (a)(6) of this section shall be required to have had an individual income in excess of $400,000 in each of the two most recent years or aggregate income with that person's spouse in excess of $600,000 in each of those years (each as adjusted for inflation in accordance with the Note to paragraph (a) of this section) and have a reasonable expectation of reaching the same income level in the current year; and

(4) All of the equity owners of entities described in paragraph (a)(8) of this section shall be required to be large accredited investors.

* * * * *

10. Amend § 230.502 by:

a. Revising the references that read "six months" in paragraph (a) to read "90 days" and revising the reference that reads "six month periods" in paragraph (a) to read "90-day periods".

b. Adding to the first sentence of paragraph (c) the phrase "or § 230.507(b)(2)(ii)" after the phrase "Except as provided in § 230.504(b)(1)".

c. Adding paragraph (e).

The addition reads as follows:

§ 230.502 General conditions to be met.

* * * * *

(e) Disqualification provisions.

(1) An issuer may not rely on Regulation D if the issuer, any predecessor of the issuer, any affiliated issuer, any director, executive officer, general partner, or managing member of the issuer, any beneficial owner of 20 percent or more of any class of its equity securities, or any promoter currently connected with the issuer:

(i) Within the last 5 years, has filed a registration statement that is the subject of a currently effective permanent or temporary injunction of a court or an administrative stop order or similar order entered by the Commission or the securities commission (or any agency or office performing like functions) of any state;

(ii) Within the last 10 years, has been convicted of a criminal offense in connection with the offer, purchase or sale of any security or involving the making of a false filing with the Commission;

(iii) Within the last 5 years, has been the subject of an adjudication or determination, after notice and opportunity for hearing, by a federal or state regulator that the person violated federal or state securities or commodities law or a law under which a business involving investments, insurance, banking, or finance is regulated; or

(iv) Is currently subject to any order, judgment or decree of any court of competent jurisdiction, entered within the last 5 years, temporarily, preliminarily or permanently restraining or enjoining such party from engaging in or continuing to engage in any conduct or practice involving securities, commodities, investments, insurance, banking, or finance, including an order for failure to comply with § 230.503;

(v) Is currently subject to a cease and desist order, entered within the last 5 years, issued under federal or state securities, commodities, investment, insurance, banking or finance laws; or

(vi) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a national securities exchange registered under section 6 of the Exchange Act or a national securities association registered under section 15A of the Exchange Act for any act or omission to act constituting conduct inconsistent with just and equitable principles or trade.

(2) Paragraph (e)(1) of this section shall not apply if:

(i) Upon a showing of good cause and without prejudice to any other action by the Commission, the Commission determines that it is not necessary under the circumstances that the exemption be denied; or

(ii) The issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under paragraph (e)(1).

* * * * *

11. Amend § 230.503 paragraph (a) by revising the reference that reads "§ 230.504, § 230.505, or § 230.506" to read "§ 230.504, § 230.505, § 230.506, or § 230.507".

12. Amend § 230.504 paragraph (b)(1) by revising the reference that reads "230.502(a), (c) and (d)" to read "230.502(a), (c), (d) and (e)".

13. Amend § 230.505 by removing paragraph (b)(2)(iii).

14. Amend § 230.506 by adding a Note at the end to read as follows:

Note to § 230.506: Securities sold in compliance with § 230.506 are "covered securities" within the meaning of section 18 of the Act by reason of section 18(b)(4)(D) of the Act, which limits state regulation as provided in section 18 of the Act.

15. Amend § 230.507 by revising it to read as follows:

§ 230.507 Exemption for limited offers and sales to large accredited investors.

(a) Exemption. Offers and sales of securities that satisfy the conditions in paragraph (b) of this section by an issuer shall be exempt from the provisions of section 5 of the Act under section 28 of the Act.

(b) Conditions to be met.

(1) General conditions. To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502(a), (c), (d) and (e) to the extent not superseded by paragraph (b)(2)(ii) of this section.

(2) Specific Conditions.

(i) Limitation on purchasers. All purchasers are or the issuer reasonably believes that all purchasers are large accredited investors.

(ii) Limited announcement. Notwithstanding § 230.502(c), offers and sales of securities may qualify for exemption under this section if the issuer or a person acting on the issuer's behalf publishes in written form an announcement of a proposed offering that prominently states that sales will be made to large accredited investors only, no money or other consideration is being solicited or will be accepted through the announcement, and the securities have not been registered with or approved by the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration, and the announcement contains no more than the following optional information:

(A) The name and address of the issuer;

(B) The name, type, number, price and aggregate amount of securities being offered and a brief description of the securities;

(C) A description of what "large accredited investor" means;

(D) Any suitability standards and minimum investment requirements for prospective purchasers in the offering;

(E) A brief description of the business of the issuer in 25 or fewer words; and

(F) The name, address and telephone number of a person to contact for additional information.

(iii) Additional Information. The issuer or a person acting on the issuer's behalf may provide information in addition to the announcement permitted under subparagraph (b)(2)(ii) of this section to a prospective purchaser only if the issuer reasonably believes that the prospective purchaser is a large accredited investor. Information may be delivered to prospective purchasers through an electronic database that is restricted to large accredited investors.

Note 1 to § 230.507: Securities sold to large accredited investors in compliance with § 230.507 are "covered securities" within the meaning of section 18 of the Act by reason of section 18(b)(3) of the Act and § 230.146(c), which limits state regulation as provided in section 18 of the Act.

Note 2 to § 230.507: A private pooled investment vehicle that would be an investment company but for the exclusion provided by § 3(c)(1) or § 3(c)(7) of the Investment Company Act may not rely on § 230.507.

16. Amend § 230.508 by:

a. Revising the references that read "§ 230.504, § 230.505 or § 230.506" in paragraph (a), (a)(3) and (b) to read "§ 230.504, § 230.505, § 230.506 or § 230.507".

b. Revising the reference that reads "and paragraph (b)(2)(i) of § 230.506" in paragraph (a)(2) to read ", paragraph (b)(2)(i) of § 230.506 and paragraph (b)(2)(i) of § 230.507".

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

17. 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, 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.

* * * * *

18. Amend Form D (referenced in § 239.500), by adding a check box that reads "Rule 507" between the "Rule 506" and "Section 4(6)" check boxes in the "Filing Under" information requested in the forepart of the Form.

(Note: The text of Form D does not, and the amendments will not, appear in the Code of Federal Regulations.)

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

Dated: August 3, 2007

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275

[Release No. IA-2628; File No. S7-25-06]

RIN 3235-AJ67

Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting a new rule that prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles. This rule is designed to clarify, in light of a recent court opinion, the Commission's ability to bring enforcement actions under the Investment Advisers Act of 1940 against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle.

EFFECTIVE DATE: [Insert date approximately 30 days from publication in FR]

FOR FURTHER INFORMATION CONTACT: David W. Blass, Assistant Director, Daniel S. Kahl, Branch Chief, or Vivien Liu, Senior Counsel, at 202-551-6787, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Commission is adopting new rule 206(4)-8 under the Investment Advisers Act of 1940 ("Advisers Act").[1]

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1 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified.

Document 5 of 39

I. INTRODUCTION

On December 13, 2006, we proposed a new rule under the Advisers Act that would prohibit advisers to pooled investment vehicles from defrauding investors or prospective investors in pooled investment vehicles they advise.[2] We proposed the rule in response to the opinion of the Court of Appeals for the District of Columbia Circuit in Goldstein v. SEC, which created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser to that pool.[3] In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of "client" as used in that section, the Court of Appeals expressed the view that, for purposes of sections 206(1) and (2) of the Advisers Act, the "client" of an investment adviser managing a pool is the pool itself, not an investor in the pool. As a result, it was unclear whether the Commission could continue to rely on sections 206(1) and (2) of the Advisers Act to bring enforcement actions in certain cases where investors in a pool are defrauded by an investment adviser to that pool.[4]

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2 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Investment Advisers Act Release No. 2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)] (the "Proposing Release"). In the Proposing Release, we also proposed two new rules that would define the term "accredited natural person" under Regulation D and section 4(6) of the Securities Act of 1933 [15 USC 77d(6)] ("Securities Act"). As proposed, these rules would add to the existing definition of "accredited investor" and apply to private offerings of certain unregistered investment pools. On May 23, 2007, we voted to propose more general amendments to the definition of accredited investor. Proposed Modernization of Smaller Company Capital-Raising and Disclosure Requirements, Securities Act Release No. (, 2007) [72 FR (, 2007)]. We plan to defer consideration of our proposal to define the term accredited natural person until we have had the opportunity to evaluate fully the comments we received on that proposal together with those we receive on our May 2007 proposal.

3 451 F.3d 873 (D.C. Cir. 2006) ("Goldstein").

4 Prior to the issuance of the Goldstein decision, we brought enforcement actions against advisers alleging false and misleading statements to investors under sections 206(1) and (2) of the Advisers Act. See, e.g., SEC v. Kirk S. Wright, International Management Associates, LLC, Litigation Release No. 19581 (Feb. 28, 2006); SEC v. Wood River Capital Management, LLC,

In its opinion, the Court of Appeals distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which is not limited to conduct aimed at clients or prospective clients of investment advisers.[5] Section 206(4) provides us with rulemaking authority to define, and prescribe means reasonably designed to prevent, fraud by advisers.[6] We proposed rule 206(4)-8 under this authority.

We received 45 comment letters in response to our proposal.[7] Most commenters generally supported the proposal. Eighteen endorsed the rule as proposed, noting that the rule would strengthen the antifraud provisions of the Advisers Act or that the rule would clarify the Commission's enforcement authority with respect to advisers.[8] Others, however, urged that we

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Litigation Release No. 19428 (Oct. 13, 2005); SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC; Bayou Accredited Fund, LLC; Bayou Affiliates Fund, LLC; Bayou No Leverage Fund, LLC; and Bayou Superfund, LLC, Litigation Release No. 19406 (Sept. 29, 2005); SEC v. Beacon Hill Asset Management LLC, Litigation Release No. 18745A (June 16, 2004).

5 See Goldstein, supra note 3, at note 6. See also United States v. Elliott, 62 F.3d 1304, 1311 (11th Cir. 1995).

6 Section 206(4) of the Advisers Act makes it unlawful for an investment adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and authorizes us "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

7 We received over 600 comment letters that addressed the proposed amendments to the term "accredited natural person" under Regulation D and section 4(6) of the Securities Act. All of the public comments we received are available for inspection in our Public Reference Room at 100 F Street, NE, Washington DC, 20549 in File No. S7-25-06, or may be viewed at www.sec.gov/comments/s7-25-06/s72506.shtml.

8 E.g., Letter of the Alternative Investments Compliance Association (Mar. 5, 2007); Letter of the CFA Center for Financial Market Integrity (Mar. 9, 2007) ("CFA Center Letter"); Letter of the Coalition of Private Investment Companies (Mar. 9, 2007); Letter of the Commonwealth of Massachusetts (Mar. 9, 2007) ("Massachusetts Letter"); Letter of the Department of Banking of the State of Connecticut (Mar. 8, 2007); Letter of the North America Securities Administrators Association (Apr. 2, 2007) ("NASAA Letter"); and Letter of the U.S. Chamber of Commerce (Mar. 9, 2007). Another commenter observed that the proposed rules are broadly similar to current U.K. legislation and regulations. See Letter of Alternative Investment Management Association (Mar. 9, 2007) ("AIMA Letter").

make revisions that would restrict the scope of the rule to more narrowly define the conduct or acts it prohibits.[9]

Today, we are adopting new rule 206(4)-8 as proposed. The rule prohibits advisers from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors. The rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.

II. DISCUSSION

Rule 206(4)-8 prohibits advisers to pooled investment vehicles from (i) making false or misleading statements to investors or prospective investors in those pools or (ii) otherwise defrauding those investors or prospective investors. We will enforce the rule through civil and administrative enforcement actions against advisers who violate it.

Section 206(4) authorizes the Commission to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." In adopting rule 206(4)-8, we intend to employ all of the broad authority that Congress provided us in section 206(4) and direct it at adviser conduct affecting an investor or potential investor in a pooled investment vehicle.

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9 E.g., Letter of American Bar Association (Mar. 12, 2007) ("ABA Letter"); Letter of Davis Polk & Wardwell (Mar. 9, 2007) ("Davis Polk Letter"); Letter of Dechert LLP (Mar. 8, 2007) ("Dechert Letter"); Letter of New York City Bar (Mar. 8, 2007) ("NYCB Letter"); Letter of Schulte Roth & Zabel LLP (Mar. 9, 2007) ("Schulte Roth Letter"); and Letter of Sullivan & Cromwell LLP (Mar. 9, 2007) ("Sullivan & Cromwell Letter").

A. Scope of Rule 206(4)-8

Some commenters questioned the scope of the rule, arguing that the Commission should define fraud.[10] We believe that we have done so, only more broadly than some commenters would have us do. As the Proposing Release indicated, our intent is to prohibit all fraud on investors in pools managed by investment advisers. Congress expected that we would use the authority provided by section 206(4) to "promulgate general antifraud rules capable of flexibility."[11] The terms material false statements or omissions and "acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" encompass the well-developed body of law under the antifraud provisions of the federal securities laws. The legal authorities identifying the types of acts, practices, and courses of business that are fraudulent, deceptive, or manipulative under the federal securities laws are numerous, and we believe that the conduct prohibited by rule 206(4)-8 is sufficiently clear and well understood.[12]

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10 E.g., ABA Letter, supra note 9; Letter of Debevoise & Plimpton LLP (Mar. 14, 2007); and NYCB Letter, supra note 9.

11 S.Rep. No. 1760, 86th Cong., 2d. Sess. (June 28, 1960) at 4. See rule 206(4)-1(a)(5) [17 CFR. 275.206(4)-1(a)(5)] under the Advisers Act; rule 17j-1(b) [17 CFR 270.17j-1(b)] under the Investment Company Act of 1940 [15 U.S.C. 80a-1] ("Investment Company Act"); and rule 13e-3(b)(1) [17 CFR 240.13e-3(b)(1)] under the Securities Exchange Act of 1934 [15 U.S.C. 77a] ("Exchange Act").

12 Loss, Seligman, & Paredes, Securities Regulation, Chap. 9 (Fraud) (Fourth Ed. 2006); Hazen, Treatise on The Law of Securities Regulation, Vol. 3, Ch. 12 (Manipulation and Fraud – Civil Liability; Implied Private Remedies; SEC Rule 10b-5; Fraud in Connection With the Purchase or Sale of Securities; Improper Trading on Nonpublic Material Information) (Fifth Ed. 2005). See, e.g., Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 11 n. 7 (1971) ("'We believe that section 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'" (quoting A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (CA2 1967))); Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."). Moreover, the established legal principles are sufficiently flexible to encompass future novel factual scenarios. United States v. Brown, 555 F.2d 336, 339-40 (2d Cir. 1977) ("The fact that there is no litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors involved but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved.").

1. Investors and Prospective Investors

Rule 206(4)-8 prohibits investment advisers from making false or misleading statements to, or engaging in other fraud on, investors or prospective investors in a pooled investment vehicle they manage. The scope of the rule is modeled on that of sections 206(1) and (2) of the Advisers Act, which make unlawful fraud by advisers against clients or prospective clients. Rule 206(4)-8 prohibits false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to "requests for proposals," electronic solicitations, and personal meetings arranged through capital introduction services.

Some commenters argued that the rule should not prohibit fraud against prospective investors in a pooled investment vehicle, asserting that such fraud does not actually harm investors until they, in fact, make an investment.[13] We disagree. False or misleading statements and other frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.[14] For similar policy reasons that we believe led Congress to apply the protections of sections 206(1) and (2) to prospective clients, we have decided to apply those of rule 206(4)-8 to prospective investors.[15] We believe that prohibiting false or misleading statements made to, or other fraud on, any prospective investors is a means reasonably designed to prevent fraud.

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13 Davis Polk Letter, supra note 9; Dechert Letter, supra note 9; NYCB Letter, supra note 9; Letter of the Securities Industry and Financial Markets Association (Mar. 9, 2007); Sullivan & Cromwell Letter, supra note 9.

14 See CFA Center Letter, supra note 8.

15 We have used the term "prospective investor" to give the term similar scope to the term "prospective client" in sections 206(1) and (2). See, e.g., In the Matter of Ralph Harold Seipel, 38 S.E.C. 256, 257-58 (1958) (the solicitation of clients is part of the activity of an investment adviser and it is immaterial for purposes of an enforcement action under sections 206(1) and (2) that an adviser engaging in fraudulent solicitations was not successful in his efforts to obtain clients).

2. Unregistered Investment Advisers

Rule 206(4)-8 applies to both registered and unregistered investment advisers.[16] As we noted in the Proposing Release, many of our enforcement cases against advisers to pooled investment vehicles have been brought against advisers that are not registered under the Advisers Act, and we believe it is critical that we continue to be in a position to bring actions against unregistered advisers that manage pools and that defraud investors in those pools.[17] The two commenters that expressed an explicit view on this aspect of the proposal supported our application of the rule to advisers that are not registered with the Commission.[18]

3. Pooled Investment Vehicles

The rule we are adopting today applies to investment advisers with respect to any "pooled investment vehicle" they advise. The rule defines a pooled investment vehicle[19] as any investment company defined in section 3(a) of the Investment Company Act[20] and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the Investment Company Act.[21] As a result, the rule

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16 A few commenters requested that we clarify how we intend to apply rule 206(4)-8 to offshore advisers' interaction with non-U.S. investors. See AIMA Letter, supra note 8; Letter of Jones Day (Mar. 9, 2007); Sullivan & Cromwell Letter, supra note 9. Our adoption of this rule will not alter our jurisdictional authority.

17 Proposing Release, supra note 2, at note 14.

18 Massachusetts Letter, supra note 8; NASAA Letter, supra note 8.

19 Rule 206(4)-8(b).

20 15 U.S.C. 80a-3(a). Unless otherwise noted, when we refer to the Investment Company Act, or any paragraph of the Investment Company Act, we are referring to 15 U.S.C. 80a of the United States Code, at which the Company Act is codified.

21 Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company an issuer the securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and that is not making or proposing to make a public offering of its securities. "Qualified purchaser" is

applies to advisers to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as advisers to investment companies that are registered with us.[22]

Several commenters supported applying the protection of the new antifraud rule to investors in all these kinds of pooled investment vehicles, noting, for example, that every investor, not just the wealthy or sophisticated that typically invest in private pools, should be protected from fraud.[23] Some other commenters urged us not to apply the rule to advisers to registered investment companies, arguing that the rule is unnecessary because other provisions of the federal securities laws prohibiting fraud are available to the Commission to address these matters.[24] They expressed concern that application of another antifraud provision with different elements would be burdensome. These commenters claimed that the rule would, for example, make it necessary for advisers to conduct extensive reviews of all communications with clients. But the other antifraud provisions available to us contain different elements because they were not specifically designed to address frauds by investment advisers with respect to investors in pooled investment vehicles. In some cases, the other antifraud provisions may not permit us to

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defined in section 2(a)(51) of the Investment Company Act generally to include a natural person (or a company owned by two or more related natural persons) who owns not less than $5,000,000 in investments; a person, acting for its own account or accounts of other qualified purchasers, who owns and invests on a discretionary basis, not less than $25,000,000; and a trust whose trustee, and each of its settlors, is a qualified purchaser.

22 We have brought enforcement actions under the Advisers Act against advisers to these types of funds. See, e.g., In the Matter of Askin Capital Management, L.P and David J. Askin, Investment Advisers Act Release No. 1492 (May 23, 1995) (hedge fund); In the Matter of Thayer Capital Partners, Investment Advisers Act Release No. 2276 (Aug. 12, 2004) (private equity fund); SEC v. Michael A. Liberty, Litigation Release No. 19601 (Mar. 8, 2006) (venture capital fund).

23 E.g., NASAA Letter, supra note 8.

24 E.g., ABA Letter, supra note 9; Letter of Investment Adviser Association (Mar. 9, 2007); Letter of Investment Company Institute (Mar. 9, 2007) ("ICI Letter"); Sullivan & Cromwell Letter, supra note 9. Commenters noted in particular that section 34(b) of the Investment Company Act already prohibits an adviser from making fraudulent material statements or omissions in a fund's registration statement or in required records.

proceed against the adviser.[25] As a result, the existing antifraud provisions may not be available to us in all cases. As we discussed above, before the Goldstein decision we had brought actions against advisers to mutual funds under sections 206(1) and (2) for defrauding investors in mutual funds.[26] Because, before the Goldstein decision, advisers to pooled investment vehicles operated with the understanding that the Advisers Act prohibited the conduct that this rule prohibits, we believe that advisers that are attentive to their traditional compliance responsibilities will not need to alter their business practices or take additional steps and incur new costs as a result of this rule's adoption.

B. Prohibition on False or Misleading Statements

Rule 206(4)-8(a)(1) prohibits any investment adviser to a pooled investment vehicle from making an untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or omitting to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading.[27]

The provision is very similar to those in many of our antifraud laws and rules that, depending upon the circumstances, may also be applicable to the same investor

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25 This may be the case with respect to section 34(b) of the Investment Company Act, for example, if the adviser's fraudulent statements are not made in a document described in that section, or with respect to rule 10b-5 under the Exchange Act, where the fraudulent conduct does not relate to a misstatement or omission in connection with the purchase or sale of any security.

26 See, e.g., In the Matter of Van Kampen Investment Advisory Corp., Investment Advisers Act Release No. 1819 (Sept. 8, 1999); In the Matter of The Dreyfus Corporation, Investment Advisers Act Release No. 1870 (May 10, 2000); In the Matter of Federated Investment Management Company, Investment Advisers Act Release No. 2448 (Nov. 28, 2005).

27 A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). See also In the Matter of Van Kampen Investment Advisory Corp., supra note 26; In the Matter of the Dreyfus Corporation, supra note 26.

communications.[28] Sections 206(1) and (2) have imposed similar obligations on advisers since 1940 and, before Goldstein, were commonly accepted as imposing similar requirements on communications with investors in a fund. For these reasons, and because the nature of the duty to communicate without false statements is so well developed in current law, we believe that commenters' concerns about the breadth of the prohibition or any chilling effect the new rule might have on investor communications are misplaced.[29] Advisers to pooled investment vehicles attentive to their traditional compliance responsibilities will not need to alter their communications with investors.

Rule 206(4)-8(a)(1) prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities. While the new rule differs in this aspect from rule 10b-5 under the Exchange Act, the conduct prohibited is similar. The new rule prohibits, for example, materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue, the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and practices

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[28] See, e.g., sections 12 and 17 of the Securities Act [15 U.S.C. 77l, 77q]; section 14 of the Exchange Act [15 U.S.C. 78n]; section 34 of the Investment Company Act; rules 156, 159, and 610 under the Securities Act [17 CFR 230.156, 230.159, 230.610]; rules 10b-5, 13e-3, 13e-4, and 15c1-2 under the Exchange Act [17 CFR 240.10b-5, 240.13e-3, 240.13e-4, 240.15c1-2]; and rule 17j-1 under the Investment Company Act [17 CFR 270.17j-1]).

[29] Letter of Managed Funds Association (Mar. 9, 2007) ("MFA Letter"); NYCB Letter, supra note 9; Davis Polk Letter, supra note 9; Dechert Letter, supra note 9; Letter of Seward & Kissel LLP (Mar. 8, 2007) ("Seward & Kissel Letter").

the adviser follows in the operation of its advisory business such as how the adviser allocates investment opportunities.[30]

C. Prohibition of Other Frauds

Rule 206(4)-8(a)(2) makes it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."[31] As we noted in the Proposing Release, the wording of this provision is drawn from the first sentence of section 206(4) and is designed to apply more broadly to deceptive conduct that may not involve statements.[32]

Some commenters asserted that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under the new rule.[33] We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors. That approach would have us adopt the rule prohibiting fraudulent communications but not fraudulent conduct.[34] But, section 206(4) itself specifically authorizes us to adopt rules defining and prescribing "acts, practices and courses of business," (*i.e.*, conduct), and does not explicitly refer to communications, which, nonetheless, represent a form of an act, practice, or

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30 We have previously brought enforcement actions alleging these or similar types of frauds. See Proposing Release, supra note 2, at note 29.

31 Rule 206(4)-8(a)(2).

32 See Section II.C of the Proposing Release, supra note 2.

33 ABA Letter, supra note 9; ICI Letter, supra note 24; Schulte Roth Letter, supra note 9; Sullivan & Cromwell Letter, supra note 9.

34 See, e.g., ABA Letter, supra note 9.

course of business. In addition, rule 206(4)-8 as adopted would provide greater protection to investors in pooled investment vehicles.

Alternatively, commenters would have us adopt a rule prohibiting identified known fraudulent conduct or would have us provide detailed commentary describing specific forms of fraudulent conduct that the rule would prohibit.[35] Either approach would fail to prohibit fraudulent conduct we did not identify, and could provide a roadmap for those wishing to engage in fraudulent conduct. This approach would be inconsistent with our historical application of the federal securities laws under which broad prohibitions have been applied against specific harmful activity.

D. Other Matters

We noted in the Proposing Release that, unlike violations of rule 10b-5 under the Exchange Act, the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter.[36] Commenters questioned whether the rule should encompass negligent conduct, arguing that it would "expand the concept of fraud itself beyond its original meaning."[37] We read the language of section 206(4) as not by its terms limited to knowing or deliberate conduct. For example, section 206(4) encompasses "acts, practices, and courses of business as are . . . deceptive," thereby reaching conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive. In addition, the Court of Appeals for the District of Columbia Circuit concluded that "scienter is not required under section 206(4)."[38]

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35 Id.

36 Section II.B of the Proposing Release, supra note 2.

37 See ABA Letter, supra note 9 at page 3.

38 SEC v. Steadman, 967 F.2d 636, at 647 (D.C. Cir. 1992). The court in Steadman analogized section 206(4) of the Advisers Act to section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter, id. (citing Aaron v. SEC, 446 U.S. 680 (1980)). In discussing section 17(a)(3) and its lack of a scienter requirement, the Steadman court

We believe use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud. As the Supreme Court noted in U.S. v. O'Hagan, "[a] prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited."[39] In O'Hagan, the Court held that under section 14(e) "the Commission may prohibit acts, not themselves fraudulent under the common law or §10(b), if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'"[40] Along these lines, the prohibitions in rule 206(4)-8 are reasonably designed to prevent fraud. We believe that, by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception. Since the Commission clearly is authorized to prescribe conduct that goes beyond fraud as a means reasonably designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective.

Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law. Nor does the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises.[41] The rule, for example, will permit us to bring an enforcement action against an investment adviser that violates a fiduciary duty imposed by other law if the violation of such law or obligation also constitutes an act, practice, or course of

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observed that, similarly, a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence. Id. at 643, note 5. But see Aaron at 690-91 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)); cf. S. Rep. No. 1760, 86th Cong., 2d. Sess. (June 28, 1960) at 8 and H. R. Rep. 2179, 86th Cong., 2d Sess. (Aug. 26, 1960) at 8 (comparing section 206(4) to section 15(c)(2) of the Exchange Act).

39 U.S. v. O'Hagan, 521 U.S. 642, 672-73 (1997).

40 Id. at 673.

41 For example, under the Uniform Limited Partnership Act, advisers who serve as general partners owe fiduciary duties to the limited partners. UNIF. LIMITED PARTNERSHIP ACT § 408 (2001).

business that is fraudulent, deceptive, or manipulative within the meaning of the rule and section 206(4).[42]

Finally, the rule does not create a private right of action.[43]

III. PAPERWORK REDUCTION ACT

The Paperwork Reduction Act of 1995 does not apply because rule 206(4)-8 does not impose a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995. The rule does not create any filing, reporting, recordkeeping, or disclosure requirements for investment advisers subject to the rule. Accordingly, there is no "collection of information" under the Paperwork Reduction Act that requires the approval of the Office of Management and Budget under 44 U.S.C. 3501.

IV. COST-BENEFIT ANALYSIS

The Commission is sensitive to costs imposed by our rules and the benefits that derive from them. In the Proposing Release, we encouraged commenters to discuss any potential costs and benefits that we did not consider in our discussion. Three commenters addressed the issue of cost. Two of them stated their belief that the rule would increase advisers' costs of compliance, by, for example, making it necessary for advisers to conduct extensive reviews of all communications with clients.[44] One stated that the rule would achieve a reasonable balance of

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[42] For example, if an adviser has a duty from a source other than the rule to make a material disclosure to an investor in a fund and negligently or deliberately fails to make the disclosure, the rule would apply to the failure.

[43] The Supreme Court has held that "there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment adviser's contract, but that the Act confers no other private causes of action, legal or equitable." Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 at 24 (1979) (footnote omitted).

[44] NYCB Letter, supra note 9; Seward & Kissel Letter, supra note 29.

providing important benefits to investors at an acceptable cost.[45] None of the three commenters, however, provided analysis or empirical data in connection with their statements.

The rule makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit 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, to any investor or prospective investor in the pooled investment vehicle. The rule also makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. For the reasons discussed, we do not believe that the rule will require advisers to incur new or additional costs.

Investment advisers to pooled investment vehicles should not be making untrue statements or omitting material facts or otherwise be engaged in fraud with respect to investors or prospective investors in pooled investment vehicles today, because federal authorities, state authorities, and private litigants often can, and do, seek redress from the adviser for the untrue statements or omissions or other frauds. In most cases, the conduct that the rule prohibits is already prohibited by federal securities statutes,[46] other federal statutes (including federal wire fraud statutes),[47] as well as state law.[48]

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45 CFA Center Letter, supra note 8.

46 See, e.g., section 10(b) of the Exchange Act [15 U.S.C. 78j(b)] and section 17(a) of the Securities Act [15 U.S.C. 77q] which would apply when the false statements are made "in connection with the purchase or sale of a security" or involve the "offer or sale" of a security, and section 34(b) of the Investment Company Act which makes it unlawful "to make any untrue statement of a

We recognize that there are costs involved in assuring that communications to investors and prospective investors do not contain untrue or misleading statements and preventing other frauds. Advisers have incurred, and will continue to incur, these costs due to the prohibitions and deterrent effect of the law and rules that apply under these circumstances. While each of the provisions noted above may have different limitation periods, apply in different factual circumstances, or require the government (or a private litigant) to prove different states of mind than the rule, as discussed above we believe that the multiple prohibitions against fraud, and the consequences under both criminal and civil law for fraud, should currently cause an adviser to take the precautions it deems necessary to refrain from such conduct.

Furthermore, prior to Goldstein, advisers operated with the understanding that the Advisers Act prohibited the same conduct that would be prohibited by the rule. Accordingly, we do not believe that advisers to pooled investment vehicles attentive to their traditional compliance responsibilities will need to take steps or alter their business practices in such a way that will require them to incur new or additional costs as a result of the adoption of the rule.

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material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to [the Investment Company Act] . . . . "

[47] See, e.g., 18 U.S.C. 1341 (Frauds and Swindles) and 18 U.S.C. 1343 (Fraud by wire, radio, or television) which make it a criminal offense to use the mails or to communicate by means of wire, having devised a scheme to defraud or for obtaining money or property by means of false or fraudulent pretenses, and 18 U.S.C. 1957 (Engaging in monetary transactions in property derived from specified unlawful activity) which makes it a criminal racketeering offense to engage or attempt to engage in a transaction in criminally derived property of a value greater than $10,000.

[48] See, e.g., Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies, 854 A.2d 121, 156 (Del. Ch. 2004) (court held that plaintiff-former member of LLC had sufficiently alleged a common law fraud claim based on allegation that a series of reports by LLC's managers contained misleading statements; court stated that "[i]n the usual fraud case, the speaking party who is subject to an accusation of fraud is on the opposite side of a commercial transaction from the plaintiff, who alleges that but for the material misstatements or omissions of the speaking party he would not have contracted with the speaking party").

We also recognize that the rule may cause some advisers to pay more attention to the information they present to better guard against making an untrue or misleading statement to an investor or prospective investor and to reevaluate measures that are intended to prevent fraud. As a consequence, some advisers might seek guidance, legal or otherwise, and more closely review the information that they disseminate to investors and prospective investors and the antifraud related policies and procedures they have implemented. While increased concern about making false statements or committing fraud could be attributable to the new rule, advisers should already be incurring these costs to ensure truthfulness and prevent fraud, regardless of the rule, because of the myriad of laws or regulations that may already apply.

The principal benefit of the rule is that it clearly enables the Commission to bring enforcement actions under the Advisers Act, if an adviser to a pooled investment vehicle disseminates false or misleading information to investors or prospective investors or otherwise commits fraud with respect to any investor or prospective investor. As noted above, the existing antifraud provisions may not be available to us in all cases. Through our enforcement actions we are able to protect fund investor assets by stopping ongoing frauds,[49] barring persons that have committed certain specified violations or offenses from being associated with an investment adviser,[50] imposing penalties,[51] seeking court orders to protect fund assets,[52] and to order disgorgement of ill-gotten gains.[53] Moreover, we believe that rule 206(4)-8 will deter advisers to pooled investment vehicles from engaging in fraudulent conduct with respect to investors in

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[49] See section 203(k) of the Advisers Act (Commission authority to issue cease and desist orders).

[50] See section 203(f) of the Advisers Act (Commission authority to bar a person from being associated with an investment adviser).

[51] See section 203(i) of the Advisers Act (Commission authority to impose civil penalties).

[52] See section 209(d) of the Advisers Act (Commission authority to seek injunctions and restraining orders in federal court).

[53] See section 203(j) of the Advisers Act (Commission authority to order disgorgement).

those pools and will provide investors with greater confidence when investing in pooled investment vehicles.

V. REGULATORY FLEXIBILITY ACT ANALYSIS

The Commission certified, pursuant to section 605(b) of the Regulatory Flexibility Act, that rule 206(4)-8 will not have a significant economic impact on a substantial number of small entities.[54] This certification was included in the Proposing Release.[55] While we encouraged written comment regarding this certification, none of the commenters responded to this request.

VI. STATUTORY AUTHORITY

We are adopting new rule 206(4)-8 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act (15 U.S.C. 80b-6(4) and 80b-11(a)).

List of Subjects

17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

VII. TEXT OF RULES

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

PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(F), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

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[54] 5 U.S.C. 605(b).

[55] Section VII.A of the Proposing Release, supra note 2.

2. Section 275.206(4)-8 is added to read as follows:

§206(4)-8 Pooled investment vehicles.

(a) Prohibition. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

(b) Definition. For purposes of this section "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)).

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

August 3, 2007

Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles

New Rule 206(4)-8 under the Investment Advisers Act of 1940 ("Advisers Act"),[1] which we adopt today, prohibits advisors from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors.[2] Although the SEC has other ways to reach fraud by advisors, this new rule will fill in gaps in the coverage of other transaction-based, anti-fraud provisions so that the SEC may pursue advisors of pooled investment vehicles who have defrauded investors and prospective investors in the course of their acting as fund advisors. I support the new rule, but I am writing separately to express my disagreement with the conclusions in the Adopting Release[3] related to the requisite mental state for violation of the rule.[4]

In discussing the mental state required for violation of the rule, the Adopting Release states that "the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter."[5] According to the Adopting Release, therefore, the rule covers negligent conduct as well as intentional conduct. My objections to this interpretation of the rule's scope are twofold. First, I do not believe that a negligence standard is consistent with the Commission's authority under Section 206(4). Second, even if a negligence standard were within our authority, for policy reasons, we <u>should</u> require a finding of scienter[6] as part of establishing a violation under this anti-fraud rule.

The Adopting Release offers several arguments in support of a negligence standard. First, it argues that the language of section 206(4) is not limited to knowing or deliberate conduct. In support of this argument, it cites the decision by the United States

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1 15 U.S.C. 80b.

2 17 CFR 275.206(4)-8. Paragraph (a) of the new rule provides:

<u>Prohibition.</u> It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Paragraph (b) of the rule defines a "pooled investment vehicle" to include any investment company and any company that relies on an exclusion from the definition of "investment company" in Section (3)(c)(1) or (3)(c)(7) of the Investment Company Act [15 U.S.C. 80a-3(c)(1) or (7))].

3 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007) ("Adopting Release").

4 <u>See</u> Section II.D of the Adopting Release. I agree with the Section's conclusions with respect to fiduciary duty (Rule 206(4)-8 does not create a fiduciary duty) and private rights of action (Rule 206(4)-8 does not create any private rights of action).

5 Adopting Release, at text accompanying note 36.

6 "Scienter" is "a mental state embracing intent to deceive, manipulate, or defraud." <u>Ernst & Ernst v. Hochfelder</u>, 425 U.S. 185, 194 (1976). Recklessness has also been found to satisfy a scienter standard.

Court of Appeals for the District of Columbia Circuit in SEC v. Steadman.[7] Second, the Adopting Release contends that use of a negligence standard is an appropriate method reasonably designed to prevent fraud. In support of this contention, it cites U.S. v. O'Hagan.[8] I will discuss each of these in turn.

The language of Section 206(4) does not reach negligent conduct. Section 206(4) makes it unlawful for an advisor "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and directs the Commission "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

The Adopting Release maintains that, because Section 206(4) "encompasses 'acts, practices, and courses of business as are ... deceptive,'" it reaches "conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive."[9] As the Supreme Court has said, however, "it is a 'familiar principle of statutory construction that words grouped in a list should be given related meaning.'"[10] Hence, it is inappropriate to base a conclusion that negligent conduct is reached by looking at the term "deceptive" apart from its companion terms.

In the Section 10(b) context, the Supreme Court has accorded special significance to the term "manipulative":

> Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.[11]

The language of Section 206(4), like the language of Section 10(b), would seem then to suggest a scienter requirement.

The Adopting Release, however, cites for the contrary conclusion a decision by the United States Court of Appeals for the District of Columbia. Indeed, it is true that in SEC v. Steadman, the court held that "scienter is not required under section 206(4)."[12] The court reached its conclusion by comparing the language of Section 206(4) to the language of Section 17(a)(3) under the Securities Act of 1933,[13] which makes it unlawful

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7 SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992).

8 U.S. v. O'Hagan, 521 U.S. 642, 672-73 (1997).

9 Adopting Release at Section II.D.

10 Schreiber v. Burlington Northern, Inc. 472 U.S. 1, 8 (1985) (quoting Securities Industry Assn. v. Board of Governors, FRS, 468 U.S. 207, 218 (1984).

11 Hochfelder, 425 U.S. at 199 (footnote to dictionary definition omitted). Hochfelder considered whether scienter was a necessary component of a private action under Section 10(b). In a subsequent case, the Court considered whether scienter was a necessary element of an injunctive action by the SEC and concluded that it was. Aaron v. SEC, 446 U.S. 680, 691 (1980) ("the rationale of Hochfelder ineluctably leads to the conclusion that scienter is an element of a violation of §10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.").

12 Steadman, 967 F.2d at 647.

13 15 U.S.C. 77a et seq.

"to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[14] The Steadman court drew a comparison between Section 17(a)(3)'s "transaction, practice, or course of business" and Section 206(4)'s "act, practice, or course of business." The court, relying on the Supreme Court's decision in Aaron, held that, in both cases, the focus was on effect.[15] The Supreme Court in Aaron, however, placed considerable weight on the terms "operate" or "would operate," neither of which appears in Section 206(4).[16] In fact, Section 206(4) instead uses the affirmative word "is," which would seem to de-emphasize effect.[17] Further, while Section 17(a)(3) speaks of only "fraud" and "deceit," Section 206(4) also includes "manipulative."

It is also helpful to note that Section 206(4), which was adopted in 1960,[18] was modeled on Section 15(c)(2) under the Securities Exchange Act of 1934.[19] Section 15(c)(2) makes it unlawful for brokers and dealers to effect transactions in or induce the purchase or sale of securities in connection with which they "engage[] in any fraudulent, deceptive, or manipulative act or practices, or make[] any fictitious quotation."[20] Hence, as the legislative history of Section 206(4) noted, Section 206(4) "is comparable to section 15(c)(2)."[21] The Steadman opinion did not address the link between Sections 206(4) and 15(c)(2).

Section 14(e) under the Exchange Act, which relates to tender offers, also follows the Section 15(c)(2) pattern.[22] Section 14(e), like Section 206(4), includes both a proscription against "engag[ing] in any fraudulent, deceptive, or manipulative acts or practices" and a directive that the SEC "by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative." Because of the similarities, it is useful to look at the Supreme Court's interpretation of Section 14(e). In Schreiber v. Burlington Northern, the Supreme Court relied on Hochfelder's interpretation of the term "manipulative" in the Section 10(b) context to interpret that term in the Section 14(e) context.[23] The Schreiber Court noted that the addition of the rulemaking authorization to Section 14(e) did not

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14 15 U.S.C. 77q(a)(3).

15 Steadman at 647.

16 Aaron, 446 U.S. at 696-97 ("the language of § 17(a)(3), under which it is unlawful for any person to 'engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit,' quite plainly focuses upon the effect of particular conduct ... rather than upon the culpability of the person responsible.") (emphasis in original).

17 Section 206(4) makes it unlawful "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." (Emphasis added.)

18 S. REP. NO. 86-1760, at 4 (1960) ("The proposal has precedent in similar authority granted to the SEC over brokers and dealers by the Securities Exchange Act of 1934.").

19 15 U.S.C. 78a et seq.

20 15 U.S.C. 78o(c)(2).

21 H.R. REP. NO. 86-2179, at 8 (1960). See also S. REP. NO. 86-1760, at 8 (1960) ("almost the identical wording of section 15(c)(2)").

22 15 U.S.C. 78n(e).

23 Schreiber, 472 U.S. at 12 ("We hold that the term, 'manipulative' as used in § 14(e) requires misrepresentation or nondisclosure. It connotes 'conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.") (citing Hochfelder, 425 U.S. at 199).

"suggest[] any change in the meaning of 'manipulative' itself."[24] In U.S. v. O'Hagan, The Supreme Court again looked at Section 14(e). This time, it considered whether Rule 14e-3(a), which prohibits trading on undisclosed information in connection with a tender offer, exceeds the SEC's authority under Section 14(e) given that the prohibition applies regardless of whether there is a duty to disclose. The Court held that Rule 14e-3(a) was within the SEC's authority under Section 14(e) because Section 14(e) allows the SEC to "prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent ... acts and practices [that] are fraudulent.'"[25] The lesson from both of these cases is that the SEC cannot effect a change in the meaning of specific statutory terms under its comparable Section 206(4) rulemaking authority.

The Adopting Release asserts that, under O'Hagan, a negligence standard is a means reasonably designed to prevent fraud. As the Adopting Release notes, conduct outside of the bounds of the statutory prohibition can be prohibited by Commission rule under Section 206(4). The rule that we are adopting here, however, differs markedly from the rules at issue in O'Hagan and Steadman.[26] Both of those rules were narrowly targeted rules that covered clearly-defined behavior. They were designed to prohibit conduct, that, although outside of the "core activity prohibited" by the statute, were designed to "assure the efficacy" of the statute.[27]

Rule 206(4)-8(a)(2), by contrast, is as broad as the statute itself. It essentially repeats the statutory prohibition. It does not logically follow, therefore, that lowering the standard of care would be the type of "means reasonably designed to prevent" within the contemplation of the regulatory mandate within Section 206(4). Lowering the standard of care is instead an attempt to rewrite the statute by assigning new definitions to the words of the statute. A potential unfortunate consequence of the Adopting Release's change in mental state is that it is now arguably contrary to statute and therefore might interfere with the SEC's ability to use the rule effectively.[28] Congress included a rulemaking directive in order to give the SEC the necessary authority to provide clarity in this area about the types of practices covered by the statute's broad prohibition,[29] not to

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24 Id. at 12 n.11.

25 O'Hagan, 521 U.S. at 672-73.

26 O'Hagan dealt with Rule 14e-3(a), which governed trading on non-public, material information in connection with a tender offer. Steadman dealt with Rule 206(4)-2, the investment advisor custody rule.

27 O'Hagan, 521 U.S. at 673-74.

28 See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984). The Adopting Release states: "Since the Commission is clearly authorized to prescribe [*sic*] conduct that goes beyond fraud as a means reasonably designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective." Adopting Release at Section II.D. This does not answer the question, however, of whether "fraudulent, deceptive, or manipulative" conduct can arise from negligent acts.

29 Up until now under Section 206(4), we have done exactly this. We have adopted rules covering advertisements [17 CFR 275.206(4)-1], custody of client funds and securities [17 CFR 275.206(4)-2], cash payments for client solicitations [17 CFR 275.206(4)-3], disclosure of financial and disciplinary information [17 CFR 275.206(4)-4], proxy voting [17 CFR 275.206(4)-6], and compliance procedures [17 CFR 275.206(4)-7].

alter the standard of care that Congress selected through the language it used.[30] Imposing a negligence standard is particularly improper given that, as the Adopting Release notes, "Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors and prospective investors in a pooled investment vehicle."[31]

Finally, from a purely practical perspective, I dispute the regulatory approach underlying the contention that "by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception."[32] By an extension of that same logic, a strict liability standard would evoke even more care by advisors. Even if the SEC is authorized to pick the standard of care that applies broadly to all "fraudulent, deceptive, or manipulative" acts and practices, arbitrarily selecting a higher standard of care "just to be on the safe side" has the potential of misdirecting enforcement and inspection resources and chilling well-intentioned advisors from serving their investors.

[30] See H.R. Rep. No. 2179 at 7 (1960) (identifying as the "problem" that Section 206(4) was intended to remedy: "there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit.").

[31] Adopting Release at Section II.D.

[32] Adopting Release at Section II.D.

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210 and 240

[RELEASE NOS. 33-8829; 34-56203; File No. S7-24-06]

RIN 3235-AJ58

Definition of the Term Significant Deficiency

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are defining the term "significant deficiency" for purposes of the Commission's rules implementing Section 302 and Section 404 of the Sarbanes-Oxley Act of 2002.

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

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 adopting amendments to Rule 12b-2[1] under the Securities Exchange Act of 1934 (the "Exchange Act")[2] and Rule 1-02[3] of Regulation S-X.[4]

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[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.

Document 6 of 39

I. BACKGROUND

On June 27, 2007, the Commission issued interpretive guidance and rule amendments to help public companies strengthen their evaluations and assessments of internal control over financial reporting ("ICFR") while reducing unnecessary costs.[5] The Interpretive Release provides guidance for management on how to conduct an evaluation of the effectiveness of a company's ICFR under the Commission's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002.[6] The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of ICFR. The rule amendments, among other things, provide that an evaluation that complies with the interpretive guidance is one way to satisfy the annual evaluation requirement in Exchange Act Rules 13a-15(c) and 15d-15(c).[7] The Interpretive Release also added a definition of the term "material weakness" to the Commission's rules. The term is defined as "a deficiency, or 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."[8]

As part of the Commission's efforts to provide more guidance to management on ICFR, the Commission initially sought comment on both the terms "significant

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[5] See Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310, Jun. 27, 2007] and Release No. 33-8810 (Jun. 20, 2007) [72 FR 35324, Jun. 27, 2007] (hereinafter "Interpretive Release").

[6] 15 U.S.C. 7262.

[7] 17 CFR 240.13a-15(c) and 15d-15(c).

[8] See Rule 1-02(p) of Regulation S-X [17 CFR 210.1-02(p)] and Exchange Act Rule 12b-2 [17 CFR 240.12b-2]. In this release, we are moving the definitions to new paragraph (a)(4) of Rule 1-02.

deficiency" and "material weakness" in a concept release on ICFR requirements,[9] and then proposed and adopted a definition of the term "material weakness."[10] Several commenters pointed out that while the proposing release for the interpretive guidance[11] referenced the term "significant deficiency," the Commission did not include a definition of the term in the proposal.[12] Certain commenters indicated that the Commission should include a definition of significant deficiency in the Interpretive Release.[13]

In light of the comments received in response to the proposed interpretive guidance, and because Commission rules implementing Section 302(a) of the Sarbanes-Oxley Act require senior management to certify they have communicated significant deficiencies to the audit committee and the external auditors, the Commission solicited additional comment on a definition for "significant deficiency." In a release issued on June 27, 2007, the Commission requested additional comment on the following definition of the term "significant deficiency:"[14]

> 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.

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[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] See Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310, Jun. 27, 2007]

[11] Release No. 33-8762 (Dec. 20, 2006) [71 FR 77635, Dec. 27, 2006].

[12] See, for example, letters from Cardinal Health, Inc. ("Cardinal"), Edison Electric Institute, and Protiviti to Release No. 33-8762, File No. S7-24-06.

[13] See, for example, letters from Cardinal and Protiviti to Release No. 33-8762, File No. S7-24-06.

[14] Release No. 33-8811 (Jun. 20, 2007) [72 FR 35346, Jun. 27, 2007].

We received 22 comment letters in response to the request for additional comment.[15] These letters came from accounting firms, professional associations, corporations and other interested parties. We have reviewed and considered all of the comments that we received on the proposed definition. We discuss our conclusions with respect to the comments in more detail in this release.

II. DISCUSSION

A company's principal executive officer and principal financial officer must certify that they have disclosed significant deficiencies in the design or operation of ICFR that are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information, to the external auditor and the audit committee, with the intended result that these parties can more effectively carry out their respective responsibilities with regard to the company's financial reporting.[16] Including a definition of "significant deficiency" in Commission rules, in addition to the definition of "material weakness," will enable management to refer to Commission rules and guidance for information on the meaning of these terms rather than referring to the auditing standards.

In developing the definition of "significant deficiency," we considered comments received in response to the Public Company Accounting Oversight Board's proposed auditing standard for audits of internal control over financial reporting. In its proposed

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[15] 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.

[16] See Section 302(a)(4) of the Sarbanes-Oxley Act (requiring signing officers to certify that they are responsible for establishing and maintaining internal controls and have designed the internal controls to ensure that material information relating to the issuer is made known to the signing officers, and have disclosed any significant deficiencies in internal control to the independent auditors and audit committee) [15 U.S.C 7241].

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."[17] Further, the PCAOB proposed to define a significant misstatement 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 its proposal, the PCAOB, working with the Commission staff, decided to modify its proposed definition to focus the auditor on the communication requirement surrounding the term "significant deficiency" and to clarify that auditors should not scope their audit procedures to search for deficiencies that are less severe than a material weakness.

In proposing the definition, we believed that the focus of the term "significant deficiency" should be on the communications required to take place among management, audit committees and independent auditors. Therefore, we believed that the framework for the definition of "significant deficiency" should vary from that recently adopted for "material weakness." Unlike the definition of the term "material weakness," we did not believe it was necessary for the proposed definition of "significant deficiency" to include a likelihood component (that is, reasonable possibility). Rather, we believed that a definition focused on matters that are important enough to merit attention would allow for, and indeed encourage, sufficient and appropriate judgment by management to

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[17] 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 (PCAOB Release No. 2006-007, Dec. 19, 2006).

determine the deficiencies that need to be reported to the independent auditor and the audit committee.

Comments on the Proposal

A majority of commenters expressed their support for the proposed definition,[18] noting that it would further the Commission's objective of improving implementation of the provisions of the Sarbanes-Oxley Act of 2002. These commenters also noted that the definition would permit the exercise of appropriate judgment by management and independent auditors to determine those deficiencies in ICFR that are important enough to merit attention by those responsible for oversight of financial reporting. In addition, they noted that a consistent definition of significant deficiency in the Commission's rules and in the PCAOB's standards was imperative to promoting effective and efficient compliance by management and auditors with respect to their responsibilities to communicate and respond to significant deficiencies in internal control. Some of these commenters also supported the Commission's inclusion of the term within its rules so that management could look to the Commission's rules for the definition.[19]

A number of commenters agreed that the proposed definition of "significant deficiency" should not include a likelihood component.[20] However, a few commenters

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[18] See, for example, letters from BDO Seidman, LLP; Center for Audit Quality; Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law of the American Bar Association; Deloitte & Touche LLP; Ernst & Young LLP; Financial Executives International – Small Public Company Task Force; Grant Thornton LLP; KPMG LLP; PepsiCo; PricewaterhouseCoopers LLP; The Internal Auditors Division of the Securities Industry and Financial Markets Association; Sprint Nextel Corporation; and The Institute of Internal Auditors.

[19] See, for example, letters from BDO Seidman LLP; Center for Audit Quality; Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law of the American Bar Association; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; and PricewaterhouseCoopers LLP.

[20] See, for example, letters from BDO Seidman, LLP; Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law of the American Bar

stated the definition should include a likelihood component because they believed that the addition of such a component would enhance management's ability to evaluate deficiencies that need to be communicated to the audit committee.[21] We agree with the commenters who stated that it was not necessary for the definition to include a likelihood component, as it could have the unintended effect of diminishing the use of appropriate judgment by management and independent auditors in performing the evaluation. We believe that excluding a likelihood component from the definition reduces the chance that management or independent auditors will design and implement evaluations or audits for the purpose of identifying deficiencies that are less severe than material weaknesses. Further, we believe the guidance provided in our Interpretive Release and in the PCAOB's Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of the Financial Statements ("Auditing Standard No. 5"), appropriately outlines that the scope of each evaluation is to detect material weaknesses, which is also consistent with comments the Commission received related to Auditing Standard No. 5.[22] Therefore, we decided not to add a likelihood component to the definition as adopted.

Many commenters believed the definition allowed for the appropriate exercise of management and auditor judgment regarding what is important enough to merit attention based on each company's particular facts and circumstances, and that some variability in

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Association; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; PepsiCo; Society of Corporate Secretaries and Governance Professionals; U.S Chamber Center for Capital Market Competitiveness; and The Institute of Internal Auditors.

[21] See, for example, letters from Financial Executives International – Small Public Company Task Force; PricewaterhouseCoopers LLP; and Simone Heidema and Erick Noorloos.

[22] See comments received for Releases 34-55912 and 34-55876.

the nature of items reported to the audit committee and auditors may result.[23] However, these commenters believed that this would be acceptable based on the specific facts and circumstances of the individual registrants, and the fact that significant deficiencies are not required to be disclosed publicly.

Some commenters also requested that further clarification be provided by the Commission related to the proposed definition. One commenter suggested that it should be clarified to allow for management, at its discretion, to communicate deficiencies to the audit committee and the auditor that it does not believe are significant deficiencies in order to provide management with the appropriate flexibility to communicate other matters as it deems appropriate.[24] Other commenters requested additional guidance on determining whether a deficiency is a significant deficiency.[25] Some of these commenters suggested that additional guidance such as providing qualitative and quantitative thresholds to consider in the evaluation, would provide management and auditors a basis to agree on whether a deficiency is a significant deficiency and would minimize unnecessary costs.[26] One of these commenters noted that further guidance with regards to materiality generally was important to provide management and auditors with more clarity when evaluating deficiencies, which would enable a more effective and efficient process.

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[23] See, for example, letters from BDO Seidman, LLP; Deloitte & Touche LLP; Ernst & Young LLP; Financial Executives International – Small Public Company Task Force; Grant Thornton LLP; PepsiCo; and PricewaterhouseCoopers LLP.

[24] See letter from The Society of Corporate Secretaries and Governance Professionals.

[25] See, for example, letters from Keith Bishop; New York State Society of Certified Public Accountants; Sprint Nextel Corporation; and U.S Chamber Center for Capital Market Competitiveness.

[26] See, for example, letters from New York State Society of Certified Public Accountants; U.S Chamber Center for Capital Market Competitiveness.

With respect to the communication requirements associated with significant deficiencies, we note that the definition of significant deficiency is used in the context of evaluating the minimum required communications under Sections 302 and 404 of the Sarbanes-Oxley Act of 2002. Neither this definition nor the Commission's rules preclude management from communicating additional deficiencies to the audit committee or the independent auditor. Finally, with regards to requests for additional guidance noted above, including on materiality when evaluating the significance of deficiencies and quantitative and qualitative guidance, we believe that the definition allows management and auditors to appropriately utilize their judgment in determining those deficiencies that are important enough to merit the attention of those responsible for oversight based on their individual facts and circumstances. Further, we do not believe that the definition of significant deficiency is the appropriate forum to address broader questions about materiality, which are fundamental to the federal securities laws.

Final Rule

We are adopting the definition of "significant deficiency" substantially as proposed. We believe the definition appropriately emphasizes the communication requirements between management, the audit committee and independent auditors on those matters that are important enough to merit attention and will allow management to use its judgment to determine the deficiencies that need to be reported to the audit committee and the independent auditor. In addition, we believe that it is important that management and auditors use the same definition of "significant deficiency." Therefore, our final rules define a significant deficiency 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 the registrant's financial reporting.[27]

III. 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 adoption of the definition of "significant deficiency" will impose any new recordkeeping or information collection requirements, or other collections of information requiring OMB's approval.

IV. COST-BENEFIT ANALYSIS

A detailed analysis of the benefits and costs was included in our releases proposing and adopting amendments to rules regarding management's reports on ICFR.[28] The amendments that we are adopting in this release define the term "significant deficiency." We requested comment on whether the amendments would impose any additional benefits or costs on public companies or small entities. No commenter identified any additional costs or burdens that would result from the proposed definition.

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[27] Rule 1-02(a)(4) of Regulation S-X [17 CFR 210.1-02(a)(4)]. We are adding a new paragraph (a)(4) to the rule to define both the terms "material weakness" and "significant deficiency." "Material weakness" was previously added to paragraph (p) of Rule 1-02.

[28] See Release No. 33-8762 (December 20, 2006) [71 FR 77635, Dec. 27, 2006] and Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310, Jun. 27, 2007].

Three commenters suggested that the definition would not result in any additional costs,[29] while a number of commenters suggested that the definition may reduce the amount of time needed by management and auditors to evaluate whether or not deficiencies are significant.[30] Several commenters also noted that one of the significant benefits of the proposed definition was the flexibility provided, which allows management and auditors to utilize their judgment to focus on those matters that are important enough to merit attention by those responsible for oversight of financial reporting.[31]

Two commenters expressed concern that companies would have difficulty in applying the definition because they believed more guidance was necessary to allow management and independent auditors to define and calibrate their procedures in order to minimize any unnecessary costs.[32] Most commenters, however, noted that the definition would permit the exercise of appropriate judgment by management and independent auditors to determine those deficiencies in ICFR that are important enough to merit attention by those responsible for oversight of financial reporting. We believe that, on balance, the amendments will allow management to use sufficient and appropriate judgment to determine whether any identified deficiencies need to be reported to the auditor and the audit committee. The flexibility allowed by the definition will enable

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[29] See, for example, letters from BDO Seidman, LLP; Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law of the American Bar Association; and Deloitte & Touche LLP.

[30] See, for example, letters from BDO Seidman, LLP; PepsiCo; Society of Corporate Secretaries and Governance Professionals; and The Institute of Internal Auditors.

[31] See, for example, letters from from BDO Seidman, LLP; Grant Thornton LLP; PricewaterhouseCoopers LLP; and The Institute of Internal Auditors.

[32] See letter from U.S Chamber Center for Capital Market Competitiveness and New York State Society of Certified Public Accountants.

management and auditors to more efficiently and effectively perform their evaluations based on a company's individual facts and circumstances. In addition, many commenters noted that a consistent definition between the Commission's rules and the PCAOB's standards was imperative to promote effective and efficient compliance by management and auditors with respect to their responsibility to communicate and respond to significant deficiencies in internal control over financial reporting.[33] A consistent definition between the Commission's rules and the PCAOB's audit standards will enable management and independent auditors to more efficiently and effectively perform their responsibilities to communicate significant deficiencies in internal control over financial reporting. Finally, eight commenters expressed their view that the definition would not have any special impact on smaller public companies.[34] We do not believe that these amendments will have much, if any, added impact on the costs to public companies or small entities.

V. EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 3(f) of the Exchange Act[35] 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

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[33] See, for example, letters from BDO Seidman, LLP; Center for Audit Quality; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; PepsiCo; PricewaterhouseCoopers LLP; and Sprint Nextel Corporation.

[34] See, for example, letters from BDO Seidman, LLP; Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law of the American Bar Association; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; PepsiCo; PricewaterhouseCoopers LLP; and The Institute of Internal Auditors.

[35] 15 U.S.C. 78c(f).

efficiency, competition and capital formation. Section 23(a)(2) of the Exchange Act[36] 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 Commission's releases proposing and adopting amendments to rules regarding management's reports on ICFR contained a detailed discussion of the effects of the rule amendments on efficiency, competition and capital formation.[37] We received some comments on the effects of the rule on efficiency. Four commenters on the proposal believed the proposed definition of "significant deficiency" would facilitate more efficient certifications of quarterly and annual reports by allowing management to use its judgment in evaluating the severity of an identified deficiency.[38] The flexibility allowed by the definition will enable management and auditors to more efficiently and effectively perform their evaluations based on a company's individual facts and circumstances, which will promote efficiency. In addition, a consistent definition between the Commission's rules and the PCAOB's audit standards will enable management and independent auditors to more efficiently perform their responsibilities to communicate significant deficiencies in internal control over financial reporting. We did

[36] 15 U.S.C. 78w(a)(2).

[37] See Release No. 33-8762 (December 20, 2006) [71 FR 77635, Dec. 27, 2006] and Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310, Jun. 27, 2007].

[38] See, for example, letters from BDO Seidman, LLP; Grant Thornton LLP; PepsiCo; and PricewaterhouseCoopers LLP.

not receive any comments on capital formation or competition. We do not believe that the rule amendment will impact capital formation or competition.

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

The Commission hereby certifies pursuant to 5 U.S.C. 605(b) that the definition of "significant deficiency" will not have a significant economic impact on a substantial number of small entities. We requested comments on the anticipated impact and seven commenters stated that the definition would not have any special impact on smaller public companies.[39] No commenter suggested that there would be a significant impact on any small entities.

VII. 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 Part 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:

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[39] See for example, letters from BDO Seidman, LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; PepsiCo; PricewaterhouseCoopers LLP; and The Institute of Internal Auditors.

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. adding paragraph (a)(4);

b. removing paragraph (p); and

c. redesignating paragraphs (q) through (cc) as paragraphs (p) through (bb).

The addition reads as follows:

§210.1-02 Definitions of terms used in Regulation S-X (17 CFR part 210).

* * * * *

(a) * * *

(4) Definitions of terms related to internal control over financial reporting. The term material weakness means 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.

The term significant deficiency means 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 registrant's financial reporting.

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PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. 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.

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4. Amend §240.12b-2 by adding the definition of "Significant deficiency" in alphabetical order to read as follows:

§240.12b-2 Definitions.

* * * * *

Significant deficiency. The term 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 registrant's financial reporting.

* * * * *

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

August 3, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release No. 34-56206; File No. S7-20-06]

RIN: 3235-AJ75

Short Selling in Connection with a Public Offering

AGENCY: Securities and Exchange Commission

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to Regulation M to further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuer's offering proceeds and dilute security holder value. The amendments eliminate the covering element of the former rule.

EFFECTIVE DATE: [Insert date 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: James Brigagliano, Associate Director, Josephine Tao, Assistant Director, Elizabeth Sandoe, Branch Chief, Victoria Crane, Branch Chief, and Joan Collopy, Special Counsel, at (202) 551-5720, Office of Trading Practices and Processing, in the Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: We are amending Rule 105 of Regulation M [17 CFR 242.105].

I. Background

Pricing integrity is essential to the capital raising process. A fundamental goal of Regulation M, Anti-Manipulation Rules Concerning Securities Offerings, is protecting the independent pricing mechanism of the securities market so that offering prices result from the

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natural forces of supply and demand unencumbered by artificial forces.[1] Rule 105 of Regulation M governs short selling in connection with public offerings and concerns short sales that are effected prior to pricing an offering. The rule is particularly concerned with short selling that can artificially depress market prices which can lead to lower than anticipated offering prices, thus causing an issuer's offering proceeds to be reduced.[2] The rule is intended to foster secondary and follow-on offering prices that are determined by independent market dynamics and not by potentially manipulative activity. Rule 105 is prophylactic. Thus, its provisions apply irrespective of a short seller's intent.[3]

Former Rule 105 ("former rule") prohibited covering short sales effected during a defined restricted period with securities purchased in an offering ("offered securities").[4] "Covering" was the prohibited activity. Specifically, the former rule made 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 shorter of (1) the period beginning five business days before the pricing of the offered securities and ending with such pricing or (2) the period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with pricing.[5]

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[1] See Securities Exchange Act Release No. 54888 (Dec. 6, 2006), 71 FR 75002 (Dec. 13, 2006) ("Proposing Release"). See also Securities Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997) ("Regulation M Adopting Release").

[2] See Proposing Release, 71 FR at 75002.

[3] See id. at 75003.

[4] Former Rule 105(a) stated, "[i]n connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (§239.90 of this chapter) filed under the Securities Act, it shall be 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 applicable Rule 105 restricted period.

[5] See former Rule 105(a).

In recent years, the Commission has become aware of non-compliance with Rule 105, and in some cases, strategies used to disguise Rule 105 violations.[6] In particular, the Commission has become aware of attempts to obfuscate the prohibited covering.[7] Due to continued violations of the rule, including a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent, the Commission published proposed amendments to Rule 105 for notice and comment.[8]

The Commission proposed to eliminate the covering requirement in order to end the progression of trading strategies designed to hide activity that violated the rule. In particular, the Commission proposed to make it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase, including enter into a contract of sale for, such security in the offering.[9] In effect, the proposal imposed an absolute prohibition against purchasing offered securities in firm commitment offerings by any person that effected a restricted period short sale(s).

We received 13 comment letters in response to the Proposing Release from one self-regulatory agency, one issuer, one academic, one investment company, four associations, and

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6 See Proposing Release, 71 FR at 75002.

7 See id. at 75004.

8 See id. at 75002.

9 See id.

five law firms.[10] Some commenters supported the proposal, others opposed it, and some commenters suggested modifications or alternative approaches. We have carefully considered each of the comments. While the comment letters are publicly available to be read in their entirety, we highlight many of the issues, concerns, and suggestions raised in the letters below.

Some commenters were supportive of the proposal and its goals. Comment letters from an issuer and a self-regulatory organization supported the specific proposal to eliminate the rule's covering component and instead prohibit purchasing in the offering.[11] One commenter stated that, "[t]he proposed amendments to Rule 105 meaningfully address the proliferation of trading strategies and structures, which are designed to disguise prohibited covering activity, by prohibiting any purchase of offered shares by someone who sold short during the restricted period. By eliminating the covering component and expanding the prohibition to all purchases of offered securities, the proposed amendments will efficiently prevent persons from engaging in strategies to avoid the appearance that offering shares are used to cover Rule 105 restricted period short sales."[12] In addition, an issuer stated the proposal would "prevent manipulative activity by those short sellers who inappropriately reap economic gains to the detriment of

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10 The comment letters are available on the Commission's Internet Web site at http://www.sec.gov/comments/s7-20-06/s72006.shtml. Comment letters were received from (1) Millenium Partners, L.P. dated March 19, 2007 (Millenium letter), (2) Fairfax Financial Holdings Limited dated March 9, 2007 (Fairfax letter), (3) Sullivan & Cromwell LLP dated Feb. 28, 2007 (Sullivan letter), (4) NYSE Regulation, Inc. dated Feb. 27, 2007 (NYSE letter), (5) Cleary Gottlieb Steen Hamilton LLP dated Feb. 16, 2007 (Cleary letter), (6) James J. Angel, PH.D., CFA dated Feb. 14, 2007 (Angel letter), (7) Schiff Hardin LLP dated Feb. 14, 2007 (Schiff letter), (8) Securities Industry and Financial Markets Association dated Feb. 13, 2007 (SIFMA letter), (9) Davis Polk & Wardwell dated Feb. 13, 2007 (Davis letter), (10) Managed Funds Association dated Feb. 12, 2007 (MFA letter), (11) Investment Company Institute dated Feb. 12, 2007 (ICI letter), (12) Morgan, Lewis Bockius LLP dated Feb. 12, 2007(Morgan letter), and (13) International Association of Small Broker-Dealers and Advisers dated Dec. 14, 2006 (IASBDA).

11 See NYSE and Fairfax letters.

12 NYSE letter.

issuers and selling shareholders who receive reduced public offering proceeds."[13] Commenters, including commenters that disagreed with aspects of the proposal, supported the goals of protecting independent pricing, bolstering investor confidence in the capital raising process and curbing non-compliance with former Rule 105.[14]

Other commenters voiced opposition to the proposed amendments.[15] One commenter stated that the proposal would: (i) force investors to make an investment decision at an earlier point in time before an offering price is determined; (ii) allow issuers and underwriters to price offerings without any market counterbalance; and (iii) harm issuers by reducing the number of buyers for certain offerings.[16] This commenter stated, in relevant part, "I believe that the proposed amendments to Rule 105 would have a deleterious effect on the market for secondary offerings by removing from the price discovery process those investors that pay careful attention to issuers and that the result will be over-optimistic pricing that does not reflect the true value of an issuer's securities. Further, I believe the proposal will harm issuers as they will face greater costs in carrying out their secondary offerings."[17] Another commenter stated its belief that the

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[13] Fairfax letter.

[14] See, e.g., NYSE letter stating that the proposal will "bolster investors confidence" and "will protect independent pricing mechanisms and price integrity and advance the intent of Regulation M, which is to prevent market manipulation and facilitate offering prices based on the natural forces of supply and demand, unencumbered by artificial influence." The NYSE letter further states that it "applauds the efforts of the Commission in proposing amendments to Rule 105 which will promote market integrity by precluding persons from engaging in manipulative conduct around the pricing of an offering so that markets can be fairly determined by supply and demand without the influence of artificial forces." See also, Fairfax letter stating "Fairfax strongly supports the Commission's continued efforts to protect the integrity of the securities markets' independent mechanism for pricing publicly offered securities." See, e.g., ICI letter stating that "the Institute supports the goals of the proposal. . . ." See also, the Millennium letter stating "Millennium fully agrees with the Commission's stated goals of reducing the risk of manipulation in connection with the pricing of offerings and eliminating 'sham' type arrangements designed to avoid compliance with existing Rule 105."

[15] See, e.g., Morgan letter.

[16] See id.

[17] See id.

rule as proposed may not achieve, and in fact may be contrary to, the Commission's investor and market protection goals.[18]

In addition to statements of support or opposition to the proposed amendments, commenters also expressed concerns about the universe of potential investors, price discovery, and investment company and investment adviser violations. With respect to the investor pool, commenters believed that the proposal could reduce the number of investors for secondary offerings. One concern was that investors would be forced out of secondary offerings if they effected certain trading strategies that involved short sales during the restricted period.[19] One commenter stated that short sales are "effected as part of, among other things, initial and dynamic hedging strategies, long/short strategies, convertible arbitrage, bona-fide market making or customer facilitation activities."[20] Some commenters noted that preventing persons that effect these strategies during a restricted period from purchasing in an offering minimizes the pool of potential investors and can have a negative effect on price discovery.[21] A second concern raised by some commenters was that investors who had no knowledge of an offering at the time of a short sale would be prohibited from purchasing in the offering.[22] Commenters generally asserted that short sales effected without knowledge of a secondary offering or takedown, such as an

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18 See MFA letter.

19 See SIFMA, Sullivan, MFA, Cleary letters.

20 Cleary letter.

21 See, e.g., Davis letter stating that "[t]rading techniques have gotten more sophisticated and there are numerous strategies that involve short sales . . . Often times these strategies are employed by investors that are interested in a particular issuer and accordingly would otherwise be likely potential purchasers in an offering. By excluding potential investors . . . the proposed rule would interfere with price discovery and potentially adversely impact the pricing of the offering." See also, SIFMA letter stating "[m]oreover, by effectively precluding a certain group of investors from receiving an allocation, the proposed changes could negatively affect pricing efficiency and could impact underwriters' decisions on whether to commit to some offerings."

22 See, e.g., MFA and Davis letters.

"overnight deal," would not be manipulative, yet an investor would be prohibited from participating in the offering under the proposed amendments.[23]

Commenters were also concerned about the impact of the proposed amendments on investment companies and investment advisers.[24] Generally, commenters discussed two possible scenarios. First, there would be a violation of the proposed rule if "one fund within a fund complex (or a series of a fund) effects a short sale during the five day period and another fund in the same complex (or another series of a fund) purchases the security in the offering. . . ."[25] Second, commenters were also concerned about proposed rule violations "if a subadviser to a fund enters into a short sale in a security during the five-day period prior to an offering, and a separate subadviser to the same fund purchases the security in the offering. . . ."[26] Similarly, in response to a question in the release, commenters suggested incorporating the aggregation unit relief concept of Regulation SHO to Rule 105 for broker-dealers.[27]

Some commenters advocated modifications to the proposed amendments such as confining the rule's application to equity offerings and incorporating the concept of a "subject" security from Regulation M so that convertible offerings would not be impacted by the

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23 See, e.g., Millenium letter. See also Sullivan letter (noting that shelf offerings also would be particularly affected by the proposed amendments since shelf offerings are essentially "overnight" deals).

24 See Schiff letter stating that the proposal "will have a disparate negative and unfair effect on funds advised by registered investment advisers that utilize multiple investment strategies or employ multiple sub-advisers." See also, ICI letter suggesting that the "Commission clarify that each individual fund within a fund complex (and each series of a fund), and each subadvised portion of a particular fund, is a separate 'person' for purposes of Rule 105" or extend the aggregation unit concept set forth in Rule 200(f) of Regulation SHO to funds.

25 ICI letter.

26 ICI letter.

27 See MFA, Schiff, and SIFMA letters supporting the expansion of Regulation SHO's aggregation unit concept to registered and unregistered entities. See also discussion regarding aggregation units in Section II below.

amendments.[28] Commenters also suggested amending the restricted period to incorporate the concept of public announcement of an offering.[29] Another suggestion was to create an exception for certain trading strategies.[30] Another proposed modification was an exception based on the Rule 101 exception for actively traded securities.[31] Many commenters supported an exception raised by a question in the Commission's Proposing Release to allow restricted period short sellers to participate in an offering if they covered such short sale(s) with a bona fide purchase prior to the offering.[32] However, some commenters were opposed to creating exceptions that would undercut the rule's prophylactic nature.[33]

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28 See, e.g., SIFMA letter.

29 See, e.g., Davis letter recommending "that the restricted period not commence until the later of public announcement of the offering or five business days before pricing." See also, SIFMA letter suggesting that the restricted period "not begin earlier than the point of public announcement of the offering." See also, Fairfax letter stating that "[f]airfax recommends that, instead of the current pre-set five day restricted period, the restricted period should be the lesser of ten days and the period between public announcement and pricing."

30 See, e.g., MFA suggesting exceptions for bona fide arbitrage and bona fide hedging. See also, SIFMA letter suggesting exceptions for "(i) convertible arbitrage; (ii) merger arbitrage; (iii) volatility trading; (iv) long/short strategies; (v) other hedging strategies; and (vi) bona-fide market making and customer facilitation activities." See also, Cleary letter suggesting an exception for among other things, "bona fide hedging activities conducted in accordance with pre-established trading strategies."

However, one issuer was opposed to such an exception stating that, "[h]edging strategies, including hedging by option market markers, should not be permitted in an issuer's securities during the restricted period if the hedging involves receiving securities purchased from the issuer in its public offering. Fairfax respectfully submits that if the hedging is *bona fide* then any short covering can be done using open market purchases. There is no hedging justification that warrants encumbering issuers' capital realization or that sufficiently outweighs the issuer's need for market prices and offering prices that are unencumbered by artificial and manipulative forces." Fairfax letter.

31 See, e.g., Cleary letter, suggesting an exception for securities that are actively-traded within the meaning of Rule 101(c)(1) of Regulation M.

32 See Morgan, Sullivan, Davis, SIFMA and MFA letters suggesting that an investor that sells short during the restricted period should be able to cover such short sales prior to the offering and participate in the offering. Other commenters were opposed to such an exception. See, e.g., Fairfax letter stating that, "covering restricted period short sales in advance of pricing would not necessarily cure any manipulative impact of the short sales if the covering purchases have no mitigating effect on an underwriter's decision to lower an offering's price (e.g., if the purchase is made immediately prior to pricing such that there is no opportunity for market reaction to the purchase in order to dissipate any downward impact from the short sale)."

33 See, e.g., NYSE letter.

Furthermore, in response to questions raised in the Proposing Release, some commenters felt that Rule 105 should not address derivatives,[34] PIPE transactions,[35] long sales,[36] convertible offerings,[37] or best efforts offerings.[38] Many commenters also were opposed to the question in the Proposing Release as to whether we should require underwriters to obtain certifications from investors stating that they had not sold short during the restricted period.[39] Other commenters sought additional interpretive guidance with respect to former Rule 105 instead of amending the rule.[40]

After considering the comments received and the purposes underlying Rule 105, we are adopting the amendments with some modifications to refine provisions and address commenters' concerns as discussed below.[41]

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34 See, e.g., MFA letter.

35 See, e.g., SIFMA and MFA letters.

36 See, e.g., SIFMA and Morgan letters.

37 See, e.g., SIFMA letter.

38 See, e.g., SIFMA letter, noting that exchange-traded funds (ETFs) are non-firm commitment offerings that "do not involve the type of discount which provides a motivation to 'capture the discount by aggressively short selling just prior to pricing,' and, as a result, do not raise the policy concern that the proposed rule changes are intended to address." See also Morgan and Cleary letters.

39 See, e.g., SIFMA letter. However, one commenter was not opposed to that concept. See Millennium letter.

40 See, e.g., Morgan letter suggesting that "a far better approach would be for the Commission to provide additional guidance to the investing community regarding the specific means that it believes would result in compliance with existing Rule 105."

41 We note that certain issues discussed in the Proposing Release and comment letters have not been incorporated into amended Rule 105 at this time. However, the Commission intends to monitor whether further action is warranted. For example, amended Rule 105 continues to retain the exception for best efforts offerings. If we become aware of potentially manipulative short selling prior to the pricing of best efforts offerings or other concerns with this exception, the Commission may re-evaluate this exception. By way of another example, PIPEs generally did not fit within the elements of former Rule 105. One reason for this is that PIPEs are typically not conducted on a firm commitment basis. PIPE offerings not conducted on a firm commitment basis continue to be excepted from Rule 105, however other areas of the securities laws continue to apply to PIPE offerings. See e.g., SEC v. Hilary L. Shane, Lit. Release No. 19227 (May 18, 2007).

II. Discussion of Amendments

The amendments are carefully and narrowly tailored to further the anti-manipulation goals of Rule 105 by ending the progression of strategies designed to conceal the covering of restricted period short sales with offered securities without unduly expanding the scope of the rule or unnecessarily restricting the pool of secondary and follow-on offering purchasers. The amended rule seeks to achieve this goal by eliminating the covering element of the former rule. However, in response to comments, as adopted, amended Rule 105 refines the amendment as proposed in several aspects, including limiting its application to equity offerings, and adding a "bona fide purchase provision" that allows a restricted period short seller to participate in an offering. The amended rule also includes new exceptions concerning separate accounts and investment companies. The exception for separate accounts allows a person to purchase the offered securities in an account where there was a short sale in another account if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts. The exception for certain investment companies allows an investment company to participate in an offering if an affiliated investment company or any series of such investment company sold short during the restricted period.

The proposed amendments would have imposed an outright ban on purchasing offered securities if a person sold short during a restricted period. The amended rule refines that approach. As proposed and as adopted, the amendment changes the prohibited activity from covering to purchasing the offered security, in order to put an end to strategies that obfuscated the prohibited covering but replicated its economic effect.[42] However, the amended rule also includes the three exceptions.

Generally, the offering prices of follow-on and secondary offerings are priced at a discount to a stock's closing price prior to pricing. This discount provides a motivation for a person who has a high expectation of receiving offering shares to capture this discount by aggressively short selling just prior to pricing and then covering the person's short sales at the lower offering prices with securities received through an allocation.[43] Covering the short sale with a "specified amount of registered offering securities at a fixed price allows a short seller largely to avoid market risk and usually guarantee a profit."[44] Eliminating the covering component and prohibiting a purchase in the offering in amended paragraph (a) reduces a potential investor's incentive to aggressively sell short prior to pricing solely due to the anticipation of this discount. Such activity can exert downward pressure on market prices for reasons other than price discovery that result in lowered offering prices and therefore reduced offering proceeds to issuers and selling security holders.[45] The prohibition on purchasing offered securities also provides a bright line demarcation of prohibited conduct consistent with the

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42 Obfuscating the prohibited covering is one way that persons have attempted to conceal Rule 105 violations. Derivatives have also been used to conceal Rule 105 violations by attempting to disguise a short sale as a long sale. See e.g., Commission Guidance on Rule 3b-3 and Married Put Transactions, Securities Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820 (Nov. 21, 2003) ("Married Put Release"). The Commission will continue to scrutinize the use of derivatives and other attempts to conceal Rule 105 violations.

43 See 71 FR 75003.

44 Id.

45 See Fairfax letter stating that they "experienced a decline in the price of a security well in excess of 3% during the period between the public announcement of an offering and the pricing of such offering."

prophylactic nature of Regulation M.[46]

A. Bona Fide Purchase Exception

In response to commenters' concerns, the amended rule adds a provision that allows restricted period short sellers to purchase the offered securities if they make a bona fide purchase of the same security prior to pricing.[47] This provision advances the goals of facilitating offering price integrity and protecting issuers from potentially manipulative activity, while not unduly restricting capital formation or short sales. The provision provides that persons can purchase offered securities even if they sell short during the Rule 105 restricted period if they make a purchase equivalent in quantity to the amount of the restricted period short sale(s) prior to pricing.[48] This provides an opportunity for a trader who had no knowledge of an offering at the time of his short sale to participate in the offering. Thus, a person who did not intend a strategy of shorting into an offering has an opportunity to participate in the offering, provided the person complies with the provision. The amendments also preserve a person's ability to change his or her mind. For example, a person may initially decide not to participate in an offering, and in doing so, may sell short during the Rule 105 restricted period. If that person subsequently

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[46] The Commission cautions that any transaction or series of transactions, whether or not subject to the provisions of amended Rule 105, continue to be subject to the anti-fraud and anti-manipulation provisions of the federal securities laws. Moreover, we remind persons intending to purchase securities in any registered secondary or follow-on offering that selling short the same securities prior to the offering continues to be subject to the registration requirements of Section 5 of the Securities Act of 1933. See, e.g., SEC v. Friedman, Billings, Ramsey & Co., Inc., et al., Civil Action No. 06-CV-02160 (D.D.C.) at http://www.sec.gov/litigation/litreleases/2006/lr19950.htm and http://www.sec.gov/litigation/complaints/2006/comp19950.pdf (alleging short selling CompuDyne stock prior to the effective date of the resale registration statement and covering those short sales with shares of CompuDyne stock purchased from FBR's customers who obtained shares in the PIPE offering).

[47] Amended Rule 105(b)(1).

[48] In the Proposing Release, we had solicited specific comment as to whether the proposed rule should provide an exception to allow persons who effect a restricted period short sale to purchase offered securities in certain described circumstances, including any alternatives, and also whether such an exception should include a documentation requirement to demonstrate compliance. See 71 FR at 75006.

decides to participate in the offering after selling short during the Rule 105 restricted period, the bona fide purchase provision provides an opportunity to do so.

In order to take advantage of this exception, the rule requires there to be a bona fide purchase of the security that is the subject of the offering.[49] While the determination as to whether a purchase is a bona fide purchase will depend on the facts and circumstances, we note that any transaction that, while made in technical compliance with the exception, is part of a plan or scheme to evade the Rule, for example, a transaction that does not include the economic elements of risk associated with a purchase for value, would not be bona fide for purposes of amended Rule 105.[50]

The purchase must be at least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale.[51] Partial purchases are insufficient. This condition is designed to help ensure that the person is making a bona fide purchase rather than simply a purchase to evade Rule 105's prohibitions. For example, the provision is not available if during a Rule 105 restricted period a person sells short 1,000 shares of common stock, subsequently purchases 500 shares of common stock prior to pricing, and then purchases 500 shares of common stock in the offering. The 500 share pre-pricing purchase is not equivalent in quantity to the entire amount of the Rule 105 restricted period short sale. Thus, the provision is unavailable. In that scenario, the person violated amended Rule 105 by short selling 1,000 shares during the Rule 105 restricted period and purchasing the offered security.

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[49] Amended Rule 105(b)(1)(i).

[50] See, e.g., discussion regarding sham transactions in Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004); see also Married Put Release, supra note 42.

[51] Amended Rule 105(b)(1)(i)(A).

The provision also requires that the person effect the bona fide purchase during regular trading hours[52] and that the bona fide purchase is reported pursuant to an effective transaction reporting plan.[53] This is designed to ensure transparency of the activity to the market so that the effects of the purchase can be reflected in the security's market price. Next, the bona fide purchase must be made after the last Rule 105 restricted period short sale and prior to pricing.[54] Purchases made during the Rule 105 restricted period but before the last Rule 105 restricted period short sale do not qualify as a bona fide purchase for purposes of this provision. Requiring the bona fide purchase to be made after the last Rule 105 restricted period short sale facilitates the dissipation of downward pressure exerted by short selling and allows any downward pressure to be offset by upward price pressure exerted by the purchase. It also helps to ensure that the person effected a bona fide purchase for purposes of closing out a short sale position.

The bona fide purchase also must occur prior to pricing to allow market reaction to the purchase before an offering is priced.[55] In addition, the bona fide purchase must occur no later than the business day prior to the day of pricing.[56] The element that the bona fide purchase occur no later than the business day prior to the day of pricing also allows an opportunity for market reaction prior to pricing an offering.[57] For example, if an offering is priced on Wednesday after

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[52] Amended Rule 105(b)(1)(i)(B).

[53] Amended Rule 105(b)(1)(i)(C).

[54] Amended Rule 105(a)(1)(i)(D).

[55] Id.

[56] Id.

[57] Amended Rule 105(b)(1). But see NYSE comment letters stating that "[s]hort sales have the effect of driving down the price of a security even if covered in the open market." See Fairfax letter stating "[m]oreover, covering restricted period short sales in advance of pricing would not necessarily cure any manipulative impact of the short sales if the covering purchases have no mitigating effect on an underwriter's decision to lower an offering's price. . . ."

the close of regular trading hours, the bona fide purchase could not be made during regular trading on Wednesday. Therefore, this provision may not be available in a truly "overnight deal" when an offering commences after the close of regular trading on the day of pricing.[58] However, this is not an impediment to participating in an overnight deal (or shelf offering)[59] for potential investors who did not short sell the security that is the subject of the offering during the Rule 105 restricted period.

Although it would not be available to some investors in this situation, the bona fide purchase provision is available to potential investors in many other scenarios. For example, a person could use the bona fide purchase provision if a Rule 105 restricted period commenced on Monday and ended with pricing on Friday and that person sold short on Tuesday before becoming aware of the offering on Wednesday. That person could make bona fide purchase on Thursday as the last business day before pricing on Friday. The bona fide purchase provision would also be available in that situation if that person continued to sell short on Wednesday after becoming aware of the offering. The provision would still be available to that person if the person effected additional short sales on Thursday prior to making a bona fide purchase on Thursday. Thus, the bona-fide purchase provision is available so long as the conditions specified in the amended rule are satisfied.

The condition that the bona fide purchase occur no later than the business day prior to the day of pricing gives the market an opportunity to consider and react to both the Rule 105 restricted period short sales and the bona fide purchase. It provides the market with an

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58 For example, if an offering is priced after the close of regular trading on Tuesday and underwriters begin to contact potential investors to purchase in the offering on Tuesday evening after pricing, the bona fide purchase provision is not available to those investors. It would not be possible for a bona fide purchase to be effected because the last business day prior to the day of pricing would have already occurred.

59 See Sullivan letter.

opportunity to consider a trading day uninfluenced by a person with a heightened incentive to manipulate.

In addition, a person relying on this provision may not effect a Rule 105 restricted period short sale within the 30 minutes before the close of regular trading hours on the business day prior to the day of pricing.[60] This condition guards against potentially manipulative activity near the close of trading that can lower offering prices and, thereby reduce an issuer's offering proceeds, by influencing market price, including the following day's opening price.

B. Separate Accounts and Investment Company Exceptions

In the proposing release, we asked whether the principles for independent trading unit aggregation that the Commission set out in Regulation SHO Rule 200(f) should be extended to non-broker-dealers, such as investment companies, and asked about appropriate criteria.[61] Under Rule 200 of Regulation SHO and its predecessors,[62] a person has to aggregate all of its positions to determine whether it is net long or short. The Commission, however, permits independent trading unit aggregation within the same broker-dealer under certain conditions.

In the Adopting Release for Regulation SHO, we noted that the conditions required for independent trading unit aggregation were adopted to limit the potential for trading rule violations through coordination among units and are designed to maintain the independence of

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60 Amended Rule 105(b)(1)(ii).

61 Rule 200 of Regulation SHO provides that, in order to determine its net position, a broker or dealer shall aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position. Rule 200(f) of Regulation SHO provides that independent trading unit aggregation is available only if: (1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity; (2) Each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades; (3) All traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; and (4) Individual traders are assigned to only one aggregation unit at any time.

62 See, e.g., Rule 3b-3.

the units.[63] We believe the principles for independent trading unit aggregation should be used to address concerns expressed by commenters about the proposed rule. Specifically, commenters to the Rule 105 proposing release expressed concerns stemming from the Commission's use of the term "person" in the proposal. The proposed rule would have prohibited "any person" from purchasing in an offering if they effected restricted period short sales. Although the former rule also used the word "person," commenters stated that eliminating the covering element could, for funds with multiple independent accounts, "create difficulties for funds effecting transactions in securities that are the subject of offerings."[64]

Commenters expressed concern that the term "person," for purposes of the proposed rule, might encompass each fund within a fund complex, each series of a series fund, or each subadvised portion of a single fund. Commenters stated that, as a result, the proposed rule might prohibit one fund within a fund complex (or a series of a fund) from purchasing offered securities if another fund in the same complex (or another series of a fund) sold short within the Rule 105 restricted period even where those funds (or series of a fund) were trading independently. Commenters also stated that the proposal would trigger a Rule 105 violation if a sub-adviser to a portion of a fund purchased offered securities after another sub-adviser to a different portion of the same fund sold short during the restricted period even if those sub-advisers were not coordinating their trading. Thus, commenters stated that we should treat funds within a fund complex, different series of a fund, and separate subadvised portions of a fund as

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[63] Securities Exchange Act Release No. 50103 (July 28, 2004) 69 FR 48008 at 48011 (Aug. 6, 2004) (Regulation SHO Adopting Release).

[64] See, e.g., ICI letter. We note that we use the term "account" as a general term that may encompass the separate accounts that commenters described in many different ways including "portions of a particular fund" (ICI letter), "unit" (MFA and SIFMA letters), "departments" (SIFMA letter) and "identifiable divisions" (SIFMA letter).

independent for purposes of Rule 105. Commenters also stated Regulation SHO's concept of independent trading unit aggregation should be expanded to unregistered entities.[65]

In light of our solicitation of comment on the questions whether the principles for independent trading unit aggregation should be extended, and under what criteria, and in response to comments received, we have determined to apply the principles to Rule 105 for separate accounts in circumstances where the decisions regarding securities transactions are made separately and without coordination of trading or cooperation.[66] In addition, we have included an exception to address commenters' concerns regarding funds within the same fund complex and different series of a fund.[67]

1. Separate Accounts.

We are adopting an exception that will permit a purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a separate account, if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts. This exception incorporates the principles of Rule 200(f) of Regulation SHO that permit a registered broker or dealer to treat non-coordinating units separately.

Rule 105 is directed at persons who short sell into an offering because they have a high likelihood of receiving discounted offering shares. These persons have a special incentive to sell short and thus do not contribute to efficient pricing. Where an account that sells short is not the account that purchases shares in the offering, if decisions regarding securities transactions for

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65 See e.g, MFA, Schiff, SIFMA, and Millenium letters.

66 For example, two sub-advised portions of the same registered investment company may be separate accounts.

67 Amended Rule 105(b)(3).

each account are made separately and without coordination of trading or cooperation among or between the accounts even though the accounts may be affiliated or otherwise related, the incentive that motivates the Rule 105 violation is not present because the short seller cannot lock in a profit by purchasing the discounted offering shares. The exception is, therefore, narrowly tailored to address the abuses that Rule 105 is designed to prevent without triggering inadvertent violations by accounts that do not coordinate their trading activity.

Indicia of Separate Accounts

For purposes of this exception, accounts are separate and operating without coordination of trading or cooperation if:

(1) The accounts have separate and distinct investment and trading strategies and objectives;

(2) Personnel for each account do not coordinate trading among or between the accounts;

(3) Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;

(4) Each account maintains a separate profit and loss statement;

(5) There is no allocation of securities between or among accounts; and

(6) Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decisions for the accounts.

Depending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception if the accounts are separate and operating without coordination of trading or cooperation. Policies and procedures reasonably designed to ensure that the above safeguards are fully implemented would be indications that accounts are separate, as would regular reviews to help ensure that such policies and procedures are up to date and fully implemented. For example, such reviews may include reviewing activities that are indicative of coordination between accounts and reviewing trading activity of a particular account that does not appear to be consistent with the stated strategy or objectives of such account.

We believe that accounts that have separate and distinct investment and trading strategies and personnel that are prohibited from coordinating trading between or among accounts would be considered to make separate decisions regarding securities transactions for purposes of Rule 105.[68] These two factors are similar to the requirements of Regulation SHO Rule 200(f)(1) and (3). We believe that these factors are important indicators that accounts are separate for purposes of the exception. Thus, if trading is coordinated between accounts, the accounts will not be considered separate for purposes of this exception.

We believe that to meet the requirements of the exception there can be no communication of securities positions, investment decisions or other trading matters between accounts.[69] Information barriers, similar to information barriers required for registered broker-dealers under Section 15(f) of the Securities Exchange Act of 1934 ("Exchange Act"), will also inhibit coordination and help maintain the separation of accounts. Information leakage, which can occur for various reasons such as close proximity of trading desks or because traders are unaware

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[68] See, e.g., Millenium letter; Schiff letter.

[69] Commenters believed that information barriers were important to ensure separation of accounts See, e.g., Millenium and Sullivan letters.

that they should not pass information between or among accounts, can give rise to either deliberate or inadvertent coordination of shorting into an offering. Similarly, the sharing of personnel with decision-making authority regarding trading activities in different accounts may lead to information leakage, whether deliberate or inadvertent, between or among accounts. Information barriers should include, at a minimum, appropriate physical barriers as well as training for all personnel.

In the case of an owner of multiple separate accounts, information barriers may not be necessary so long as the account owner is not influencing the trading decisions, *i.e.*, the owner does not allocate securities between or among accounts; has no authority to execute trades in individual securities in the accounts; and has no authority to pre-approve trading decisions for the accounts.

Another indicator that accounts are separate is the maintenance of separate profit and loss statements for each account. While an entity may also want to ensure that accounts have separate legal identities and separate taxpayer identification numbers, we believe that maintaining separate profit and loss statements indicates that an account is operating separately from other accounts, and is being treated by common management as separate.

Another factor that indicates separateness is restricting personnel with management or oversight responsibilities over the entity from allocating securities between or among accounts. This factor is designed to ensure that when one account receives an offering allocation after the other account sells short, the offering allocation is not transferred to the account that sold short. Such a transfer would be contrary to the exception, which is that accounts be separate and free of coordination or cooperation among or between other accounts.

A further factor that indicates separateness is restricting a person with oversight or managerial responsibility over multiple separate accounts from having authority to execute trades in individual securities in the accounts or the authority to pre-approve trading decisions for the accounts and such person does not execute trades for the account and does not pre-approve trading decisions for the accounts. This is designed to ensure non-coordination by a single person with control over multiple accounts. Thus, such person may neither direct an account to sell short during the restricted period, nor direct another account to purchase securities in an offering. In some circumstances, the manager may receive allocations and his allocating offering shares to an account that has a restricted period short sale would be a violation of Rule 105. If allocation of the offered securities is effected by a formula or predetermined basis, an account that has a restricted period short sale must not receive the offering shares.

Examples of persons eligible for the separate account exception include:

- An individual investor who invests capital in two or more accounts and grants full discretionary trading authority to the respective managers of each account, if the individual investor cannot coordinate trading between the accounts or make investment decisions for the accounts, and the managers do not coordinate trading between the accounts.

- An adviser that provides capital to two or more advisers or two private investment funds, if the funds are separate legal entities, maintain different accounts and separate profit and loss statements, and do not coordinate trading or share information or allocate securities between the accounts.

- A money manager that provides capital to two separate advisers, if the funds managed by the advisers are separate legal entities, competitive with one another, maintain different accounts and separate profit and loss statements, and do not coordinate trading or share information or allocate securities.

- An adviser that operates a black box using a trading algorithm, if the black box is separate from another black box or another trading unit.

We note that a fund that invests in multiple funds and owns shares of each fund rather than shares of each fund's underlying investments will likely not need to rely on this exception when one of the multiple funds sells short during the restricted period and another one purchases offered securities. In such cases, the shares of each fund are different securities from the underlying securities. For example, a hedge fund that invests in several other, unaffiliated hedge funds and does not coordinate the trading activity of these funds would not violate Rule 105 if a particular hedge fund in which the fund invested may have sold short underlying securities during a restricted period and another hedge fund in which the fund has invested purchased securities in a subsequent offering.

Some registered investment companies retain multiple investment sub-advisers whose activities are subject to the supervision of a single, primary investment adviser. In such instances, each sub-advised portion of that fund or series may be able to rely on the exception in amended Rule 105(b)(2). In particular, if a sub-adviser to a registered fund, or a series of that fund, engages in a short sale of a security while another sub-adviser to the same fund or series goes long in that security through an offering enumerated in the rule, those decisions would be viewed as being made separately and without coordination of trading or cooperation among or between the sub-advised portions, provided that the sub-advisers met the elements of Rule 17a-10(a)(1) - (2) under the Investment Company Act of 1940 ("Investment Company Act"), and provided further that the fund's, or series', primary investment adviser does not execute trades in individual securities, and does not pre-approve trading decisions for the sub-advised portions.

We believe the exception provides a carefully honed response to the comments we received on this issue. The factors regarding separateness are provided to assist entities in determining whether they qualify for the exception. We note that these factors are not exhaustive, and persons otherwise may be able to rely on this exception. We understand that there may be other types of structures and entities that have safeguards and protections that fall within the exception. In addition, we will consider specific requests for exemptive relief on a case-by-case basis.

We will closely monitor whether use of the exception in any way undermines the purposes of Rule 105, and will consider whether further guidance or changes to the exception are appropriate. We note that an entity that does not comply with the exception may be in violation not only of Rule 105, but also the antifraud provisions. For instance, evidence of coordination, cooperation, or attempts to circumvent the rule or hide coordinated or cooperative activity could be evidence of fraud or manipulation for purposes of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

2. Investment Companies

In adopting Regulation SHO, we noted that the conditions required for independent trading unit aggregation were adopted to limit the potential for abuse associated with coordination among units and are designed to maintain the independence of the units.[70] The fact that brokers and dealers are subject to the oversight of self-regulatory organizations and have compliance responsibilities with regard to supervisory procedures and books and records requirements provided additional assurances that the Commission's concerns would be addressed.

Similarly, provisions of the Investment Company Act generally prohibit concerted action between funds in a complex and between different series of the same fund. Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder prohibit an affiliated person of a registered investment company, and the affiliates of that affiliated person, acting as principal, from participating in any joint enterprise, or other joint enterprise or arrangement with their affiliated

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[70] Regulation SHO Adopting Release, 69 FR at 48011.

investment company. Funds in the same investment company complex will generally be affiliates of each other.[71] An arrangement by which one fund sells a security short while another affiliated fund intentionally goes long to cover that position would generally be the type of joint arrangement that is prohibited by Section 17(d) and Rule 17d-1. As a result, Section 17(d) and Rule 17d-1 would prevent these persons from engaging in activities that the amended rule 105 seeks to prohibit.

Rule 105 is directed at persons who sell short into an offering because they have a high expectation of receiving discounted offering shares. These persons have a heightened incentive to sell short to affect the price of the offered securities that they intended to purchase in order to lock in a profit. However, if the account that sells short during the restricted period is prohibited from concerted action with the account that purchases in the offering, the ability to lock in a profit from selling short prior to pricing and purchasing the offered securities is not present.

Thus, in response to comments, we are including an exception in amended Rule 105 related to registered investment companies. Under this exception, an individual fund within a fund complex, or a series of a fund, will not be prohibited from purchasing the offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period.[72]

By applying Regulation SHO's aggregation unit concept in this manner, we believe we have addressed commenters' concerns regarding the amended rule's scope with respect to

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[71] See, e.g., Steadman Security Corp., 46 S.E.C. 896, 920 n.81 (1977) ("the investment adviser almost always controls the fund. Only in the very rare case where the adviser's role is simply that of advising others who may or may not elect to be guided by his advice . . . can the adviser realistically be deemed not in control.").

[72] Where there are multiple subadvisers to the same fund or series, each sub-advised portion of that fund or series may be able to rely on the exception in amended Rule 105(b)(2) for separate accounts, for example, if each sub-adviser relies on and acts consistently with rules or exemptions that require the implementation of contractual provisions prohibiting consultation between subadvisers.

investment companies registered under the Investment Company Act and accomplished the goals of Rule 105, the prevention of manipulation and the facilitation of offering prices based on the natural forces of supply and demand.

C. Additional Amendments

The amendments modify paragraph (a) of the former rule in several other ways. First, the amendment refines the scope of the rule by restricting its application to offerings of "equity" securities for cash. The former rule was silent as to the rule's application solely to "equity" securities. However language in Rule 10b-21, the predecessor to Rule 105, did limit application of the rule's prohibitions to short sales of "equity securities of the same class as securities offered for cash" and the Commission, in adopting Rule 105, did not express its intent to alter the reach of the rule beyond equity securities.[73] We received comment on the Proposing Release suggesting that including debt securities in the rule is unnecessary because debt securities are less susceptible to manipulation.[74] According to commenters, this is because debt securities trade more on the basis of factors such as yield and credit rating and are priced on factors such as interest rates, and short sales of debt securities prior to pricing of a debt offering are not common.[75] Although the amendments clarify the scope of the rule to apply only to "equity" securities, the Commission intends to continue to monitor whether trading patterns in debt securities raise manipulative concerns in connection with debt offerings. We also received comment on the Proposing Release suggesting that the proposal be modified to include an

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[73] Former Rule 10b-21.

[74] See, e.g., SIFMA letter.

[75] See e.g., Id. This commenter also noted that including debt securities in the amended rule would be inconsistent with the overall limited application of Regulation M's prohibitions to debt securities. See id.

exception for actively-traded securities within the meaning of Rule 101(c)(1) of Regulation M.[76] However, many of the securities that were involved in the enforcement cases brought by the Commission alleging violations of former Rule 105 far exceeded the public float value in the Regulation M "actively-traded" threshold level (that is, having an average daily trading volume value of at least $1 million and a public float value of at least $150 million).[77] Moreover, we believe that the bona fide purchase provision will address commenters' concerns for additional flexibility for actively-traded securities without having to carve out an additional exception for such securities.

The amendments also encompass offerings made pursuant to Form 1-E, Notification under Regulation E. Regulation E exempts from registration under the Securities Act of 1933 ("Securities Act") securities issued by registered small business investment companies or by investment companies that have elected to be regulated as business development companies pursuant to Section 54(a) of the Investment Company Act.[78] Regulation E was originally patterned after Regulation A under the Securities Act.[79]

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[76] See, e.g., Cleary, SIFMA, MFA letters.

[77] See e.g, SEC v. Galleon Management , L.P, Civil Action No. 1: 05CV1006 (RMU) (May 19, 2005) in which Galleon participated in an August 2003 offering of Centene Corp. The Form 10-K for Centene Corp., for the fiscal year ended December 31, 2003, reported a $404,751,936 aggregate market value of the voting and non-voting common equity held by non-affiliates which exceeds the $150 million public float threshold in Regulation M's actively-traded securities exception.

[78] 17 CFR 230.601 - 610a (2007).

[79] See Amendments to the Offering Exemption Under Regulation E of the Securities Act of 1933, Securities Act Release No. 6526 (Apr. 25, 1984). Although we subsequently amended Regulation A to change its requirements, those amendments do not affect the trading activities that are subject to Rule 105.

We have long recognized the danger posed by market participants using securities obtained pursuant to an offering under Regulation A to cover short positions.[80] We asked the following question in the Proposing Release: Regulation E under the Securities Act provides certain small business investment companies and business development companies with a registration exemption that is similar to Regulation A. Should Rule 105 apply to offerings made pursuant to Form 1-E, Notification under Regulation E?[81] We received no public comment arguing against including Regulation E in Rule 105's purview, or articulating why offerings under Regulation E should not be subject to Rule 105.

In light of the important investor protections that Rule 105 provides, we have determined that it is prudent that offerings under Regulation A and Regulation E should be treated identically under Rule 105. We are concerned that short selling of securities issued pursuant to Regulation E during a Rule 105 restricted period raises the same manipulative concerns to which Rule 105 is directed, and which are present with offerings made pursuant to Regulation A. Subjecting offerings made pursuant to Regulation E to the provisions of Rule 105 is designed to ensure that participants in the secondary market for the securities of small business investment companies and business development companies will enjoy the same protections afforded to participants in the secondary market for the securities of similarly placed non-investment companies. Including offerings made pursuant to Form 1-E will place small business investment companies and business development companies on an equal footing with small issuers that

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80 See, e.g., Short Sales in Connection with a Public Offering, Securities Exchange Act Release No. 26028 (Aug. 25, 1988)(subjecting offerings made pursuant to an offering under Regulation A to the provisions of Rule 10b-21(T), a predecessor rule to Rule 105).

81 71 FR at 75007.

utilize Regulation A. Consequently, we have amended Rule 105 to encompass offerings made on Form 1-E.

We have also amended the language of Rule 105(a) to include the term "subject security" and harmonize it with language used in other Regulation M rules. The amended rule states that it is unlawful for any person to sell short the security that is the "subject" of the offering and purchase offered securities. The term "subject" security is included in Regulation M Rule 100's definition of covered security.[82] Rule 100 defines a covered security as "any security that is the subject of the distribution, or any reference security."[83] While amended and former Rule 105 apply to offerings of securities rather than to distributions, the "subject" security language is consistent with Regulation M and, in response to commenters concerns, clarifies that the amended rule does not apply to reference securities. Therefore, in an offering of securities convertible into common equity, even though the convertible securities are themselves equity securities,[84] a person may still sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105.[85] Convertible offerings appear to be priced on many factors in addition to the underlying equity's price, such as credit rating, which may make convertible offerings less susceptible to manipulation through pre-pricing short sales. However, the Commission will continue to monitor the convertible offering market and may re-evaluate these offerings.

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[82] 17 CFR 242.100.

[83] 17 CFR 242.100.

[84] Any security convertible into an equity security is, likewise, an equity security. See Exchange Act Rule 3a11-1.

[85] While, for purposes of Regulation M, the underlying common equity is not the subject of the convertible securities distribution, sellers should be aware that the registration provisions of the Securities Act of 1933 may still apply to both the convertible security and the underlying equity security at the time of the offering.

In response to commenters' concerns, amended paragraph (a) retains the language of the former rule that the purchase of the offered security is made "from an underwriter or broker or dealer participating in the offering." Although we stated in the Proposing Release that the language "from an underwriter or broker or dealer participating in the offering" was unnecessary because Rule 105 covers shelf offerings now, three of the commenters stated their belief that retaining this language is necessary in order not to extend the scope of the rule to unnecessarily preclude a broker or dealer from participating in an offering as a distribution participant, and purchasing the offering securities from the issuer as part of the distribution process, in situations where a unit within the same broker-dealer firm may have effected a Rule 105 restricted period short sale.[86] Thus, a broker or dealer is not precluded from participating in an offering as a distribution participant and may purchase the offering securities from an issuer as part of the distribution process if a unit within the same firm effected a short sale(s) during the Rule 105 restricted period.

Amended paragraph (a) also retains the "purchase" language of the former rule. The Proposing Release used the language "purchase, including enter into a contract of sale for, the security in the offering." We have determined that it is not necessary to include the additional language regarding "enter into a contract of sale" because a purchase or sale under the Securities Act includes any contract of sale.[87] Thus, for purposes of amended Rule105, the purchase occurs at the time the investor becomes committed by agreement or is commitment to buy the offered

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86 See SIFMA, Davis, MFA letters.

87 See, e.g., Securities Offering Reform, Release No. 33-8591, 70 FR 44722, 44765 and at note 391 ("Securities Offering Reform"). See also MFA Letter (commenting on the "contract of sale" language).

security, whether such agreement is oral or written.[88]

The amendments to Rule 105 are targeted and narrow, and thus do not restrict short sales beyond what the Commission believes is necessary to address recent non-compliance and strategies to conceal the prohibited covering of the former rule. While some commenters suggested shortening the rule's restricted period to incorporate the concept of public announcement of an offering,[89] we believe that there is a risk that an investor could learn about a potential shelf offering before it is publicly announced and would still be permitted to sell short even with the knowledge of an upcoming offering.[90] In addition, the amendments will help promote the process of capital formation. Moreover, in response to commenters, the absolute ban on purchasing offered securities in the Proposing Release has been refined to address many of the commenters' concerns, while still advancing the goals of the Rule.

The amended rule does not ban short sales. Traders can sell short during a Rule 105 restricted period if they choose not to purchase offered securities. Traders can sell short prior to the restricted period and receive an offering allocation. Compliance with the bona fide purchase provision also allows traders to sell short during the Rule 105 restricted period and receive an allocation. The bona fide purchase provision is designed to promote capital formation while the

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88 See Securities Offering Reform at n.391(referring to Securities Act Section 2(a)(3) and noting, in relevant part, that, "Courts have held consistently that the date of a sale is the date of contractual commitment, not the date that a confirmation is sent or received or payment is made. See, e.g., Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 891 (2d Cir. 1972) (holding that a purchase occurs at "the time when the parties to the transaction are committed to one another"); In re Alliance Pharmaceutical Corp., Secs. Lit., 279 F. Supp. 2d 171, 186-187 (S.D.N.Y. 2003) (following the holding in Radiation Dynamics with respect to the timing of a contract of sale); Pahmer v. Greenberg, 926 F. Supp. 287 (citing Finkel v. Stratton Corp., 962 F.2d 169, 173 (2d Cir. 1992) ("[A] sale occurs for Section 12[(a)](2) purposes when the parties obligate themselves to perform what they have agreed to perform even if the formal performance of their agreement is to be after a lapse of time")); Adams v. Cavanaugh Communities Corp., 847 F. Supp. 1390, 1402 (N.D. Ill. 1994) (noting that the Seventh Circuit has followed the Radiation Dynamics decision)."

89 See, e.g., Davis, SIFMA, Fairfax letters, supra note 29.

90 See Sullivan letter.

conditions for the provision are designed to reduce artificial influences on pricing. As such, the bona fide purchase provision advances the Commission's investor and market protection goals. At the same time, the provision addresses commenters' concerns regarding not having to make investment decisions before the offering price is determined, allowing issuers and underwriters to price offerings with "market counterbalance," and not reducing the number of buyers for certain offerings.[91] Additionally, while several commenters suggested that a better approach for the Commission would be to simply provide additional interpretive guidance to the investment community as to what constitutes "covering" for purposes of former Rule 105, we believe that the amendments provide a bright line demarcation of prohibited activity that is consistent with the prophylactic nature of Regulation M and that will likely better deter non-compliance with Rule 105. Thus, the amendments provide additional guidance to the investment community in terms of compliance with Rule 105, but while still addressing potentially manipulative activity in a manner that may more effectively bolster issuer and investor confidence in the offering process and thus encourage capital formation.

III. Derivatives

In the Proposing Release, we stated our understanding that persons may use options or other derivatives in ways that may cause the harm that Rule 105 is designed to prevent and requested comment on trading strategies involving derivatives that may depress market prices and result in lower offering prices to issuers in ways not covered by then current Rule 105 or the proposal.[92] The Commission requested specific detail about particular derivatives used, transactions, and the role of the parties involved in the transactions. Commenters did address the

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[91] See, e.g., Morgan letter.

[92] Proposing Release, 71 FR at 75005.

issue of derivatives but only to a limited extent.[93] For example, one commenter requested that the Commission specifically prohibit short sales of, and equivalent transactions in, derivative securities from Rule 105.[94] This commenter noted that Commission guidance about the applicability of the general anti-manipulation rules has not been effective in preventing short sellers intent on manipulating an issuer's securities from using various synthetic shorts, married puts and sham transactions to accomplish indirectly what Rule 105 prohibits directly.[95] Similarly, another commenter also noted that derivatives strategies, including married puts and sham swap transactions, have been utilized to avoid the prohibitions of Rule 105 and that new creative strategies that involve other derivatives which fall outside these parameters are likely in the future.[96] One commenter stated its belief that applying Rule 105 to transactions in derivatives "would be another significant departure from the Commission's philosophy underlying Regulation M and the covering of derivatives in its prophylactic rules.[97] Another commenter stated its belief that "derivatives" is a term that is both too broad and too vague to properly be addressed as one all encompassing entity under a rule.[98]

In view of above-referenced comments, the Commission will continue to monitor the use of derivative strategies that may replicate the economic effect of the activity that Rule 105 is

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93 See, e.g., Fairfax letter.

94 Id.

95 Id.

96 NYSE letter.

97 MFA letter.

98 Morgan letter (noting also that the Commission had previously seen the linkages between prices in these markets and the primary market as too attenuated to be a direct influence and too attenuated to permit effective manipulation of the primary market and that, because of the large number of different types of derivatives and the attenuated price relationship among the derivatives and the underlying stock, a blanket application to derivatives would result in unnecessary and complicated regulation).

designed to prevent. Among the issues we will monitor and evaluate further is whether the link between the derivatives trading and the underlying equities is sufficiently attenuated as not to warrant additional regulation. In addition, we will consider the extent to which derivative strategies are a functional substitute for the equity trading covered by the rule. We also note that any transaction or series of transactions remain subject to the anti-fraud and anti-manipulation provisions of the securities laws even if they do not implicate Rule 105.

IV. Paperwork Reduction Act

There is no collection of information requirement within the meaning of the Paperwork Reduction Act for Rule 105.

V. Cost-Benefit Analysis

We are sensitive to the costs and benefits of Rule 105 and we have considered the costs and benefits of the adopting amendments. To assist us in evaluating the costs and benefits, in the Proposing Release, we encouraged commenters to discuss any costs or benefits associated with the proposal. Commenters were requested to provide analysis and data to support their views on the costs and benefits associated with the proposal. Commenters were encouraged to discuss any additional costs or benefits or reductions in costs in addition to those discussed in the Proposing Release. The Commission requested comment on potential costs for modification to any computer systems and any surveillance mechanisms as well as any potential benefits resulting from the proposal for issuers, investors, broker or dealers, other securities industry professional, regulators, or other market participants. No comment letters provided estimates of specific costs.

A. Adopted Amendments to Rule 105 of Regulation M

In general, former Rule 105 prohibited persons who sold short prior to pricing certain offerings during a defined restricted period from covering such short sales with offering securities. The prohibited activity was the covering. Under the amendments, the prohibited activity is now purchasing in the offering. As amended, Rule 105 of Regulation M makes it unlawful in connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A (§239.90) or Form 1-E (§239.200) filed under the Securities Act ("offered securities"), for any person to sell short the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period that is the shorter of the period beginning five business days before the pricing of the offered securities and ending with such pricing or beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing. The amendments provide, however, that it shall not be unlawful for such person to purchase the offered securities if such person makes a bona fide purchase(s) of the security that is the subject of the offering that is at least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale(s). The purchase must be effected during regular trading hours, reported to an effective transaction reporting plan, and effected after the last Rule 105 restricted period short sale, prior to pricing and no later than the business day prior to the day of pricing. In order to rely on the bona fide purchase provision, a person may not effect a short sale, which is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing.

In addition, the amendments provide exceptions for separate accounts and investment companies. Accordingly, the purchase of the offered security in an account of a person shall not be prohibited where such person sold short during the Rule 105 restricted period in a separate account, if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between accounts. Further, the amendments include an exception for investment companies registered under Section 8 of the Investment Company Act that allow such an investment company to participate in an offering if an affiliated investment company or any series of such company sold short during the restricted period.

The goal of Rule 105 is to promote offering prices that are based upon market prices determined by supply and demand rather than artificial forces. The rule is prophylactic and prohibits the conduct irrespective of the short seller's intent. The amended rule eliminates the covering requirement of the former rule because there had been non-compliance with the former rule coupled with persons effecting strategies to hide the prohibited covering.

B. Benefits

The amendments are intended to end the proliferation of strategies designed to hide covering restricted period short sales with offered securities. The amendments seek to fulfill this objective by eliminating the covering requirement. Putting an end to activity designed to conceal covering with offered securities but replicate the same economic outcome is expected to better deter those attempting to place artificial downward pressure on market prices, which can lower offering prices and thereby reduce an issuer's offering proceeds. The amendments are expected to benefit issuers because they likely will receive offering proceeds that are not lower than anticipated due to short sales prior to pricing by persons who would cover such short sales with offering securities and then attempt to conceal the prohibited covering. Academic research shows that prices decline by 1 – 3 % on average during the five days before pricing for follow-on offerings under the current restrictions.[99] In its comment letter, Fairfax Financial indicated that the academic literature underestimates the effect of short selling during the Rule 105 restricted period and provided an example of an offering with a larger price decline. No commenters provided arguments suggesting that this price decline is due to factors other than noncompliance with former Rule 105.

The amendments will work to safeguard the integrity of the capital raising process by promoting offering prices based on the independent forces of supply and demand rather than artificial prices due to potentially manipulative short sales prior to pricing. This may boost investor confidence that investment decisions can be based on market prices and offering prices that are unencumbered by artificial forces, and thus may facilitate capital formation.

Prohibiting purchasing in the offering when one has sold short during the restricted period provides a bright line demarcation of prohibited activity consistent with the prophylactic nature of Regulation M. The amended rule likely will better deter non-compliance with Rule 105 because it may be more difficult to conceal an offering purchase than to conceal covering. The amendments also benefit traders who want to comply with Regulation M by providing a bright line delineation of unlawful conduct. This bright line demarcation of prohibited conduct is also a benefit to regulators surveilling for and investigating potential Rule 105 violations.

The amendments clarify the pool of securities offerings to which Rule 105 applies. Application of the rule is limited to offerings of "equity" securities. This precise language benefits persons determining whether or not the rule is applicable in a particular situation. The

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[99] See, e.g., Shane A. Corwin, The Determinants of Underpricing for Seasoned Equity Offers, 58 J. Fin 2249 (Oct. 2003). Although the study does not purport to explain why this happened, it is worth noting that that the study found that prices did in fact decline during the five day restricted period prior to the pricing of the offering. Various reasons for this price decline have been posited in the literature of which short selling is only one possible explanation.

amended rule also harmonizes its language with other rules of Regulation M by using the term "subject" security. The amendments also benefit traders by making it clear that the rule does not apply to reference securities so that, in a convertible offering, a trader can sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105.

The new provisions concerning bona fide purchases, separate accounts, and investment companies benefit issuers because they narrowly tailor the rule to address a specific abuse in a manner consistent with the goals of Rule 105 without unnecessarily shrinking the potential universe of offering investors. The bona fide purchase provision also benefits issuers because it requires that the bona fide purchase must occur no later than the business day prior to the day of pricing. This benefits issuers because it provides an opportunity for market reaction to the purchase prior to pricing the offering.

The bona fide purchase provision also benefits short sellers because they are able to effect certain short sales without being precluded from making an offering purchase where we believe the price impact of the purchase offsets the price impact of the short sales. The separate account exception benefits short sellers who will not have to restrict their short sales because of the possibility of a separate but related account purchasing offered securities. Similarly, the investment company exception benefits investment companies who sell short because they will not have to restrict their short sales do to the possibility of an affiliated investment company or any series of such company purchasing offered securities. The separate account and investment company provisions also benefit potential investors who may want to purchase offered securities. These potential investors will not be precluded from doing so because of restricted period short sales in a separate account or affiliated investment company.

The amendments do not ban short sales. Rather, the amendments maintain much of the prior rule's flexibility for effecting short sales such as allowing traders to sell short prior to the restricted period and receive an allocation, and to sell short during the restricted period if they do not participate in an offering. Persons can also sell short during the restricted period and participate in the offering if they make a bona fide purchase. The amendments benefit the securities market generally because they allow for short sales that may contribute to pricing efficiency and price discovery.

The amendments also benefit issuers by expanding the rule's scope to cover offerings made pursuant to Form 1-E. Issuers making such offerings should be less likely to receive reduced offering proceeds due to short sales effected immediately before pricing an offering. Subjecting offerings made pursuant to Regulation E to the provisions of Rule 105 will help to ensure that participants in the secondary market for the securities of small business investment companies and business development companies will enjoy the same protections afforded to participants in the secondary market for the securities of similarly placed non-investment companies. Similarly, including offerings made pursuant to Form 1-E will place small business investment companies and business development companies on an equal footing with small issuers that utilize Regulation A.

By putting an end to activity designed to conceal covering with offered securities but in a manner designed to replicate the same economic outcome, the amendments are expected to lead to a reduction in short sales in violation of Rule 105 that place artificial downward pressure on market prices, which can lower offering prices and thereby reduce an issuer's offering proceeds. Therefore, the amendments will likely strengthen the ability of underwriters to set offering prices based on independent supply and demand without being encumbered by artificial activity in the market.

C. Costs

We recognize that the amendments to Rule 105 may result in some costs to certain market participants. Under the former rule, persons that effected restricted period short sales were prohibited from covering such short sales with offering securities. Thus, persons were required to have systems and surveillance mechanisms for information gathering, management and recordkeeping systems or procedures in order to comply with the former rule. For that reason, persons are not expected to incur costs for having to develop new surveillance mechanisms. Any existing mechanisms may need to be modified but we do not anticipate that any costs associated with such modification will be significant. We note, however, that one commenter stated that in order to comply with the proposed amendments, a large trading organization would need to implement significant changes to its trading infrastructure to identify and track offerings subject to Rule 105. However, while there are some differences in what persons will have to track under the amended Rule, including potential added costs associated with the bona fide purchase provision, persons needed to identify and track offerings subject to the former rule, and thus, such costs were likely already incurred when the rule was first adopted and, therefore, any additional costs are likely to be minimal.

The adopting amendments provide that a person who sells short during the restricted period cannot purchase in the offering. We believe that this bright line demarcation of prohibited conduct may perhaps even be easier to surveil and comply with, and which may lead to reduced costs. Further, we believe that this bright line demarcation of prohibited conduct may also lead to a reduction in costs given the anticipated reduction in schemes that may currently be in place to conceal covering.

We anticipate that some entities may incur costs associated with educating traders regarding the adopted amendments and updating compliance manuals. We do not anticipate that such costs will be significant.

We do not anticipate that registered investment companies will incur significant costs associated with the amendments. Many registered investment companies do not effect short sale strategies. In addition, the separate account exception may used by sub-advisers to the same investment company. If the sub-advisers' accounts are separate, one sub-adviser can purchase the offered securities if another sub-adviser sold short during the Rule 105 restricted period. Further, the investment company exception can be used by an individual fund within the same complex or a series of a fund so that one fund or series can purchase an offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period. Accordingly, sub-advisers and investment companies relying on these exceptions will not incur costs from altering their trading.

There may be some costs to short sellers relying on the bona fide purchase provision as they will need to make a market purchase in order to participate in the offering. Moreover, under the amendments, restricted period short sellers relying on the bona fide purchase provision must make a purchase prior to pricing, but the purchase must occur no later than the business day prior to the day of pricing. In rare circumstances, there also may be costs to a person who sells short near the 30 minutes prior to close of regular trading hours on the business day prior to the day of pricing and is then approached to participate in an offering. That person may incur some costs in making the market purchase in order to participate in the offering as well as some costs in determining the exact time of the short sale. We expect any such cost will be minimal.

We anticipate that many persons will be able to rely on the separate account exception based on their current structures. For example, the exception would be available to an individual investor who invests capital in two or more accounts, grants full discretionary trading to the respective managers of each account, does not coordinate trading between the accounts or make investment decisions for the accounts and has managers that do not coordinate trading. We expect that many individual investors with multiple accounts currently have such a structure in place and would not incur costs to comply with this exception. By way of another example, a pension fund that provides capital to two or more advisers may currently fall within the exception and would not incur costs in order to comply with the separate account exception.

We do not anticipate significant costs to be incurred by persons relying on the investment company exception. This exception allows certain investment companies to participate in an offering if an affiliated investment company or any series of such company sold short during the restricted period. We expect that the investment companies at which the exception is directed currently have structures in place that will allow them to take advantage of the exception and thus should not incur significant costs, if any, in relying on the exception.

There may be persons who are unable to rely on the investment company or separate account exceptions. We note that such persons are not required to use the exceptions and thus there is no cost associated with the exception that a person would incur. Rather than rely on these exceptions, such persons may instead choose not to purchase an offered security, refrain from selling short during the restricted period if they choose to purchase the offered security, or use the bona fide purchase exception. A person may however, choose to voluntarily adjust their structures so as to be able to use the investment company or separate account exceptions and may incur costs in doing so.

There may be costs to a person that is unable to rely on the new exceptions and chooses to seek to obtain exemptive relief from the Commission. However, we anticipate the three new exceptions will be used by many persons and accordingly should reduce the need for exemptive relief. Therefore, we do not anticipate numerous requests for exemptive relief. In addition, persons can tailor their trading so as to not run afoul of the rule and eliminate the need for exemptive relief.

In response to the Proposing Release, one commenter noted potential costs associated with the possibility of the proposals impairing trading strategies of hedge funds and other active traders, with likely negative consequences for capital raising.[100] Another commenter noted that the proposals will have an adverse impact on capital raising through secondary offerings and impose greater costs to issuers by: forcing investors to make an investment decision at an earlier point in time before an offering price is determined; allowing issuers and underwriters to price offerings without market counterbalance; and reducing the number of buyers for secondary offerings.[101] However, we believe that modifying the proposal to include the bona fide purchase provision will address commenters' concerns about the potential negative consequences or impact on capital raising, including concerns about a decrease in the number of potential buyers in an offering and increased costs to issuers. The provision also allows potential buyers to decide to invest at a time much closer to the pricing of an offering than as originally proposed.

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[100] See MFA letter.

[101] See Morgan letter.

We do not expect the amendments to result in a major increase in costs. We expect that the amendments likely will curtail the potential for manipulative activity that can reduce offering proceeds. The change will provide a protective measure against abusive conduct that hampers the capital raising process and negatively impacts issuers. We believe that any costs associated with the amendments are justified by the benefits derived from preventing the manipulative activity of effecting restricted period short sales and covering with offering shares.

VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[102] requires us, when engaging in rulemaking and where we are required to consider or determine where an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[103] requires the Commission, in adopting rules under the Exchange Act, to consider the anticompetitive effects of any rules it adopts under the Exchange Act. 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. In the Proposing Release, we solicited comment on the proposal's effects on efficiency, competition, and capital formation. Additionally, we requested comment on the potential impact of the proposed amendments on the economy on an annual basis pursuant to the Small Business Regulatory Enforcement Act of 1966 ("SBREFA").[104]

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[102] 15 U.S.C.78c(f).

[103] 15 U.S.C.78w(a)(2).

[104] Pub. L. 104-121, tit. II, 110 Stat. 857 (1996).

In response to the Proposing Release, one commenter stated its belief that the proposed amendments could result in unintended negative consequences, including the creation of new hurdles that hinder the efficiency of the capital formation process – to the ultimate detriment of the issuers the Rule is seeking to protect.[105] This commenter also expressed concern about the impact of the proposed amendments in situations where investors effect short sales during the rule's restricted period without any knowledge that the offering is going to occur; and that by effectively precluding a group of investors from receiving an allocation, the proposed amendments could negatively impact underwriters' decision on whether to commit to some offerings.[106] We believe that the bona fide purchase provision addresses these concerns, in that most of these investors will not be precluded from participating in such offerings.

We believe that the amendments are expected to promote capital formation through enhanced investor confidence in the integrity of the U.S. securities market because the amendments prohibit conduct that can manipulate market prices and could result in lower offering prices.[107] Capital formation may also be facilitated because issuers may be more likely to offer securities for sale in the U.S. securities market because there are rules in place to deter potentially manipulative conduct that effects offering prices. The bona fide purchase provision will likely contribute to capital formation by helping to ensure that the universe of potential offering investors is not unduly limited.

The amendments also promote pricing efficiency. Short sales contributing to price discovery and efficiency can occur at any time under Rule 105 if a person chooses not to

105 See SIFMA letter

106 See id.

107 Academic research shows that prices decline during the five days before pricing for follow-on offerings under the current restrictions. See supra note 99. See also Fairfax letter.

purchase in an offering. Persons can sell short prior to the restricted period and purchase offering securities. In addition, the bona fide purchase provision retains an opportunity for persons to sell short during the Rule 105 restricted period and still participate in certain offerings. The amendments are expected to lessen the incentive to engage in trading activity that could lead to a loss in pricing efficiency prior to when an offering is priced because it is now more difficult to obscure the prohibited activity of making an offering purchase.

The amendments are not expected to impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. An individual fund within a fund complex, or a series of a fund, may rely on the investment company exception if the conditions of the exception are met. A separately subadvised portion of a fund may rely on the separate account exception if the conditions of the exception are satisfied. Because of the broad diversity of other fund structures, we will consider individual requests on a case-by-case basis.

The Commission believes that the amendments are in the public interest because of the strategies designed to hide the covering prohibited by former Rule 105 and the resulting artificial downward pressure placed on market prices, which can lower offering prices and thereby reduce an issuer's offering proceeds.

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the Regulatory Flexibility Act in conjunction with the Proposing Release. The Proposing Release included, and solicited comment on, the IRFA.

A. Need for the Amendments

There has been non-compliance with former Rule 105 and persons engaging in strategies to hide that non-compliance. In particular, persons engineered strategies to conceal the prohibited covering. We have observed that these strategies evolved over time. The Commission is adopting these amendments to forestall the continuation of these obfuscating transactions and protect the integrity of the U.S. capital raising process. We believe the amendments are necessary to cut-off the likely future development of more complex attempts to disguise violations of the Rule.

B. Objectives of the Amendments

The amendments are designed to facilitate offering prices determined by independent market forces. The amendments enhance market integrity by prohibiting conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by an independent market. The amendments are designed to promote offering prices that are determined by the natural forces of supply and demand. We believe the amendments safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce offering proceeds. The amendments are expected to promote investor confidence in the market which should foster capital formation.

C. Significant Issues Raised by Public Comments

The IRFA appeared in the Proposing Release.[108] We requested comment on the IRFA on "(1) the number of persons that are subject to Rule 105 and the number of such persons that are small entities; (2) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact . . . and (3) how to quantify the

[108] See Proposing Release Section X, 71 FR at 75009.

number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments."[109] We received one comment letter that discussed the IRFA.[110]

D. Small Entities Subject to the Rule

The amendments apply to persons that effect short sales during the restricted period. For purposes of amended Rule 105, the term "person" is unchanged from the former rule. The persons covered by the amendments include small entities. Generally, these entities were already subject to former Rule 105 and were likely to have been monitoring restricted period short sales. For that reason, we do not anticipate that there will be any significant additional costs associated with compliance with the amendments for these businesses. Although it is impossible to quantify every type of small entity that may sell short during a Rule 105 restricted period, paragraph (c)(1) of Rule 0-10[111] 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. As of the start of 2006, the Commission estimates that there were approximately 911 broker dealers that qualified as small entities as defined above.[112]

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109 Proposing Release, 71 FR at 75010.

110 See letter from Cleary (disagreeing with the statement that there are no duplicative rules). However, we note that the amendments do not replace, but are designed to work in conjunction with other provisions under the federal securities laws, such as Exchange Act Section 10(b) and Rule 10b-5 and Securities Act Section 5.

111 17 CFR 240.0-10(c)(1).

112 These numbers are based on the Office of Economic Analysis' review of 2006 FOCUS Report filings reflecting registered broker dealers. The number does not include broker-dealers that are delinquent on FOCUS Report filings.

Any business, however, regardless of industry, will be subject to Rule 105 if they sell short during the applicable restricted period. The Commission believes that, except for the broker-dealers discussed above, especially in the absence of commenters addressing the issue, an estimate of the number of small entities that fall under the amendments is not feasible.

As with the former rule, the amended rule does not distinguish offerings by whether an issuer is small or large. Its provisions apply equally to any offering that falls within the rule's conditions regardless of the size of the issuer.

E. Projected Reporting, Recordkeeping and Other Compliance Requirements

The amendments may impose limited new compliance requirements on any affected party, including broker-dealers that are small entities. Under the amendments, persons covered by the rule who sell short during the restricted period cannot purchase securities in the offering. While compliance is required to ensure the prohibition is not violated, there are no new recordkeeping or reporting obligations.

The amendments do not modify the measurement of restricted periods that apply. Therefore, since the former rule also addresses conduct around short selling that occurs during a Rule 105 restricted period, the monitoring that is required of market participants to ensure compliance with the amended rule will not change.

We note that the compliance with the amended rule is expected to be simpler than compliance with the former rule, which prohibited covering. Monitoring for an offering purchase, notwithstanding any additional monitoring that may be needed to help ensure compliance with the bona fide purchase provision, is simpler than monitoring for covering because it is so easily identifiable. As with the former rule, responsibility for compliance with the amendments rests with the person that sells short during the Rule 105 restricted period. The amendments are focused on eliminating schemes to disguise the covering prohibited by the former rule and are not intended to change compliance responsibilities.

There are no new reporting or recordkeeping requirements in the amended rule. The amendments do not contain recordkeeping or reporting requirements for broker-dealers or any recordkeeping or reporting requirements unique to small entities.

F. Agency Action to Minimize Effect on Small Entities

We have considered various alternatives to accomplish our objectives which minimize any significant adverse impact on small entities and other entities. While we proposed a stricter rule, we modified the proposal to include a limited bona fide purchase provision in response to commenters' concerns. We believe that the amendments are narrowly tailored to address particular conduct, hiding the covering prohibited by the former rule. The amendments apply restrictions where they are most needed and ease the proposed amendments, in light of comments, where the risk of potentially manipulative activity is not as great. The amendments are not expected to adversely effect small entities because they do not impose any new recordkeeping, or reporting requirements.

VIII. Statutory Basis and Text of Amendments

Pursuant to sections 7, 17(a), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), and 77s(a)]; sections 2, 3, 7(c)(2), 9(a), 10, 11A(c), 12, 13, 14, 15(b), 15(c), 15(g), 17(a), 17(b), 17(h), 23(a), 30A, and 36 of the Exchange Act [15 U.S.C. 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, and 78mm]; and sections 23, 30, 38 of the Investment Company Act [15 U.S.C. 80a-23, 80a-29 and 80a-37].

Text of Amendments

List of Subjects in 17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, Part 242 of the Code of Federal Regulations is amended as follows:

PART 242 – REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITIES FUTURES

1. 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.

2. Section 242.105 is amended by:

a. Revising paragraph (a);

b. Redesignating paragraph (b) and (c) as paragraphs (c) and (d); and

c. Adding new paragraph (b).

The revision and addition reads as follows:

§242.105 Short selling in connection with a public offering.

(a) Unlawful Activity. In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A (§239.90 of this chapter) or Form 1-E (§239.200 of this chapter) filed under the Securities Act of 1933 ("offered securities"), it shall be unlawful for any person to sell short (as defined in §242.200(a)) the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") that is the shorter of the period:

(1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or

(2) Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.

(b) Excepted Activity.

(1) Bona Fide Purchase. It shall not be prohibited for such person to purchase the offered securities as provided in paragraph (a) of this section if:

(i) Such person makes a bona fide purchase(s) of the security that is the subject of the offering that is:

(A) At least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale(s);

(B) Effected during regular trading hours;

(C) Reported to an "effective transaction reporting plan" (as defined in §242.600(b)(22)); and

(D) Effected after the last Rule 105 restricted period short sale, and no later than the business day prior to the day of pricing; and

(ii) Such person did not effect a short sale, that is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours (as defined in §242.600(b)(64)) on the business day prior to the day of pricing.

(2) Separate Accounts. Paragraph (a) of this section shall not prohibit the purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a separate account, if decisions regarding securities transactions for each

account are made separately and without coordination of trading or cooperation among or between the accounts.

(3) Investment Companies. Paragraph (a) of this section shall not prohibit an investment company (as defined by Section 3 of the Investment Company Act) that is registered under Section 8 of the Investment Company Act, or a series of such company (investment company) from purchasing an offered security where any of the following sold the offered security short during the Rule 105 restricted period:

(i) An affiliated investment company, or any series of such a company; or

(ii) A separate series of the investment company.

* * * * *

By the Commission

Nancy M. Morris

Nancy M. Morris
Secretary

Date: August 6, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 240, 249 and 274

[RELEASE NOS. 33-8830, 34-56205, IC-27923]

DELETION OF REFERENCES TO IRS IDENTIFICATION NUMBERS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are removing a number of references to filers' IRS identification numbers currently found in several disclosure schedules and forms because we do not need that information to process the documents, nor is the information material to investors.

EFFECTIVE DATE: [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: James Budge [(202) 551-3115], Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20459-5553.

SUPPLEMENTARY INFORMATION: We are adopting minor, technical amendments to Form 144[1] under the Securities Act of 1933 ("Securities Act")[2] and Forms 3, 4 and 5,[3] descriptions of these forms[4] and Schedules 13D, 13G and TO[5] under the Securities Exchange Act of 1934 ("Exchange Act").[6]

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[1] 17 CFR 239.144.

[2] 15 U.S.C. 77a et seq.

[3] 17 CFR 249.103, 249.104 and 249.105. Forms 3 and 4 also are referenced in connection with the Investment Company Act of 1940 ("Investment Company Act") [15 U.S.C. 80a-1 et seq.] in 17 CFR 274.202 and 274.203.

[4] 17 CFR 249.103, 249.104 and 249.105, respectively.

[5] 17 CFR 240.13d-101, 240.13d-102 and 240.14d-100, respectively.

[6] 15 U.S.C. 78a et seq.

Document 8 of 39

I. THE AMENDMENTS

IRS Identification Numbers

We are amending several disclosure schedules, forms and form descriptions to delete references to IRS identification numbers.

Schedules 13D, 13G and TO provide that a reporting person that is an entity may, at its option, include its IRS identification number on the cover page.[7] Form 144 requires a reporting person that is an entity to include its IRS identification number in the filing.[8] Although we sought IRS identification numbers in the past to better process filings, we no longer use them. In addition, IRS identification numbers serve no useful purpose to investors in the context of these disclosure documents. The number appears in beneficial ownership reports and Schedule TO only when a non-natural person chooses to include it. In the case of Form 144, only forms filed by non-natural persons include the number. Since the Commission and the public have more reliable means to track who is filing these documents based on information unrelated to IRS identification numbers, we are eliminating references to IRS identification numbers in these schedules and Form 144.[9]

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[7] Schedules 13D and 13G are used by significant security holders to disclose securities ownership and transaction information under Exchange Act Sections 13(d) [15 U.S.C. 78m(d)] and 13(g) [15 U.S.C. 78m(g)]. Schedule TO is used by bidders to disclose tender offer information under Exchange Act Sections 13(e)(1) [15 U.S.C. 78m(e)(1)] and 14(d)(1) [15 U.S.C. 78n(d)(1)]. Schedule TO indirectly permits filers that are entities to include an IRS identification number by permitting them to amend a previously filed Schedule 13D to create a combined filing with the Schedule TO.

[8] Form 144 is used by security holders to disclose securities transaction information under Securities Act Rule 144 [17 CFR 230.144].

[9] In Schedules 13D and 13G, references appear in Item 1 of the cover page and its related instruction. In all three schedules references appear under the heading "Special Instructions for Complying with Schedule . . . ." In Form 144, we are deleting IRS identification numbers references from Item 2(b) and its related instruction. The remaining Items in Form 144 will be renumbered as needed.

In 2003, we modified Forms 3, 4 and 5 in part to remove provisions allowing reporting persons to provide IRS identification numbers in those filings.[10] However, several references to IRS identification numbers inadvertently were not removed from related form descriptions and instructions. Accordingly, we are amending those descriptions and instructions to remove all references to IRS identification numbers.[11]

II. PAPERWORK REDUCTION ACT

The amendments will affect three schedules and four forms that contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[12] The titles of the affected information collections are Securities Act Form 144 and Exchange Act Schedules 13D, 13G and TO and Forms 3, 4 and 5.

Form 144 (OMB Control Number 3235-0101) is used by security holders to disclose securities transaction information under Securities Act Rule 144.

Schedules 13D and 13G (both with OMB Control Number 3235-0145) are used by significant security holders to disclose securities ownership and transaction information under Exchange Act Sections 13(d) and 13(g).

Schedule TO (OMB Control Number 3235-0515) is used by bidders to disclose tender offer information under Exchange Act Sections 13(e)(1) and 14(d)(1).

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[10] Form 3 is used by an officer, director or principal security holder (collectively, "insider") to disclose securities ownership information under Exchange Act Section 16(a) [15 U.S.C. 78p(a)]. Forms 4 and 5 are used by insiders to disclose securities transaction information under Exchange Act Section 16(a). Forms 3, 4 and 5 permitted filers that were entities to include their IRS identification numbers until the forms were amended in 2003. See Release No. 33-8230 (May 7, 2003) [68 FR 25788 (May 13, 2003)].

[11] The forms are described at 17 CFR 249.103, 249.104, 249.105, 274.202 and 274.203. Only the descriptions under 17 CFR Part 249, however, contain references to IRS identification numbers. We are amending these descriptions, as well as the paragraph that precedes the heading "General Instructions" in each form.

[12] 44 U.S.C. 3501 et seq.

Form 3 (OMB Control Number 3235-0104) is used by insiders to disclose securities ownership information under Exchange Act Section 16(a).

Forms 4 (OMB Control Number 3235-0287) and 5 (OMB Control Number 3235-0362) are used by insiders to disclose securities transaction information under Exchange Act Section 16(a).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The removal of the provisions will result in a negligible reduction in filer burden that is too minimal to quantify and does not affect any collection of information in a substantive way. 44 U.S.C. 3507(h)(3) and 5 CFR 1320(g). Consequently, we have not submitted the revisions to the collections of information to the Office of Management and Budget for review under 44 U.S.C. 3507(d) and 5 CFR 1320.11.

III. COST-BENEFIT ANALYSIS

We expect that the amendments will neither significantly benefit investors or filers of beneficial ownership reports and Schedules TO and investors, nor will they impose costs on them, since the inclusion of IRS numbers in those documents now is voluntary. The amendment to remove Form 144's requirement that non-natural reporting persons disclose their IRS identification numbers should slightly benefit those filers by reducing the amount of information they must provide; these amendments should not impose costs on filers or investors.

IV. EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act[13] requires us, when adopting rules under the Exchange Act, to consider the impact that any 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,[14] Section 3(f) of the Exchange Act,[15] and Section 2(c) of the Investment Company Act[16] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

The amendments merely remove the voluntary or required inclusion of information that is no longer useful and make conforming technical changes. We believe the amendments will not impose a burden on competition and have no impact on efficiency, competition or capital formation.

V. CERTAIN FINDINGS

Under the Administrative Procedure Act ("APA"), notice of proposed rulemaking is not required when an agency, for good cause, finds "that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[17] As we have explained previously, IRS identification numbers do not provide useful information in the context of

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[13] 15 U.S.C. 78w(a)(2).

[14] 15 U.S.C. 77b(b).

[15] 15 U.S.C. 78c(f).

[16] 15 U.S.C. 80a-2(c).

[17] 5 U.S.C. 553(b)(3)(B).

federal securities law disclosures made in Schedules 13D, 13G and TO and Form 144 filings. They are provided only in certain of those filings, mostly on a voluntary basis. The changes we are adopting today remove the opportunities to provide information that we sought for internal processing purposes, but have found is no longer useful. Therefore, we believe publication for public comment is unnecessary. In addition, the amendments to Forms 3, 4 and 5 and their descriptions to delete references to the filer's IRS identification number are technical changes to conform to a previous rule change and have no practical effect. Accordingly, we find that publishing notice of these amendments is likewise unnecessary.[18]

The APA also requires publication of a rule at least 30 days before its effective date unless the agency finds otherwise for good cause.[19] Since we find this information to be not useful or necessary, we see no reason to retain the provisions for 30 days after these rule changes are published in the Federal Register. We believe filers should be able to have the limited benefits of these changes immediately. Consequently, we find there is good cause for the amendments to take effect immediately upon publication in the Federal Register.

VI. STATUTORY BASIS

We are adopting the amendments under the authority in Section 19(a)[20] of the Securities Act, Sections 13,[21] 14,[22] 16[23] and 23(a)[24] of the Exchange Act, and Sections 30(h)[25] and 38[26] of the Investment Company Act.

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[18] For similar reasons, the amendments do not require analysis under the Regulatory Flexibility Act or a report to Congress under the Small Business Regulatory Fairness Act. See 5 U.S.C. 601(2) (for purposes of a Regulatory Flexibility Act analysis, the term "rule" means any rule for which the agency publishes a general notice of proposed rulemaking) and 5 U.S.C. 804(3)(C) (for purposes of Congressional review of agency rulemaking, the term "rule" does not include any rule of agency organization, procedure or practice that does not substantially affect the rights or obligations of non-agency parties).

[19] See 5 U.S.C. 553(d)(3).

[20] 15 U.S.C. 77s(a).

TEXT OF RULE AMENDMENTS

List of Subjects in 17 CFR Parts 239, 240, 249 and 274

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, we 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 continues 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), 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.

* * * * *

2. Amend Form 144 (referenced in §239.144) by:

a. Removing Item 2(b) and redesignating Items 2(c) and 2(d) as Items 2(b) and 2(c);

b. Removing Instruction 2(b) and redesignating Instructions 2(c) and 2(d) as Instructions (b) and 2(c).

Note -- The text of Form 144 does not and this amendment will not appear in the

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[21] 15 U.S.C. 78m.

[22] 15 U.S.C. 78n.

[23] 15 U.S.C. 78p.

[24] 15 U.S.C. 78w(a).

[25] 15 U.S.C. 80a-29(h).

[26] 15 U.S.C. 80a-37.

Code of Federal Regulations.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. 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.

* * * * *

4. Amend §240.13d-101 by:

a. Revising Item 1 on the Cover Page;

b. Revising Item 1 of the Instructions for Cover Page; and

c. Revising the Special Instructions for Complying with Schedule 13D,

to read as follows:

§240.13d-101 Schedule 13D - Information to be included in statements filed pursuant to §240.13d-1(a) and amendments thereto filed pursuant to §240.13d-2(a).

Securities and Exchange Commission

Washington, D.C. 20549

Schedule 13D

* * * * *

(1) Names of reporting persons.

* * * * *

Instructions for Cover Page

(1) Names of Reporting Persons - Furnish the full legal name of each person for whom the report is filed – i.e., each person required to sign the schedule itself – including each member of a group. Do not include the name of a person required to be identified in the report but who is not a reporting person.

* * * * *

Special Instructions for Complying With Schedule 13D

Under sections 13(d) and 23 of the Securities Exchange Act of 1934 and the rules and regulations thereunder, the Commission is authorized to solicit the information required to be supplied by this schedule by certain security holders of certain issuers.

Disclosure of the information specified in this schedule is mandatory. The information will be used for the primary purpose of determining and disclosing the holdings of certain beneficial owners of certain equity securities. This statement will be made a matter of public record. Therefore, any information given will be available for inspection by any member of the public.

Because of the public nature of the information, the Commission can use it for a variety of purposes, including referral to other governmental authorities or securities self-regulatory organizations for investigatory purposes or in connection with litigation involving the federal securities laws or other civil, criminal or regulatory statutes or provisions.

Failure to disclose the information requested by this schedule may result in civil or criminal action against the persons involved for violation of the federal securities laws and rules promulgated thereunder.

* * * * *

5. Amend §240.13d-102 by:

a. Revising Item 1 on the Cover Page;

a. Revising Item 1 of the Instructions for Cover Page; and

b. Revising the Special Instructions for Complying with Schedule 13G,

to read as follows:

§240.13d-102 Schedule 13G - Information to be included in statements filed pursuant to §240.13d-1(b), (c), and (d) and amendments thereto filed pursuant to §240.13d-2.

Securities and Exchange Commission

Washington, D.C. 20549

SCHEDULE 13G

* * * * *

(1) Names of reporting persons.

* * * * *

Instructions for Cover Page

(1) Names of Reporting Persons - Furnish the full legal name of each person for whom the report is filed – i.e., each person required to sign the schedule itself – including each member of a group. Do not include the name of a person required to be identified in the report but who is not a reporting person.

* * * * *

Special Instructions for Complying With Schedule 13G

Under Sections 13(d), 13(g) and 23 of the Securities Exchange Act of 1934 and the rules and regulations thereunder, the Commission is authorized to solicit the information required to be supplied by this schedule by certain security holders of certain issuers.

Disclosure of the information specified in this schedule is mandatory. The information will be used for the primary purpose of determining and disclosing the holdings of certain beneficial owners of certain equity securities. This statement will be made a matter of public record. Therefore, any information given will be available for inspection by any member of the public.

Because of the public nature of the information, the Commission can use it for a variety of purposes, including referral to other governmental authorities or securities self-regulatory organizations for investigatory purposes or in connection with litigation involving the Federal securities laws or other civil, criminal or regulatory statutes or provisions.

Failure to disclose the information requested by this schedule may result in civil or criminal action against the persons involved for violation of the Federal securities laws and rules promulgated thereunder.

* * * * *

6. Amend §240.14d-100 by revising the Special Instructions for Complying with Schedule TO to read as follows:

§240.14d-100 Schedule TO. Tender offer statement under section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934.

Securities and Exchange Commission,

Washington, D.C. 20549

SCHEDULE TO

* * * * *

Special Instructions for Complying With Schedule TO

Under Sections 13(e), 14(d) and 23 of the Act and the rules and regulations of the Act, the Commission is authorized to solicit the information required to be supplied by this schedule.

Disclosure of the information specified in this schedule is mandatory. The information will be used for the primary purpose of disclosing tender offer and going-private transactions. This statement will be made a matter of public record. Therefore, any information given will be available for inspection by any member of the public.

Because of the public nature of the information, the Commission can use it for a variety of purposes, including referral to other governmental authorities or securities self-regulatory organizations for investigatory purposes or in connection with litigation involving the federal securities laws or other civil, criminal or regulatory statutes or provisions.

Failure to disclose the information required by this schedule may result in civil or criminal action against the persons involved for violation of the federal securities laws and rules.

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

8. Amend §249.103 by:

a. Removing from the first sentence the phrase "sections 17(a) and 20(a) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79q(a) and 79t(a));"

b. Removing from the third sentence the phrase ", except for disclosure of I.R.S. identification number by entities, which is voluntary"; and

c. Removing the fourth sentence.

9. Amend §249.104 by:

a. Removing from the first sentence the phrase "sections 17(a) and 20(a) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79q(a) and 79t(a));"

b. Removing from the third sentence the phrase ", except for disclosure of I.R.S. identification number by entities, which is voluntary"; and

c. Removing the fourth sentence.

10. Amend §249.105 by:

a. Removing from the first sentence the phrase "sections 17(a) and 20(a) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79q(a) and 79t(a));"

b. Removing from the third sentence the phrase ", except for disclosure of I.R.S. identification number by entities, which is voluntary"; and

c. Removing the fourth sentence.

11. Amend Form 5 (referenced in §249.105) by

a. Removing the phrase ", Section 17(a) of the Public Utility Holding Company Act of 1935" from the first paragraph following the heading "Annual Statement of Changes in Beneficial Ownership of Securities";

b. Removing from the first sentence of the second paragraph of the introductory section preceding the General Instructions the phrase ", except for disclosure of the I.R.S. identification number of the reporting person if such person is an entity, which is voluntary"; and

c. Removing the second sentence of the second paragraph of the introductory section preceding the General Instructions.

Note – The text of Form 5 does not and this amendment will not appear in the Code of Federal Regulations.

PART 274 – FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

12. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

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PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

PART 274 – FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

13. Amend Form 3 (referenced in §249.103 and §274.202) by:

a. Removing the phrase ", Sections 17(a) and 20(a) of the Public Utility Holding Company Act of 1935" from the first paragraph following the heading "Initial Statement of Beneficial Ownership of Securities";

b. Removing from the first sentence of the second paragraph of the introductory section preceding the General Instructions the phrase ", except for disclosure of the I.R.S. identification number of the reporting person if such person is an entity, which is voluntary"; and

c. Removing the second sentence of the second paragraph of the introductory section preceding the General Instructions.

Note – The text of Form 3 does not and this amendment will not appear in the Code of Federal Regulations.

14. Amend Form 4 (referenced in §249.104 and §274.203) by

a. Removing the phrase ", Sections 17(a) and 20(a) of the Public Utility Holding Company Act of 1935" from the first paragraph following the heading "Statement of Changes in Beneficial Ownership";

b. Removing from the first sentence of the second paragraph of the introductory section preceding the General Instructions the phrase ", except for disclosure of the I.R.S. identification number of the reporting person if such person is an entity, which is voluntary"; and

c. Removing the second sentence of the second paragraph of the introductory section preceding the General Instructions.

Note – The text of Form 4 does not and this amendment will not appear in the Code of Federal Regulations.

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

August 6, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release No. 34-56213; File No. S7-19-07]

RIN 3235-AJ57

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is re-proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the options market maker exception. In addition, we are requesting comment regarding specific alternatives to our proposal to eliminate the options market maker exception.

We are also proposing an amendment to the long sale marking provisions of Regulation SHO that would require that brokers and dealers marking a sale as "long" document the present location of the securities being sold.

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

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

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- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-19-07 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.

All submissions should refer to File Number S7-19-07. 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: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Elizabeth A. Sandoe, Branch Chief, Joan M. Collopy, Special Counsel, and Lillian S. Hagen, 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 requesting public comment on proposed amendments to Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.[1] Among other things, Regulation SHO imposes a close-out requirement to address failures to deliver stock on trade settlement date[2] and to target potentially abusive "naked" short selling[3] in certain equity securities.[4] While the majority of

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1 17 CFR 242.200. See also Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) ("Adopting Release"), available at http://www.sec.gov/rules/final/34-50103.htm.

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

2 Generally, investors must complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or "trade date plus three days"). T+3 means that when the investor purchases a security, the purchaser's payment must be received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. Because the Commission recognized that there are many legitimate reasons why broker-dealers may not deliver securities on settlement date, it adopted Rule 15c6-1, which prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1. However, failure to deliver securities on T+3 does not violate the rule.

3 We have previously noted that abusive "naked" short selling, while not defined in the federal securities laws generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle. See Securities Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) ("2006 Proposing Release").

4 In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of Sedona Corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with Sedona stock, and depressed its price. See Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, SEC v. Rhino Advisors, Inc. and Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y). See also, Securities Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) ("2003 Proposing Release") (describing the alleged activity in the case involving stock of Sedona Corporation); Adopting Release, 69 FR at 48016, n.76.

trades settle on time,[5] Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might impact the market for that security.[6] Although high fails levels exist only for a small percentage of issuers,[7] we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently. Moreover, sellers that fail to deliver securities on settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that are designed to improperly depress the price of a security.

In addition, many issuers and investors continue to express concerns about extended fails

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5 According to the National Securities Clearing Corporation ("NSCC"), 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3.

6 These fails to deliver may result from either short or long sales of stock. There may be many reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. Also, broker-dealers that make a market in a security ("market makers") and who sell short thinly-traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

7 The average daily number of securities on a threshold list (as defined infra note 13) in March 2007 was approximately 311 securities, which comprised 0.39% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO's current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

to deliver in connection with "naked" short selling.[8] To the extent that large and persistent fails to deliver might be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price, such fails to deliver may undermine the confidence of investors.[9] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[10] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver in the issuer's security.[11] Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security's price.[12]

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8 See, e.g., letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 ("Overstock"); letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006 ("TASER"); letter from John Royce, dated April 30, 2007; letter from Michael Read, dated April 29, 2007; letter from Robert DeVivo, dated April 26, 2007; letter from Ahmed Akhtar, dated April 26, 2007.

9 See, e.g., letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 ("NCANS"); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 ("State of Connecticut") (discussing the impact of fails to deliver on investor confidence).

10 See, e.g., letter from Congressman Tom Feeney - Florida, U.S. House of Representatives, dated Sept. 25, 2006 ("Feeney") (expressing concern about the impact of potential "naked" short selling on capital formation, claiming that "naked" short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets); letter from Zix Corporation, dated Sept. 19, 2006 ("Zix") (stating that "[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company "do something" about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities").

11 Due, in part, to such concerns, issuers have taken actions to attempt to make transfer of their securities "custody only," thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company ("DTC") or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

12 See also 2006 Proposing Release, 71 FR at 41712 (discussing the impact of large and persistent fails to deliver on the market). See also 2003 Proposing Release, 68 FR at 62975 (discussing the impact of "naked" short selling on the market).

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to securities in which a substantial amount of fails to deliver have occurred (also known as "threshold securities").[13] As adopted in August 2004, Rule 203(b)(3) of Regulation SHO included two exceptions to the mandatory close-out requirement. The first was the "grandfather" provision, which excepted fails to deliver established prior to a security becoming a threshold security.[14] The second was the "options market maker exception," which excepted any fail to deliver in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.[15]

At the time of Regulation SHO's adoption, the Commission stated that it would monitor the operation of Regulation SHO to determine whether grandfathered fail to deliver positions were being cleared up under the existing delivery and settlement guidelines or whether any further regulatory action with respect to the close out provisions of Regulation SHO was warranted.[16] In addition, with respect to the options market maker exception, the Commission

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[13] A threshold security is defined in Rule 203(c)(6) as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)): (i) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and (ii) that is included on a list ("threshold securities list") disseminated to its members by a self-regulatory organization ("SRO"). See 17 CFR 242.203(c)(6). Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

[14] See Adopting Release, 69 FR at 48031. The "grandfathered" status applied in two situations: (i) to fail to deliver positions occurring before January 3, 2005, Regulation SHO's effective date; and (ii) to fail to deliver positions that were established on or after January 3, 2005 but prior to the security appearing on a threshold securities list.

[15] See Adopting Release, 69 FR at 48031.

[16] See id. at 48018.

noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission's original expectations.[17]

Based, in part, on the results of examinations conducted by the Commission's staff and the SROs since Regulation SHO's adoption, as well as the persistence of certain securities on threshold securities lists, on July 14, 2006, the Commission published proposed amendments to Regulation SHO,[18] which were intended to reduce the number of persistent fails to deliver in certain equity securities by eliminating the grandfather provision and narrowing the options market maker exception contained in that rule. In addition, in March 2007, the Commission re-opened the comment period to the 2006 Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the National Association of Securities Dealers, Inc.'s ("NASD's") analysis that the NASD had submitted to the public file on March 12, 2007. In addition, the notice regarding the re-opening of the comment period directed the public's attention to summaries of data collected by the Commission's Office of Compliance Inspections and Examinations and the New York Stock Exchange LLC ("NYSE")[19]

On June 13, 2007, in a companion rule to this proposal, after careful consideration of public comments, we approved the adoption of the amendment, as proposed, to eliminate the grandfather provision of Regulation SHO.[20] With respect to the options market maker exception,

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17 See id. at 48019.

18 See 2006 Proposing Release, 71 FR 41719.

19 In formulating its proposal to eliminate the grandfather provision and narrow the options market maker exception of Regulation SHO, the Commission relied in part on data collected by the NASD. In response to commenters' concerns regarding the public availability of data relied on by the Commission, we re-opened the comment period to the 2006 Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the NASD's analysis that the NASD had submitted to the public file on March 12, 2007. See Securities Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007) ("Regulation SHO Re-Opening Release").

20 See Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

however, in response to comments to the 2006 Proposing Release, we are re-proposing amendments to the current options market maker exception that would eliminate the exception.

We are concerned that persistent fails to deliver will continue in certain equity securities unless the options market maker exception is eliminated entirely. Thus, as discussed more fully below, our proposal would modify Rule 203(b)(3) by eliminating the exception. In addition, we are requesting comment regarding alternatives to eliminating the options market maker exception that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames.

We are also proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that brokers and dealers marking a sale as "long" document the present location of the securities.

II. Background

A. Rule 203(b)(3)'s Close-out Requirement

One of Regulation SHO's primary goals is to reduce fails to deliver in those securities with a substantial amount of fails to deliver by imposing additional delivery requirements on participants of a registered clearing agency with fails to deliver in these securities.[21] As discussed above, we believe that additional delivery requirements help protect and enhance the operation, integrity and stability of the markets, as well as reduce short selling abuses.

Thus, Rule 203(b)(3)'s close-out requirement requires a participant of a clearing agency registered with the Commission[22] to take immediate action to close out a fail to deliver position

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21 See Adopting Release, 69 FR at 48009.

22 For purposes of Regulation SHO, the term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24). The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A), 78q-1 and 15 U.S.C. 78q-1(b), respectively. See also, Adopting Release, 69 FR at 48031. As of May 2007, approximately 90% of participants of the NSCC, the primary

in a threshold security in the Continuous Net Settlement ("CNS")[23] system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.[24] In addition, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iv) prohibits the participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.[25]

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registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

[23] The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The National Securities Clearing Corporation ("NSCC") clears and settles the majority of equity securities trades conducted on the exchanges and over the counter. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the contraparty to both sides of the transaction. While NSCC's rules do not authorize it to require member firms to close out or otherwise resolve fails to deliver, NSCC reports to the SROs those securities with fails to deliver of 10,000 shares or more. The SROs use NSCC fails data to determine which securities are threshold securities for purposes of Regulation SHO.

[24] 17 CFR 242.203(b)(3).

[25] Id. at (b)(3)(iv). It is possible under Regulation SHO that a close out by a participant of a registered clearing agency may result in a fail to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. However, Regulation SHO prohibits a participant of a registered clearing agency, or a broker-dealer for which it clears transactions, from engaging in "sham close outs" by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a fail to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another fail to deliver position. See id. at (b)(3)(vii); Adopting Release, 69 FR at 48018 n.96. In addition, we note that borrowing securities, or otherwise entering into an arrangement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement.

B. Regulation SHO's Options Market Maker Exception

1. Current Options Market Maker Exception

Regulation SHO's options market maker exception excepts from the close-out requirement of Rule 203(b)(3) any fail to deliver position in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security.[26] The options market maker exception was created to address concerns regarding liquidity and the pricing of options.[27] The exception does not require that such fails to deliver be closed out.

Since Regulation SHO's effective date in January, 2005, the Staff and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.[28] However, despite this positive

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26 17 CFR 242.203(b)(3)(iii).

27 In response to the proposal to adopt Regulation SHO and the Commission's determination at that time not to provide an exception for market makers, including options market makers, from the delivery requirements of proposed Regulation SHO, the Commission received letters that stated that the effect of not including such an exception would be to cease altogether options trading in securities that are difficult to borrow, as it was argued that no options market makers would make markets without the ability to hedge by selling short the underlying security. In addition, one commenter stated that the heightened delivery requirements of proposed Regulation SHO for threshold securities could drain liquidity in other securities where there is no current indication of significant settlement failures. The commenter believed that, while a blanket exception would be preferable, at a minimum the implementation of any such provision should not apply to market maker positions acquired prior to the effective date of the rule, and likewise should not apply to any short position acquired prior to the time that the subject security meets the designated threshold. See Adopting Release, 69 FR at 48019 (discussing the comment letters received in response to the delivery requirements of proposed Regulation SHO). In part, in response to these comments, we adopted a limited options market maker exception to the close-out requirement of Regulation SHO. As discussed in more detail in this release and, in particular, in Section II.B.3. below, we no longer believe that the current options market maker exception is necessary.

28 For example, in comparing a period prior to the effective date of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to March 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- the average daily aggregate fails to deliver declined by 29.5%;

impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements.

Based on the examinations and our discussions with the SROs and market participants, we believe that these persistent fail to deliver positions may be attributable, in part, to reliance on the options market maker exception.[29] Accordingly, on July 14, 2006, the Commission published the 2006 Proposing Release that included proposed amendments to limit the duration of the options market maker exception.[30]

The Commission, in the 2006 Proposing Release, proposed that for securities that are threshold securities on the effective date of the amendment, any previously excepted fail to deliver position in the threshold security that resulted from short sales effected by a registered options market maker to establish or maintain a hedge on an options position that existed before the security became a threshold security, but that has expired or been liquidated on or before the effective date of the amendment, would be required to be closed out within 35 consecutive settlement days of the effective date of the amendment. In addition, if the fail to deliver position persisted for 35 consecutive settlement days, the proposal would have prohibited a participant of

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- the average daily number of securities with aggregate fails to deliver of at least 10,000 shares declined by 5.8%;
- the average daily number of fails to deliver declined by 15.1%;
- the average age of a fail to deliver position declined by 25.5%;
- the average daily number of threshold securities declined by 39.0%; and
- the average daily fails to deliver of threshold securities declined by 52.9%.

See also supra note 7.

29 As noted in the 2006 Proposing Release and the Regulation SHO Re-Opening Release, we believe that the persistent fails to deliver may be attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception. See 2006 Proposing Release, 71 FR at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079 (providing a summary of data received from certain SROs regarding reasons for the extended fails to deliver).

30 See 2006 Proposing Release, 71 FR at 41722.

a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closed out the entire fail to deliver position by purchasing securities of like kind and quantity.

If the security became a threshold security after the effective date of the amendment, all fail to deliver positions in the security that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on an options position that existed before the security became a threshold security would have to be closed out within 13 consecutive settlement days of the security becoming a threshold security or of the expiration or liquidation of the options position, whichever was later. In addition, if the fail to deliver position persisted for 13 consecutive settlement days from the date on which the security became a threshold security or the options position had expired or was liquidated, whichever was later, the proposal would have prohibited a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closed out the entire fail to deliver position by purchasing securities of like kind and quantity.

Thus, under the 2006 Proposing Release, registered options market makers would still have been able to continue to keep open fail to deliver positions in threshold securities that resulted from short sales to hedge an options position created prior to the time the underlying security became a threshold security, provided the options position had not expired or been liquidated. Once the underlying security became a threshold security and the specific options position being hedged had expired or been liquidated, however, such fails to deliver would have been subject to a 13 consecutive settlement day close-out requirement.

2. Comments to the 2006 Proposing Release

We received a number of comment letters on the proposed narrowing of the options market maker exception from a variety of entities including options market makers, SROs, associations, issuers, an academic, and individual retail investors.[31]

Several commenters supported the proposal to narrow the options market maker exception. For example, one commenter stated that 13 consecutive settlement days was more than a sufficient amount of time in which to close out a fail to deliver position relating to an options position.[32] Another commenter stated that it believes the current "exemption can be exploited to manipulate prices downward by manipulators buying large numbers of put options in already heavily-shorted securities."[33] Some of these commenters recommended that the Commission eliminate the options market maker exception altogether,[34] or, reduce the close-out

[31] See, e.g., letter from Overstock, supra note 8; letter from NCANS, supra note 9; letter from Joseph P. Borg, Esq., President, North American Securities Administrators Association, Inc., dated Oct. 4, 2006 ("NASAA"); letter from TASER, supra note 8; Letter from James J. Angel, PhD, CFA, dated July 18, 2006 ("Angel"); letter from Margaret Wiermanski, Chief Operations Officer and Matthew Abraham, Compliance Officer, CTC LLC, dated Sept. 28, 2006 ("CTC LLC"); letter from Timothy D. Lobach, Keystone Trading Partners, dated Sept. 19, 2006 ("Keystone"); letter from Steve Keltz, General Counsel, Citigroup Derivatives Markets, Inc., dated Sept. 29, 2006 ("Citigroup"); letter from Robert Bellick, Managing Director, Chris Gust, Managing Director, and Megan Flaherty, Director of Compliance and Chief Legal Counsel, Wolverine Trading LLC, dated Sept. 25, 2006 ("Wolverine"); letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated October 11, 2006 ("CBOE"); letter from The American Stock Exchange, Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE/Arca, The Options Clearing Corporation, Philadelphia Stock Exchange, dated Sept. 22, 2006 ("Options Exchanges"); letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated Sept. 19, 2006 ("SIA"); letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association Section of Business Law, dated Sept. 27, 2006 ("ABA"); letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS Securities LLC, dated Sept. 22, 2006 ("UBS").

[32] See letter from Overstock, supra note 8.

[33] See letter from NCANS, supra note 9.

[34] See, e.g., id.

requirement to five consecutive settlement days.[35] In addition, commenters that supported the proposal to narrow the options market maker exception also urged the Commission to enhance the documentation requirements for establishing eligibility for the exception.[36]

Commenters who opposed the proposal to narrow the options market maker exception stated that the proposed amendments would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[37] These commenters stated that they believe the proposed amendments would likely discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[38] Moreover, these commenters claimed that the reluctance of options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[39]

Many of the commenters who opposed the proposal to narrow the options market maker exception argued that the requirement that fail to deliver positions be closed out upon liquidation or expiration of a specifically hedged options position was impracticable, given that the industry practice is to use hedges to manage risk of an entire inventory, not just a specific options

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35 See letter from NASAA, supra note 31.

36 See, e.g., id.; TASER, supra note 8.

37 See, e.g., letter from CBOE, supra note 31.

38 See id.

39 See letter from Citigroup, supra note 31.

position.[40] These commenters noted that options market makers typically facilitate an investor's rolling of an existing options position to either a different strike price within the same expiration month or to a future month as expiration approaches, and retain the short position to hedge the new options position.[41] These commenters argued that the amendment would require the options market maker to buy in the short position and/or pre-borrow to maintain a hedge, even though the overall position may have changed very little from a risk perspective, which, they argued, could potentially be a costly and time consuming measure.[42]

Commenters who opposed the proposed amendments to the options market maker exception favored maintaining the current exception, which they believe is already narrowly tailored.[43] For example, one commenter stated that it believes the current exception preserves the integrity of legitimate hedging practices and prevents manipulative short squeezes.[44] Another commenter stated that the current exception enables it to better service market participants by allowing it to continuously quote and disseminate bids and offers even where it may be difficult to borrow certain stock.[45] Another commenter stated that it is unaware of any statistics establishing that fails to deliver attributable to legitimate options market making activity are correlated to abusive short selling practices, and cautioned that "the possible

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40 For example, CBOE stated that options market makers hedge on a class basis and, therefore, as options positions are rolled to forward months, the options market maker may need to maintain the hedge. Thus, the stock position would need to be maintained not because it hedges a particular series, but because it maintains a delta of an overall position. See letter from CBOE, supra note 31. See, also, letters from CTC LLC, supra note 31; Citigroup, supra note 31; Wolverine, supra note 31.

41 See, e.g., letters from Citigroup, supra note 31 ; Wolverine, supra note 31; Options Exchanges, supra note 31.

42 See, e.g., letters from Wolverine, supra note 31 ; Citigroup, supra note 31.

43 See id.

44 See letter from Keystone, supra note 31.

45 See letter from Citigroup, supra note 31.

detrimental effects on options markets in threshold securities should first be quantified to guard against an unanticipated, significant peril to another facet of the capital markets."[46]

3. Response to Comments to the 2006 Proposing Release

We proposed to narrow the options market maker exception in Regulation SHO because we are concerned about large and persistent fails to deliver in threshold securities attributable, in part, to the options market maker exception, and our concerns that such fails to deliver might have a negative effect on the market in these securities.[47]

Regulation SHO's options market maker exception does not require fails to deliver to be closed out if they resulted from short sales effected by registered options market makers to establish or maintain a hedge on options positions established before the underlying security became a threshold security. For the reasons discussed below, although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that such an impact, if any, would be minimal.

First, we believe that the potential effects, if any, of a mandatory close-out requirement would be minimal because the number of securities that would be impacted by a mandatory close-out requirement would be relatively small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high

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46 See letter from CTC LLC, supra note 31. Statistical evidence of options market maker failing practices can be found in Failure is an Option: Impediments to Short Selling and Options Prices by Evans, Geczy, Musto, and Reed, forthcoming in the Review of Financial Studies. See http://finance.wharton.upenn.edu/~musto/papers/egmr.pdf

47 See 2006 Proposing Release, 71 FR at 41711-41712; see also, Regulation SHO Re-Opening Release, 72 FR 15079-15080. See also, discussion above in Section I. Introduction.

(0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[48] Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. In addition, as noted by one commenter, a small number of securities that meet the definition of a "threshold security" have listed options, and those securities form a very small percentage of all securities that have options traded on them.[49] Moreover, the current options market maker exception only excepts from Regulation SHO's mandatory 13 consecutive settlement day close-out requirement those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established before the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established after the underlying security became a threshold security. Because the current options market maker exception has a very limited application, the overall impact of its removal on liquidity, hedging costs, spreads, and depth, should be relatively small.

Second, to the extent that a mandatory close-out requirement could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that any such potential effects would likely be mitigated by the fact that even though fails to deliver that were previously-excepted from the close-out

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48 See supra note 7 (discussing the number of threshold securities as of March 31, 2007)

49 See letter from Options Exchanges, supra note 31 (noting that as of the date of the 2006 Proposing Release, approximately 84 of the approximately 300 threshold securities had options traded on them). This commenter also noted that "options on a number of these threshold securities are very actively traded as are the securities themselves. Among the actively traded threshold securities with active options trading are iShares Russell 2000 ETF, Avanir Pharmaceuticals, Krispy Kreme Donuts, Martha Stewart Living Omnimedia, Mittal Steel, Navarre Corp., and Novastar Financial." See id.

requirement of Regulation SHO would not be permitted to continue indefinitely, such fails to deliver would not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under a mandatory close-out requirement, such as that imposed currently by the 13 consecutive settlement day requirement of Rule 203(b)(3) of Regulation SHO, fails to deliver in threshold securities would have an extended period of time within which to be closed out. An extended close-out requirement would provide options market makers with some flexibility in conducting their hedging activities in that it would allow them to not buy-in a fail to deliver position or pre-borrow to maintain a hedge for the time that the fail to deliver position can remain open.

Third, as noted above, Regulation SHO's current options market maker exception is limited to only those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established <u>before</u> the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established <u>after</u> the underlying security became a threshold security. In examining the application of the current mandatory close-out requirement of Regulation SHO for all non-excepted fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-excepted fails to deliver in threshold securities has impacted options market makers' willingness to provide liquidity in threshold securities, made it more costly for options market makers to accommodate customer orders, or resulted in wider bid-ask spreads or less depth.

Similarly, all fails to deliver in threshold securities resulting from long or short sales of securities in the equities markets must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement, and we are not aware that such a requirement has impacted the willingness of market makers to make markets in securities subject to the close-out requirement, or led to decreased liquidity, wider spreads, or less depth in these securities. Thus, we believe that the impact of requiring that fails to deliver in threshold securities resulting from short sales to hedge options positions created before the security became a threshold security be closed out would similarly be minimal, if any.

Fourth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in certain securities, we believe that such effects are justified by our belief, as discussed in more detail below, that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets.

Fifth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about "naked" short selling causing a drop in an issuer's stock price and that it may limit an issuer's ability to access the capital markets.[50] We believe that, by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process. The reduction in fails to deliver and the resulting reduction in the number of securities on the threshold securities lists could result in increased investor confidence, and the promotion of price efficiency and capital formation.

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continue to observe a small number of threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, we adopted amendments to eliminate Regulation SHO's grandfather provision that

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[50] See, e.g., letter from Feeney, supra note 10.

allowed fails to deliver resulting from long or short sales of equity securities to persist indefinitely if the fails to deliver occurred prior to the security becoming a threshold security.[51] We believe that once a security becomes a threshold security, fails to deliver in that security must be closed out, regardless of whether or not the fails to deliver resulted from sales of the security in connection with the options or equities markets.

Moreover, we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. We are also concerned that the current options market maker exception might allow for a regulatory arbitrage not permitted in the equities markets. For example, an options market maker who sells short to hedge put options purchased by a market participant unable to locate shares for a short sale in accordance with Rule 203(b)(2) of Regulation SHO may not have to close out any fails to deliver that result from such short sales under the current options market maker exception. The ability of options market makers to sell short and never have to close out a resulting fail to deliver position, provided the short sale was effected to hedge options positions created before the security became a threshold security, runs counter to the goal of similar treatment for fails to deliver resulting from sales of securities in the options and equities markets, because no such ability is available in the equity markets.[52]

Although commenters who opposed the proposed amendments to the options market maker exception favored maintaining Regulation SHO's current options market maker

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51 See Securities Exchange Act Release No. 56212 (Aug. 7, 2007); see also, 2006 Proposing Release, 71 FR at 41711-41712.

52 See Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

exception, it has become apparent to us during the comment process that the language of the current exception is being interpreted more broadly than the Commission intended, such that the exception seems to be operating significantly differently from our original expectations.[53] Thus, we are concerned that options market makers are claiming the exception even where options positions are created after the underlying security becomes a threshold security. For example, options market makers' practice of "rolling" positions from one expiration month to the next potentially allows these options market makers to not close out fail to deliver positions as required by the close-out requirements of Regulation SHO. According to commenters, when the options that allow an options market maker to be exempt from the close-out requirement expire or are closed out, investors on the opposite side may roll their long put or short call positions to a new expiration month.[54] It appears that options market makers are not treating the rolling of options positions to a new expiration month as creating new options positions for purposes of the current options market maker exception even though the current options position typically is closed out and the same position is opened in the next expiration month.[55]

Thus, options market makers providing liquidity to customers who are "rolling" positions from one expiration month to the next appear to use the original short sale to maintain the hedge on these new options positions, rather than closing out that original short sale and any fails to deliver that resulted from the short sale and establishing a new hedge. Regulation SHO's current options market maker exception provides that a fail to deliver position does not have to be closed

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[53] The Commission noted in the Adopting Release that it would monitor the operation of Regulation SHO and, in so doing, would take into consideration any indications that the options market maker exception was operating significantly differently from the Commission's original expectations. See Adopting Release, 69 FR at 48018-48019.

[54] See, e.g., letters from ABA, supra note 31; Wolverine, supra note 31.

[55] See, e.g., letter from Wolverine, supra note 31.

out if it results from a short sale effected to establish or maintain a hedge on options positions created before the underlying security became a threshold security. Options market makers also may not be closing out fails to deliver that result from short sales effected to maintain or establish a hedge on options positions created after the underlying security became a threshold security. Such conduct would not be in compliance with the current options market maker exception and would allow options market makers to avoid improperly Regulation SHO's close-out requirement.[56]

In addition, as a practical matter, we note that the cost of maintaining a fail to deliver position may change over time and, in particular, when a security becomes a threshold security. Thus, if options market makers, in accommodating their customers' rolling of options positions from one expiration month to the next, use the original short sale to maintain the hedge on these new options positions rather than closing out that short sale and any fails to deliver that resulted from the short sale and establishing a new hedge, any additional cost of maintaining a fail to deliver in the underlying security would not be properly transferred to the options positions.

Despite our concerns noted above regarding the application of Regulation SHO's current options market maker exception, we credit commenters' statements that the amendments proposed in 2006 to narrow the current options market maker exception would be costly and difficult to implement, or even possibly unworkable, because they do not reflect how options market makers hedge their options positions. According to commenters, options market makers usually hedge their options positions on a portfolio basis.[57] Thus, an options market maker

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[56] In addition, we are concerned that options market makers may not have systems in place to determine whether or not fails to deliver resulted from short sales effected to establish or maintain a hedge on options positions created before or after the underlying security became a threshold security, and, therefore, may not be complying with the requirements of the current exception.

[57] See, e.g., letters from CBOE, supra note 31; Options Exchanges, supra note 31; Wolverine, supra note 31; UBS, supra note 31; Angel, supra note 31.

typically does not assign a particular short or long position to a particular options position as would be required if the Commission were to adopt the 2006 amendments, as proposed. Only one commenter asked that the Commission be sensitive to the time necessary to make systems changes to track the requirements of the proposed amendments.[58] Most commenters simply stated that the amendments proposed in 2006 would be difficult and costly to implement or possibly unworkable.

Based on commenters' concerns that they would be unable to comply with the amendments to the options market maker exception as proposed in the 2006 Proposing Release, and statements indicating that options market makers might be violating the current exception, we have determined to re-propose amendments to the options market maker exception.

III. Proposed Amendments to the Options Market Maker Exception

A. Elimination of the Options Market Maker Exception

We propose to eliminate the options market maker exception in Rule 203(b)(3) of Regulation SHO. In particular, the proposed amendment would require that any previously excepted fail to deliver position in a threshold security on the effective date of the amendment, including any adjustments to that fail to deliver position, be closed out within 35 consecutive settlement days[59] of the effective date of the amendment. This 35 consecutive settlement day requirement would be a one-time phase-in period. Thus, after 35 consecutive settlement days

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58 See letter from UBS, supra note 31.

59 If the security is a threshold security on the effective date of the amendment, participants of a registered clearing agency would have to close out that position within 35 consecutive settlement days, regardless of whether the security becomes a non-threshold security after the effective date of the amendment.

We chose 35 settlement days because 35 days was used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended. See Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007). In addition, we believe that 35 settlement days would allow participants time to close out their previously-excepted fail to deliver positions given that some participants may have large previously-excepted fails with respect to a number of securities.

from the effective date of the amendment this phase-in period would expire and any additional fails to deliver in the threshold security would be subject to the current mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.[60]

In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO, if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the proposed amendment would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. Any fails to deliver that were not previously-excepted from the close-out requirement of Rule 203(b)(3) of Regulation SHO as of the effective date of the amendment and, therefore, not subject to the one-time 35 consecutive settlement day phase-in period, would be subject to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive

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60 For example, assume that on the effective date of the amendment XYZ security is a threshold security and a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge options positions that were created before XYZ security became a threshold security. The participant must close out the fails to deliver in XYZ security within 35 consecutive settlement days of the effective date of the amendment, including any additional fails to deliver during that 35-day period that result from short sales by the registered options market maker to hedge options positions that were created before XYZ security became a threshold security. After the 35-day period has expired, if XYZ security remains a threshold security, any additional fails to deliver in XYZ security must be closed out in accordance with Regulation SHO's 13 consecutive settlement day close-out requirement, regardless of whether or not the fails to deliver resulted from short sales by a registered options market maker to hedge options positions that were created before XYZ security became a threshold security.

settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

For the reasons discussed above and in the 2006 Proposing Release, we believe that no fail to deliver position should be left open indefinitely. Although we included in Rule 203 of Regulation SHO exceptions to the close-out requirement of the rule, we also stated that we would pay close attention to the operation and efficacy of the provisions adopted in Rule 203, and would consider whether any further action was warranted.[61] As discussed above, we continue to see a small number of threshold securities with large and persistent fails to deliver that are not being closed out under existing delivery and settlement requirements. We are concerned that these fails to deliver may have a potentially negative impact on the market for these securities by impeding the orderly functioning of the markets for these securities, depriving investors of ownership rights, undermining investor and issuer confidence in the markets, and being indicative of potentially manipulative trading activities. In addition, a seller that fails to deliver securities on trade settlement date effectively unilaterally converts a securities contract (that should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.

Thus, by proposing to eliminate the current options market maker exception of Regulation SHO so that all fails to deliver in threshold securities that result from short sales effected to maintain or establish a hedge on options positions would have to be closed out within Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement similar to all other fails to deliver in threshold securities, we hope to reduce the number of threshold securities with large and persistent fail to deliver and, thereby, limit any potential negative impact of such fails to deliver on the market for these securities.

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61 See Adopting Release, 69 FR at 48019.

In addition, the overly-broad interpretation of the current options market maker exception, as discussed above, could be contributing to some securities with listed options having large and persistent fails to deliver and remaining on the threshold securities list. Thus, we further believe it would be appropriate to eliminate the current exception.

By proposing to eliminate the current options market maker exception, fails to deliver from hedging activities by options market makers would be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options market would not receive an advantage over those trading such securities in the equities markets.

In addition, we believe the proposed amendment would be warranted because it strikes the appropriate balance between reducing large and persistent fails to deliver in threshold securities while still allowing participants some flexibility in conducting their hedging activities. Under the proposed amendment, other than those previously-excepted fails to deliver that would be subject to the one-time 35 day phase-in period, all fails to deliver in threshold securities would be subject to the current mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. Thus, the proposed amendment would provide flexibility because it would allow an extended period of time (i.e., 13 consecutive settlement days) within which to close out all fails to deliver in threshold securities, rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position could remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

In addition, we note that the one-time 35 consecutive settlement day phase-in period would help reduce any potential for market disruption, such as increased volatility or short squeezes, from having to close-out previously-excepted fail to deliver positions particularly as participants would be able to begin to close out such positions at anytime before the 35-day phase-in period.

Request for Comment

The Commission seeks comment generally on all aspects of this proposed amendment to Regulation SHO. In addition, we seek comment on the following:

- The proposed amendment to eliminate the options market maker exception would require that fails to deliver that result from short sales effected to maintain or establish a hedge on options positions be closed out within Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement similar to other fails to deliver in any threshold security. We believe that fails to deliver in threshold securities should not last indefinitely. Thus, we proposed and adopted amendments to eliminate the grandfather provision in Regulation SHO so that fails to deliver resulting from long or short sales in the equities markets must be closed out within 13 consecutive settlement days. Should fails to deliver that result from short sales effected to maintain or establish a hedge on options positions be treated differently from fails to deliver that result from short or long sales of threshold securities in the equities markets? If so, why? Should market makers in the options markets be permitted to maintain a fail to deliver position in a threshold security for an extended period of time or indefinitely when market makers in the equities markets are not able to do so? If so, why? If not, why not?

- The options market maker exception was created to provide options market makers with flexibility in establishing and maintaining hedges on options positions created before the underlying security became a threshold security. Would elimination of the options market maker exception be appropriate? If so, why? If not, why not? Would elimination of the options market maker exception result in fewer options on threshold securities and what effect would this have on market efficiency and capital formation? Would eliminating the exception reduce the willingness of options market makers to make markets in securities that might become threshold securities or that are threshold securities? Would eliminating the exception result in increased costs to investors? Would options investors bear any additional costs that are not borne by the equivalent equity investors? Would eliminating this exception reduce liquidity in securities that might become threshold securities or that are threshold securities? How significant would such an impact be, if any, given that fails to deliver would be subject to Regulation SHO's current 13 consecutive settlement days close-out requirement similar to all other fails to deliver in threshold securities and that we are not aware that compliance with the current mandatory close-out requirement of Regulation SHO for non-excepted fails to deliver has resulted in market disruption? What other measures or time-frames would be effective in fostering Regulation SHO's goal of reducing fails to deliver while at the same time allowing market making by options market makers?
- Based on current experience with Regulation SHO, what have been the costs and benefits of the current options market maker exception?
- What are the costs and benefits of the proposed amendment to eliminate the options market maker exception?

- What technical or operational challenges would options market makers face in complying with the proposed amendment?
- Would the proposed amendment create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the 35 consecutive settlement day phase-in period from fails to deliver that are not eligible for the phase-in period? If there are additional costs associated with tracking fails to deliver subject to the 35 versus 13 consecutive settlement day requirements, would these additional costs justify the benefits of providing firms with a 35 consecutive settlement day phase-in period? Would a 35 consecutive settlement day phase-in period be necessary given that firms would have been on notice that they would have to close out these fail to deliver positions following the effective date of the amendment?
- Should we consider changing the proposed phase-in period to 35 calendar days? If not, why not? If so, would this create systems problems or other costs? Would a phase-in period create examination or surveillance difficulties?
- Please provide specific comment as to what length of implementation period would be necessary such that participants would be able to meet the requirements that fail to deliver positions in threshold securities be closed out within the applicable time-frames, if adopted.

B. Alternatives to Eliminating the Options Market Maker Exception

As discussed above, due to the fact that large and persistent fails to deliver are not being closed out under existing delivery and settlement requirements and because we are concerned that these fails to deliver may have a negative impact on the market for those securities, we believe that the options market maker exception to the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO should be eliminated. In addition, we believe that the options market maker exception should be eliminated because we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities market.

We anticipate, however, that in response to our request for comment on the proposed amendments to eliminate the options market maker exception, we will receive comment that an options market maker exception, similar to the current exception in Regulation SHO, is necessary. It has become apparent to us, however, that the current exception is being interpreted in such a way that the exception seems to be operating significantly differently from our original expectations, and that options market makers might be using the current exception to improperly avoid closing out certain fails to deliver in threshold securities. In addition, commenters stated that the proposed amendments to the options market maker exception set forth in the 2006 Proposing Release would be impractical given the industry practice of using hedges to manage the risk of an entire inventory, not just a specific options position.[62] Thus, in conjunction with our proposal to eliminate the options market maker exception, we have determined to solicit comment regarding two narrowly-tailored alternatives to the current options market maker exception and to our proposed elimination of that exception.

Because we are concerned that any exception to Regulation SHO's close-out requirement for fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions might result in continued large and persistent fails to deliver in securities with options traded on them, the proposed alternatives would provide very limited exceptions to the close-out

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62 See, e.g., letters from CBOE, supra note 31 ; CTC LLC, supra note 31; Citigroup, supra note 31; Wolverine, supra note 31.

requirement of Regulation SHO so that all fails to deliver in threshold securities underlying options would eventually have to be closed out. Similar to elimination of the options market maker exception, by proposing to require that all fails to deliver be closed out within specific time-frames, the proposed alternatives should reduce large and persistent fails to deliver. The proposed alternatives, however, would provide participants of a registered clearing agency, or options market makers for which they clear transactions, longer periods of time than Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement, within which to close out such fails to deliver.

Also, similar to the proposed amendment to eliminate the options market maker exception, by proposing to require that fails to deliver be closed out within specific time-frames, the proposed alternatives would be more likely to result in shareholders receiving the benefits of ownership than under the current options market maker exception. Sellers would also be less able to unilaterally convert securities contracts into undated futures-type contracts to which the buyer may not have agreed, or that would have been priced differently. In addition, the delivery requirements of the proposed alternatives could enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected. An increase in investor confidence in the market could facilitate investment.

The proposed alternatives could benefit issuers because investors may be more willing to commit capital where fails levels are lower. In addition, some issuers could believe that a reduction in fails to deliver could reverse unwarranted reputational damage potentially caused by large and persistent fails to deliver and what they believe might be an indication of manipulative trading activities, such as "naked" short selling.[63] Thus, the proposed requirement that all fails to deliver be closed out within specific time-frames, as proposed to be required by the alternatives, could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

Although the proposed alternatives could lessen the potential negative impact of large and persistent fails to deliver similar to the proposed elimination of the options market maker exception because the proposed alternatives would require that fails to deliver in threshold securities eventually be closed out, we believe that complete elimination of the options market maker exception would achieve this goal more effectively. Under the proposed elimination of the options market maker exception, all fails to deliver in threshold securities would have to be closed out within Regulation SHO's mandatory 13 consecutive settlement day close-out requirement. The proposed alternatives, however, would each allow a longer period of time for fail to deliver positions to be closed out. Specifically, the first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second alternative, although some fails to deliver would be required to be closed out in less than 35 consecutive settlement days, other fails to deliver would not have be closed out until 35 consecutive settlement days from the security becoming a threshold security.

Similar to our discussions above in connection with our response to comments regarding the proposed amendment in the 2006 Proposing Release to limit the duration of the current options market maker exception and regarding the proposed amendment to eliminate the options market maker exception, we believe the mandatory close-out requirements of each of the

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63 See, e.g., supra note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with "naked" short selling).

proposed alternatives would similarly minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to the close-out requirements of the proposed alternatives, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted by the close-requirements would be relatively small. The proposed alternatives would apply only to those threshold securities with listed options[64] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series that were created before, rather than after, the security became a threshold security because all other fails to deliver in threshold securities are subject to Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement.

In addition, the proposed alternatives would provide options market makers with flexibility in conducting their hedging activities because they would each allow an extended period of time (i.e., 35 consecutive settlement days for purposes of proposed Alternative 1 and 13 or 35 consecutive settlement days for purposes of proposed Alternative 2) within which to close out all fails to deliver in threshold securities. As discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of options market makers to make markets, liquidity, hedging costs, depth, and spreads because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (i.e., 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be

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64 See letter from Options Exchanges, supra note 49 (discussing the number of threshold securities with listed options).

closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position can remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

The extended close-out requirements of the proposed alternatives would expire, however, after 35 consecutive settlement days of the security becoming a threshold security. In each of the proposed alternatives, after the excepted period expires, any additional fails to deliver that result from short sales in the threshold security, whether or not effected to establish or maintain a hedge on options series in the portfolio that were created before the security became a threshold security, would have to be closed within Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement.

The proposed alternatives are narrowly tailored in response to our concerns that options market makers are interpreting the current exception more broadly than the Commission intended and in response to comments that options market makers manage their risk based on an assessment of the entire portfolio rather than of a specific options position. Based on comments that portfolio hedging is the industry practice, the proposed alternatives refer to the hedging of options series in a portfolio rather than an options position. In addition, the proposed alternatives would permit options market makers to adjust their hedges on options series created before the underlying security became a threshold security provided any resulting fails to deliver are closed out within the applicable time-frames.

The proposed alternatives would also require that participants of a registered clearing agency and options market makers document that any fails to deliver in threshold securities that have not been closed out in accordance with the 13 consecutive settlement days close-out requirement of Rule 203(b)(3) of Regulation SHO are eligible for the options market maker exception.[65] The current exception does not set forth a specific documentation requirement, although some options market makers may in fact keep records that relate to their compliance with the exception. In the absence of such a requirement, we are concerned that many options market makers are not preparing or retaining records with regard to their eligibility for the exception. Without such a documentation requirement, it may be difficult for the Commission and SROs to monitor whether the options market maker exception is being applied consistently with the rule.

Thus, to the extent we retain an options market maker exception, we believe it would be necessary to add a provision to Regulation SHO that would require both options market makers and participants of a registered clearing agency that rely on the options market maker exception to not close out a fail to deliver position in accordance with the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO to obtain, prepare, and keep documentation demonstrating that a fail to deliver position has not been closed out because it qualified for the exception. Such documentation could indicate, among other things, when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out.

A documentation requirement would enable the Commission and the SROs to monitor more effectively whether or not the options market maker exception is being applied correctly. In addition, the information would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

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[65] Commenters to the 2006 Proposing Release urged the Commission to add specific documentation requirements for establishing eligibility for the options market maker exception. See, e.g., letters from NASAA, supra note 31; TASER, supra note 8.

The Alternatives

We are requesting comment regarding specific alternatives, as described below, to eliminating the options market maker exception. Each of the proposed alternatives would provide for a 35 consecutive settlement day phase-in period similar to the phase-in period discussed above for securities that are threshold securities on the effective date of the amendment and that have previously excepted fail to deliver positions.[66] In addition, as explained in more detail below, these alternatives would apply only to fails to deliver resulting from short sales effected by a registered options market maker to establish or maintain a hedge on any options series created before an underlying security became a threshold security. These alternatives would also require such fails to deliver to be closed out within specific time-frames so that the fails to deliver would not last indefinitely.

i. Alternative 1

We request comment regarding an options market maker exception that would require a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series within a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within 35 consecutive settlement days of the security becoming a threshold security. After the 35 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

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66 This 35 consecutive settlement day phase-in period would operate in the same manner as that outlined above in the discussion of the elimination of the options market maker exception.

We propose 35 consecutive settlement days for purposes of proposed Alternative 1 because 35 days was used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended and, therefore, is a period of time with which market participants subject to Regulation SHO are familiar.[67] In addition, because we believe that all fails to deliver should be closed out within specific time-frames we did not want to propose an alternative that would allow fails to deliver to continue indefinitely, or for a period of time that would undermine the goal of requiring that all fails to deliver be closed out within a reasonable time period. We believe that 35 consecutive settlement days would allow participants time to close out their excepted fail to deliver positions without extending the close-out requirement beyond what we believe would be a reasonable period of time within which fails to deliver should be closed out.

In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO, if the fail to deliver position persists for 35 consecutive settlement days, the proposed alternative would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

Example

The following is an example of how proposed Alternative 1 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market

[67] See Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security. The participant must close out the entire fail to deliver position in XYZ security, including any additional fails that result from short sales to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 35 consecutive settlement days of the date on which XYZ security became a threshold security in March. After the 35 consecutive settlement days, any additional fails to deliver in XYZ security, whether or not they result or resulted from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

ii. Alternative 2

As another alternative to eliminating the options market maker exception, we request comment regarding a proposed options market maker exception that would require a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within the earlier of: (i) 35 consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated. After the 35 or 13 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

We propose to require in Alternative 2 that fails to deliver be closed out within 13 consecutive settlement days if all options series within the portfolio that were created before the security became a threshold security expire or are liquidated because, at that point, there would be nothing in the portfolio for the original short sale and resulting fail to deliver position to hedge. We chose a proposed close-out requirement of 13 consecutive settlement days for such situations because it is a time-frame currently used in the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO[68] and, therefore, is a time-frame with which market participants subject to the close-out requirement of Regulation SHO are currently familiar and with which such entities appear able to comply.

In addition, as discussed above for proposed Alternative 1, we chose 35 consecutive settlement days for purposes of proposed Alternative 2 because this is also a time-frame already used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended and, therefore, is a time-frame with which market participants subject to Regulation SHO are already familiar.[69] In addition, because we believe that all fails to deliver should be closed out within specific time-frames we did not want to propose an alternative that would allow fails to deliver to continue indefinitely, or for a period of time that would undermine the goal of requiring that all fails to deliver be closed out within a reasonable time period. We believe that a close-out requirement that provides that fails to deliver must be closed out within the time-frames specified by proposed Alternative 2 would allow participants time to close out their excepted fail to deliver positions without extending the close-out requirement beyond what we believe would be a reasonable period of time within which fails to deliver should be closed out.

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68 See 17 CFR 242.203(b)(3).

69 See Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO, if the excepted fail to deliver position has persisted for longer than the earlier of: (i) 35 consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire excepted fail to deliver position by purchasing securities of like kind and quantity.

Example 1

The following is an example of how proposed Alternative 2 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge its XYZ portfolio that were created before XYZ security became a threshold security. On the date on which XYZ security becomes a threshold security, XYZ portfolio consists of XYZ April 50 Calls and XYZ July 50 Calls. The last date on which the options within XYZ portfolio expire is July, which is later than 35 consecutive settlement days from the date on which XYZ security became a threshold security. In addition, none of the options series within XYZ portfolio have been exercised. Thus, the participant must close out the entire fail to deliver position in XYZ security, including any additional fails that result from short sales to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 35 consecutive settlement days of the date on which XYZ security became a threshold security in March. After the 35 consecutive settlement days, any additional fails to deliver in XYZ security, whether or not they result or resulted from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

Example 2

The following is another example of how proposed Alternative 2 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge options series in its XYZ portfolio that were created before XYZ security became a threshold security. On the date on which XYZ security becomes a threshold security, XYZ portfolio consists of XYZ April 50 Calls and XYZ July 50 Calls. Options market maker firm exercises both call options in March, shortly after XYZ security became a threshold security. Because options market maker firm liquidated the entire XYZ portfolio prior to the expiration of 35 consecutive settlement days from the date on which XYZ security became a threshold security, or the last expiration date for the options comprising the XYZ portfolio, the participant must close out the entire fail to deliver position in XYZ security, including any additional fails to deliver that result from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 13 consecutive settlement days of the date on which the options series within XYZ portfolio were exercised.

Request for Comment

The Commission seeks comment generally on all aspects of the proposed alternatives to elimination of the options market maker exception. In addition, we seek comment on the following:

- As set forth in proposed Alternative 1, should participants of a registered clearing agency, or options market makers that have been allocated the close-out requirement under Regulation SHO, have a limited exception to the close-out requirement that would allow 35 consecutive settlement days from the security becoming a threshold security for the fail to deliver position to be closed out? If so, why? If not, why not? Alternatively, as set forth in proposed Alternative 2, should the limited exception allow the earlier of: (i) 35 consecutive settlement days from the date on which the security becomes a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, for the fail to deliver position to be closed out? If so, why?
- In our discussion above regarding the impact of the proposed amendment to eliminate Regulation SHO's current options market maker exception on liquidity, spreads, depth, and hedging costs, we stated that we believe that such an impact would be minimal, if any. For similar reasons, we believe that the impact of the mandatory close-out requirements in the proposed alternatives on liquidity, spreads, depth, and hedging costs would be minimal, if any. To what extent would an options market maker exception as set forth in the proposed alternatives, rather than eliminating the exception, impact liquidity in securities that might become threshold securities or in threshold securities? To what extent would an options market maker exception as set forth in the proposed alternatives, rather than eliminating the

exception, impact the willingness of options market makers to make markets in securities that might become threshold securities or in threshold securities? What other measures or time-frames would be effective in fostering Regulation SHO's goal of reducing fails to deliver while at the same time not discouraging market making by options market makers?

- In the proposed alternatives to eliminating the options market maker exception, fails to deliver would only be excepted from the close out requirement of Regulation SHO if the fail to deliver position results or resulted from a short sale effected to establish or maintain a hedge on options series created before the security became a threshold security. Is the reference to "options series" appropriate? Please explain.
- Are the terms "expiration" and "liquidation" of an options series sufficiently inclusive to prevent participants from evading the close-out requirements in the proposed alternatives? Are these terms understandable for compliance purposes? If not, what terms would be more appropriate? What difficulties, if any, could arise from having to determine the last date on which all options series within a portfolio that were created before the security became a threshold securities have expired or been liquidated?
- We provide examples of how the proposed alternatives would be applied. We request comment regarding these examples, and suggestions regarding additional examples that would be helpful in understanding how the proposed alternatives would work that could be incorporated by the Commission into any future releases, if the Commission were to adopt either of the proposed alternatives.
- What types of costs would be incurred in complying with the proposed alternatives? For example, what types of costs, if any, could be incurred for tracking the 35 or 13 consecutive settlement day close-out requirements? What types of costs, if any, could be incurred in

determining whether or not options series were created before the security became a threshold security? What types of costs could be incurred in determining whether or not a fail to deliver position resulted from a short sale to establish or maintain a hedge on options series created before the security became a threshold security? How would these costs differ from costs incurred to comply with the current options market maker exception in Regulation SHO? Would the costs relating to the alternative proposals justify the benefits of allowing for a limited exception to the close-out requirement for options market makers?

- What would be the costs and benefits of the proposed alternatives to eliminating the options market maker exception?
- Under the proposed alternatives, after the specific time-frames have expired, fails to deliver would be required to be closed out in compliance with the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO regardless of whether or not the fails to deliver result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series created before the security became a threshold security. Under the proposed alternatives, might an options market maker need to maintain such fail to deliver positions beyond the 13 consecutive settlement days allowed by the close-out requirement of Rule 203(b)(3) of Regulation SHO? What might be the impact, if any, of requiring such fails to deliver to be closed out?
- What technical or operational challenges would options market makers face in complying with the proposed alternatives?
- Should we consider changing the proposed alternatives to 35 calendar days from the date on which the security becomes a threshold security? If so, would this create systems problems or other costs?

- The proposed alternatives would require that options market makers document eligibility for the exception. What should options market makers and participants of a registered clearing agency be required to include in the documentation? Should we specify in detail what would be required to be retained? For example, should we require that such documentation include, at a minimum, documentation evidencing when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out?
- The proposed alternatives would require that participants of a registered clearing agency maintain documentation to demonstrate that a fail to deliver position has not been closed out due to the options market maker exception. Would this documentation requirement raise compliance concerns or any other concerns for participants? If so, please explain.
- The proposed alternatives would allow for a 35 consecutive settlement day phase-in period for previously excepted fails to deliver to be closed out. Is 35 consecutive settlement days from the effective date of the amendment a long enough period of time, or too long, for fails to deliver that were previously excepted from the close-out requirement of Regulation SHO to be closed out? If so, what would be an appropriate period of time?
- Would the proposed phase-in period create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that could be needed for participants to track fails to deliver subject to the 35 consecutive settlement day phase-in period from fails to deliver that are not eligible for the phase-in period? If there were additional costs associated with tracking fails to deliver subject to the phase-in period, would these additional costs justify the benefits of providing firms with a 35 consecutive settlement day phase-in period? Is a 35 consecutive settlement day phase-in period necessary given that firms would

have been on notice that they would have to close out these fail to deliver positions following the effective date of the amendment? Please provide estimates of these costs.

- Please provide specific comment as to what length of implementation period would be necessary such that participants would be able to meet the requirements that fail to deliver positions in threshold securities be closed out within the applicable time-frames, if adopted.

IV. Proposed Amendment to Rule 200(g)(1) of Regulation SHO

We are proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that brokers-dealers marking orders as "long" sales document the present location of the securities.

Prior to the adoption of Regulation SHO in August 2004, broker-dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b). Former NASD Rule 3370(b) required a broker-dealer making an affirmative determination that a customer was long to notate on the order ticket at the time an order was taken, the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[70]

Regulation SHO does not contain a similar provision to former NASD Rule 3370(b) regarding documentation of long sales.[71] Rule 200(g)(1) of Regulation SHO, however, provides

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[70] NASD repealed NASD Rule 3370(b), the "affirmative determination" for long sales, following the adoption of Regulation SHO. The repeal of NASD Rule 3370(b) was effective on January 3, 2005, the effective date of Regulation SHO. See NASD Notice to Members 04-93. See also, Securities Exchange Act Release No. 50822 (Dec. 8, 2004), 69 FR 74554 (Dec. 14, 2004).

[71] Because Regulation SHO does not include a similar provision to former NASD Rule 3370(b) regarding documentation of long sales, on July 20, 2005, the NASD filed with the Commission, pursuant to Section 19(b)(3)(A) of the Exchange Act, a rule filing to amend NASD Rule 3370 to clarify that members must make an affirmative determination and document compliance when effecting long sale orders. In the filing, the NASD stated that it proposed to amend NASD Rule 3370 "to re-adopt expressly the affirmative determination requirements as they now relate to member obligations with respect to long sales under Regulation SHO." The

that a broker-dealer may mark an order to sell "long" only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of Rule 200,[72] and either the security is in the physical possession or control of the broker or dealer or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.[73] Thus, in marking a sell order "long," a broker-dealer must determine whether the customer is "deemed to own" the securities being sold.

In the 2006 Proposing Release we requested comment regarding whether we should consider amending Regulation SHO to include documentation requirements for long sales

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NASD designated the rule change as "non-controversial." In response to the proposed rule change, the Commission received three comment letters, the substance of which called into question the "non-controversial" designation of the proposal. The Commission found that it was appropriate in the public interest, for the protection of investors, and otherwise in furtherance of the purposes of the Exchange Act, to abrogate the proposed rule change. See Securities Exchange Act Release No. 52426 (Sept. 14, 2005); Securities Exchange Act Release No. 52131 (July 27, 2005), 70 FR 44707 (Aug. 3, 2005). The NASD took no further action with respect to the proposed rule change.

72 Rule 200(a) defines the term "short sale," while Rules 200(b) through 200(f) set forth circumstances in which a seller is deemed to own securities. See 17 CFR 242.200(a)-(f).

73 17 CFR 242.200(g)(1).

similar to those required by former NASD Rule 3370(b).[74] We received approximately 8 comment letters in response to the request for comment.[75]

Commenters that supported documentation requirements for long sales argued that the "volume of outstanding fails is too large to permit the execution of trades where there is doubt about delivery."[76] Commenters opposing documentation requirements for long sales stated that pre-trade documentation would unnecessarily impair efficiency, as broker-dealers already have procedures to ensure orders are marked properly based on information provided by customers and their own books and records, and the documentation requirements would add substantial cost.[77] One commenter stated that compliance with such pre-trade documentation requirements

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[74] See 2006 Proposing Release, 71 FR at 41714. Specifically we stated: "Current Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it has demonstrated that it has ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. Former NASD Rule 3370 required that a broker making an affirmative determination that a customer was long must make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Should we consider amending Regulation SHO to include these additional documentation requirements? If so, should any modifications be made to these additional requirements? In the prior SRO rules, brokers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment ("DVP trades"). Under Regulation SHO, a broker may not lend or arrange to lend, or fail, on any security marked long unless, among other things, the broker knows or has been reasonably informed by the seller that the seller owns the security and that the seller would deliver the security prior to settlement and failed to do so. Is it generally reasonable for a broker to believe that a DVP trade will settle on time? Should we consider including or specifically excluding an exception for DVP trades or other trades on any rule requiring documentation of long sales?"

[75] See, e.g., letters from NASAA, supra note 31; UBS, supra note 31; SIA, supra note 31. See also, letter from Leonard J. Amoruso, Compliance and Regulatory Affairs, Knight Capital Group, Inc., dated Sept. 20, 2006 ("Knight"); letter from John G. Gaine, President, Managed Funds Association, dated Sept. 19, 2006 ("MFA"); letter from Martin Schwartz, Chief Compliance Officer, Millennium Partners, LP, Oct. 10, 2006 ("Millennium"); letter from Susan Trimbath, Ph.D., CEO and Chief Economist, STP Advisory Services, LLC, Aug. 29, 2006 ("Trimbath"); letter from Wayne Klein, Director, Division of Securities, State of Utah Department of Commerce, Sept. 13, 2006 ("Utah Department of Commerce").

[76] See, e.g., Letters from NASAA, supra note 31; Utah Department of Commerce, supra note 75.

[77] See letters from MFA, supra note 75; UBS, supra note 31; Knight, supra note 75.

would require a complete revamping of front end systems.[78] Another commenter stated that the requirements would be inconsistent with the goal of fostering liquidity.[79]

Commenters also argued that the Commission has not presented evidence that long sales are contributing to a troublesome level of fails[80] or abusive or manipulative activity,[81] and that lack of documentation is related to those fails.[82] One commenter stated that there is no valid purpose to put this additional burden on the industry.[83] Another commenter argued that requiring this additional documentation should be considered only where the benefits clearly outweigh the burdens.[84] Commenters also suggested that if the Commission did adopt additional long sale documentation requirements, it should except prime broker and DVP trades, "done with" trades, and orders submitted electronically,[85] or where settlement instructions are on file with the executing broker.[86]

Although some commenters stated that pre-trade documentation for long sales would be inconsistent with the goal of fostering liquidity, would unnecessarily impair efficiency, and

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78 See letter from SIA, supra note 31.

79 See letter from Millennium, supra note 75.

80 See letter from MFA, supra note 75. See also, letter from Millennium, supra note 75.

81 See letter from SIA, supra note 31 .

82 See letter from MFA, supra note 75.

83 See letter from UBS, supra note 31.

84 See letter from MFA, supra note 75.

85 See letters from SIA, supra note 31; Knight, supra note 75. The SIA commented that "a broker-dealer should be provided an exception from such long sale annotation requirements if the broker-dealer has information regarding the client's custodial relationship. Providing such an exception would be consistent with the Commission's long-standing policy of allowing broker-dealers to enter into bona-fide agreements with their customers regarding marking of orders." See letter from SIA, supra note 31.

86 See letter from Knight, supra note 75.

would add substantial cost,[87] we believe that such costs, to the extent that there are any, would be justified by the benefits of a documentation requirement, as described below. In addition, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[88] Thus, many broker-dealers should already be familiar with a documentation requirement and one method that could be used to comply with such a requirement. Such familiarity should help reduce any costs associated with implementing the proposed documentation requirement. In addition, unlike with former NASD Rule 3370(b), the proposed amendment would not specify the format or methodology of the proposed documentation requirement. The absence of such specifications should help reduce costs to broker-dealers that would have to comply with this proposal because broker-dealers would be able to determine the most cost effective format and methodology for meeting the proposed documentation requirement.

We are proposing for further comment a documentation requirement for broker-dealers marking orders to sell "long" pursuant to Regulation SHO that would require such broker-dealers to document the present location of the securities being sold. First, we believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold,

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87 See, e.g., letters from MFA, supra note 75; UBS, supra note 31; Knight, supra note 75; SIA, supra note 31; Millenium, supra note 75.

88 Brokers and dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b) prior to the adoption of Regulation SHO.

the broker-dealer would have reason to believe that the seller is not "deemed to own" the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale "short" rather than "long."[89] We believe that this proposed documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

Second, we are concerned that broker-dealers marking orders "long" may not be making a determination prior to marking the order that the seller is "deemed to own" the security being sold.[90] Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[91] We believe that a proposed documentation requirement would help ensure that the broker-dealer marking the sale "long" has inquired into, and determined that, the seller is "deemed to own" the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

Third, we believe that the proposed documentation requirement would enable the Commission and SROs to examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is "deemed to own" the securities being sold in compliance with that rule.

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89 See 17 CFR 242.200(g).

90 See id. at 242.200(g)(1).

91 In the Adopting Release, we stated that " . . . Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. This requirement is consistent with changes being made to the order marking requirements, which require that for an order to be marked long, the seller must own the security." See Adopting Release, 69 FR at 48021.

We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the "locate" requirement of Regulation SHO,[92] and Rule 105 of Regulation M.[93]

We believe that any costs that would arise from the proposed requirement that a broker-dealer must document the present location of securities being sold long when making the determination that a customer is deemed to own the securities being sold would be minimal because Rule 200(g)(1) currently requires that broker-dealers must ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[94] Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers could, however, need to put mechanisms in place to facilitate efficient documenting of the information required by the proposed amendment.

Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendment to Rule 200(g) of Regulation SHO. In addition, we seek comment on the following:

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92 See 17 CFR 242.203(b)(1). Rule 203(b)(1) of Regulation SHO provides that "[a] broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due . . . ." This provision is commonly referred to as the "locate" requirement.

93 See 17 CFR 242.105 (prohibiting persons from covering a short sale with offering securities if the short sale occurred during the Rule 105 restricted period). See also, In the Matter of Goldman Sachs Execution & Clearing, L.P. f/k/a Spear, Leeds, & Kellogg, L.P., Securities Exchange Act Release No. 55465 (Mar. 14, 2007), Admin. Proc. File No. 3-12590 (settling enforcement proceedings against a prime broker and clearing affiliate of The Goldman Sachs Group, Inc., Goldman Sachs Execution and Clearing L.P., for its violations arising from an illegal trading scheme carried out by customers through their accounts at the firm, which included the mismarking of sell orders as "long.").

94 See 17 CFR 242.200(g).

- Is the proposed documentation requirement appropriate? If not, why not?
- Commenters that responded to the request for comment regarding documentation of long sales in the 2006 Proposing Release stated that market participants already have in place procedures to ensure that orders to sell shares are properly marked. What are those procedures and how do they ensure that orders are properly marked? How do broker-dealers currently comply with the "deemed to own" requirement of Rule 200(g)(1) of Regulation SHO?
- One commenter that responded to the request for comment regarding documentation of long sales in the 2006 Proposing Release stated that the requirement would be inconsistent with the goal of fostering liquidity.[95] To what extent, if any, would the proposed amendment impact liquidity in securities being sold long? Please explain.
- The "locate" requirement of Rule 203(b)(1) of Regulation SHO contains an exception for market makers. Should market makers also have an exception for the proposed long sale documentation requirement? Please explain.
- Should we specify the proposed format of the documentation? Should the proposed documentation be on the order ticket or elsewhere? Please provide recommended alternatives and estimates of the costs of various alternatives.
- Under what circumstances, if any, should we allow the documentation to be generated post-trade?
- In addition to proposing documentation of the present location of the securities being sold, should we require additional documentation requirements to those proposed, such as requiring broker-dealers to make a record reflecting the basis for believing that the securities

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95 See letter from Millennium, supra note 75.

are in good deliverable form, and the basis for believing that the securities will be in the broker-dealer's possession or control no later than settlement of the transaction?

- The Commission has previously stated that it may be unreasonable for a broker-dealer to treat a sale as long where orders marked "long" from the same customer repeatedly require borrowed shares for delivery or result in fails to deliver.[96] A broker-dealer also may not treat a sale as long if the broker-dealer knows or has reason to know that the customer borrowed the shares being sold.[97] Should broker-dealers be required to take additional steps to determine whether or not the seller is deemed to own the securities being sold in conjunction with documenting the present location of the securities?
- The proposed amendment would impose an obligation on broker-dealers to inquire into the present location of securities being sold and to document that location. To what extent would this proposed requirement impact the accuracy of marking by broker-dealers? To what extent would this proposed requirement impact the level of fails to deliver in a security, such as fails to deliver due to mismarking? To what extent would this proposed requirement impact compliance with other short sale-related regulations, such as the locate requirement of Regulation SHO and Rule 105 of Regulation M?
- Should any trades be excepted from the proposed documentation requirement? For example, under former NASD Rule 3370(b) broker-dealers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment ("DVP trades"). Should we consider including or specifically excluding an exception for DVP

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96 See Adopting Release, 69 FR at 48019, n.111.

97 See id.

trades? Should any other trades be specifically included or excluded from the proposed documentation requirement?

- Former NASD Rule 3370(b) required broker-dealers making an affirmative determination that a customer was long to make a notation on the order ticket at the time an order was taken regarding the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. The proposed amendment would require broker-dealers to document only the present location of the securities being sold long. To what extent would the requirements of the proposed amendment impose costs, such as personnel, systems, or surveillance costs on market participants that are any different from such costs imposed on market participants to comply with former NASD Rule 3370(b)?
- Most broker-dealers allow investors to submit orders electronically. Do these systems automatically verify the location of shares for long sales before routing the orders for execution? If so, how much would it cost for broker-dealers to adjust their systems to record the location of the securities being sold on the trade record? If not, what changes would the proposed documentation requirement require and how much would it cost for broker-dealers to adjust their systems to verify and document the location of the shares for long sales? To what extent do investors communicate order requests via other means, such as by telephone or in person? How do the costs of the proposed documentation requirement differ for these order requests versus electronic order submissions?
- Some investors have direct access to alternative trading systems. Are alternative trading systems already programmed to verify the location of the shares in orders marked as long

sales? If not, to what extent, if any, should alternative trading systems be responsible for meeting this requirement? How much would it cost?

- Some broker-dealers sponsor direct access to exchanges for preferred clients. To what extent do these broker-dealers currently document the location of shares for long sales that their clients send directly to exchanges? What costs are associated with such documentation?
- Do algorithmic trading systems[98] present any problems for compliance with the proposed amendment? Are there any other current market practices that present problems for compliance with documentation requirements?

V. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Regulation SHO under the Exchange Act, including the proposed alternatives to the proposal to eliminate the options market maker exception. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendments to Regulation SHO. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposals where appropriate.

VI. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulation SHO would impose new "collection of information" requirements within the meaning of the Paperwork Reduction Act of

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[98] An algorithmic trading program detects trading opportunities for the strategies input by investors and responds to them by placing and managing orders on behalf of those investors.

1995 ("PRA")[99] which the Commission has submitted to the Office of Management and Budget ("OMB") for review in accordance with 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 unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information.

A. Summary of Collections of Information

The proposed amendment to eliminate the options market maker exception to the close-out requirement of Regulation SHO would not impose a new "collection of information" within the meaning of the PRA. The two proposed alternatives to elimination of the options market maker exception and the proposed amendment to Rule 200(g) of Regulation SHO would impose a new "collection of information" within the meaning of the PRA.

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed alternatives to elimination of the options market maker exception would both require that options market makers and participants of a registered clearing agency document that any fail to deliver positions that have not been closed out are excepted from the close-out requirement of Regulation SHO because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security. This would be a new collection of information because Regulation SHO does not currently require documentation to show eligibility for the options market maker exception.

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99 44 U.S.C. 3501 et seq.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as "long" sales document the present location of the securities.

Under Rule 200(g)(1), a broker-dealer may mark an order to sell "long" only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of Rule 200,[100] and either the security is in the physical possession or control of the broker or dealer or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.[101] Thus, in marking a sell order "long," a broker or dealer must determine whether the customer is "deemed to own" the securities being sold.

This would be a new collection of information because Regulation SHO does not currently require documentation by brokers and dealers when marking sell orders as "long."

B. Proposed Use of Information

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The information that would be required by the proposed alternatives to elimination of the options market maker exception would assist the Commission in fulfilling its mandate under the Exchange Act to prevent fraudulent, manipulative, and deceptive acts and practices. The Commission and SROs would use the information collected to monitor whether or not the options market maker exception to the close-out requirement of Regulation SHO is being applied

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[100] Rule 200(a) defines the term "short sale," while Rules 200(b) through 200(f) set forth circumstances in which a seller is deemed to own securities. See 17 CFR 242.200(a)-(f).

[101] 17 CFR 242.200(g)(1).

consistently with the rule. The information required by the proposed amendment would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

ii. Proposed Amendment to Rule 200(g)(1)

The information that would be required by the proposed amendment to Rule 200(g)(1) would assist the Commission in fulfilling its mandate under the Exchange Act to prevent fraudulent, manipulative, and deceptive acts and practices. Such a documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not "deemed to own" the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale "short" rather than "long."[102] We believe that this documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

In addition, we are concerned that broker-dealers marking orders "long" may not be making a determination prior to marking the order that the seller is "deemed to own" the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[103] We believe that a documentation requirement would help ensure that the broker-dealer marking the sale "long" has inquired into, and determined that, the seller is "deemed to own" the securities being

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102 See id.

103 See id.

sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the documentation requirement would enable the Commission and SROs to examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this documentation requirement would provide a record that the seller is "deemed to own" the securities being sold in compliance with that rule. We also believe that the documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the "locate" requirement of Regulation SHO,[104] and Rule 105 of Regulation M.[105]

C. Respondents

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The documentation requirement of the proposed alternatives to elimination of the options market maker exception would apply to all participants of a registered clearing agency and options market makers who have not closed out a fail to deliver position in a threshold security because it resulted from short sales effected by the registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as "long" sales document the present location of the

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104 See supra note 92.

105 See supra note 93.

securities. Thus, the amendment would apply to all brokers-dealers registered with the Commission as they could all execute long sales. The Commission's Office of Economic Analysis ("OEA") estimates that at year-end 2006 there are approximately 5,808 active brokers-dealers registered with the Commission.[106]

D. Total Annual and Record-Keeping Burdens

i. <u>Proposed Alternatives to Elimination of the Options Market Maker Exception</u>

The proposed alternatives to elimination of the options market maker exception would require that options market makers and participants of a registered clearing agency document that any fail to deliver positions that have not been closed out are excepted from the close-out requirement of Regulation SHO because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

We estimate that it would take an options market maker no more than approximately 0.16 hours (10 minutes) to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.[107] We understand that eligibility for the options market maker exception would likely be determined on a daily basis, rather than on a

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106 This number is based on OEA's review of 2006 FOCUS Report filings reflecting registered brokers-dealers. This number does not include broker-dealers that are delinquent with FOCUS Report filings.

107 We do not believe that the documentation requirement is complex. We understand that options market makers receive daily trading reports from NSCC reflecting an options market maker's trading activity for that day. Options market makers should be able to use such information to document eligibility for the exception from the close-out requirement of Regulation SHO. Because options market makers receive these daily trading reports, we estimate that it would take an options market maker no more than approximately 10 minutes to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.

trade by trade basis. Based on data from the first quarter of 2006,[108] for purposes of this PRA, we estimate that, on average, there would be approximately 75 securities each day that are (i) on a threshold securities list, and (ii) have open interest in exchange traded options. On average, we estimate there would be approximately 5 options market makers engaged in delta hedging these options.[109] Thus, we estimate that on average, options market makers would have to document compliance with the proposed alternatives to the elimination of the options market maker exception 94,500 times per year (5 options market makers checking for compliance once per day on 75 securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated annual burden hour per year would be 15,120 burden hours (94,500 @ 0.16 hours/documentation). A reasonable estimate for the paperwork compliance for the proposed alternatives for each options market maker would be approximately 3,024 burden hours (18,900 instances of documentation per respondent @ 0.16 hours/documentation).

We estimate that it would take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.[110] If a participant of a registered clearing agency had a fail to deliver position in a threshold security and after twelve

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108 We used the first quarter of 2006 because this is the most recent period over which we have access to option open interest data.

109 This estimate is based on there being 5 options exchanges that have a specialist or specialist-like structure and an estimation that each exchange would have 1 options market maker actively engaged in hedging threshold securities with listed options.

110 We do not believe that the documentation requirement is complex. Such documentation requirement could involve a participant of a registered clearing agency contacting a registered options market maker for which it clears transactions to determine whether or not trading activity by the registered options market maker was responsible for the fail to deliver position and whether or not the fail to deliver position resulted from short sales effected by the registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security. After making such determination, the proposed amendment would require that the participant document this information. We estimate that such procedures would take a participant of a registered clearing agency no more than approximately 10 minutes to complete.

consecutive settlement days the participant determined whether or not the fail to deliver position was excepted from Regulation SHO's close-out requirement due to hedging activity by a registered options market maker, we estimate that a participant of a registered clearing agency would have to make such determination with respect to approximately three threshold securities per day.[111] We understand that there are currently approximately sixteen participants of a registered clearing agency that clear transactions for options market makers.[112] Thus, we estimate that on average, a participant of a registered clearing agency would have to document compliance with the proposed alternatives to the elimination of the options market maker exception 12,096 times per year (16 participants checking for compliance once per day on three securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated annual burden hour per year would be approximately 1,935 burden hours (12,096 @ 0.16 hours/documentation). A reasonable estimate for the paperwork compliance for the proposed alternatives for each participant would be approximately 120 burden hours (756 instances of documentation per respondent @ 0.16 hours/documentation).

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as "long" sales document the present location of the securities. We estimate that all of the approximately 5,808 registered broker-dealers may effect sell orders in securities covered by Regulation SHO and, therefore, would be required to comply with the proposed documentation requirement.

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111 We estimated that a participant would make such a determination for approximately 3 threshold securities per day based on data from the first quarter of 2006. We used the first quarter of 2006 because this is the most recent period over which we have access to option open interest data.

112 This number is based on information received from the Options Clearing Corporation.

For purposes of the PRA, OEA has estimated that a total of 2,750,000,000 trades are executed annually.[113] Of these 2,750,000,000 trades, OEA estimates that approximately 75%, that is, 2,062,500,000, of these trades would be "long" sales.[114] This would be an average of approximately 355,114 annual long sales by each respondent. In addition, because we believe that the documentation process is or will be automated, we estimate that it would take a registered broker-dealer approximately 0.000139 hours (0.5 seconds) to document the present location of the securities being sold.[115]

Thus, the total approximate estimated annual burden hour per year would be 286,688 burden hours (2,062,500,000 trades @ 0.000139 hours/trade). A reasonable estimate for the paperwork compliance for the proposed amendment for each broker-dealer would be approximately 49 burden hours (355,114 trades per respondent @ 0.000139 hours/response).

To the extent that broker-dealers need to automate the documentation process, we anticipate that such broker-dealers would spend varying amounts of time reprogramming systems, integrating systems, and potentially updating front-end software. Some broker-dealers may spend very little time automating the documentation process, while changes at other broker-

113 In calendar year 2006, there were approximately 2.099 billion trades in NYSE and Nasdaq-listed stocks. In addition, there were approximately 2.114 billion trades in over-the-counter bulletin board ("OTCBB") traded stocks. OEA estimates that if we were to include Amex-listed and pink sheet stocks, the total annual trades would be approximately 2.75 billion trades.

114 See 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), available at http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf.

115 In the 2003 Proposing Release, we stated that we thought it was reasonable that it would only take 0.5 seconds or 0.000139 hours to mark an order "long," "short," or "short exempt." See 2003 Proposing Release, 68 FR at 63000. We believe it is reasonable that it would take a similar amount of time to document the present location of the securities being sold, if the documentation process were automated. In addition, we note that Regulation SHO requires broker-dealers executing short sales to document compliance with the "locate" requirements of Rule 203(b)(1) of Regulation SHO, i.e., prior to accepting or effecting a short sale in an equity security, a broker-dealer must document that it has (i) borrowed the security, or entered into a bona-fide arrangement to borrow the security, or (ii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. Thus, broker-dealers should already have in place systems similar to those necessary to document the present location of the securities being sold for purposes of long sales.

dealers might be more involved. On average, we estimate that reprogramming burdens at a broker-dealer would be approximately 16 hours (or two days) with one programmer.[116] If broker-dealers hired new computer programmers at $67/hour, this would cost $1,072 per broker-dealer (16 hours @ $67 per hour) or an aggregate of $6,226,176 across all broker-dealers.[117]

E. Collection of Information is Mandatory

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed collection of information for the proposed alternatives to elimination of the options market maker exception would be mandatory for a participant of a registered clearing agency and options market maker where a fail to deliver position has not been closed out because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed collection of information would be mandatory for a broker-dealer marking a sell order as "long" pursuant to Rule 200(g)(1).

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116 We believe that most of the relevant information is already stored in electronic form and, therefore, we do not believe that the automation process would be difficult or time-consuming to implement. Hence, we estimate that automation would on average take no longer than approximately 16 hours (2 days) to complete.

117 The $67/hour figure for a computer programmer is based on the salary for a Senior Computer Operator from the SIA Report on Office Salaries in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

F. Confidentiality

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed collection of information for the proposed alternatives to elimination of the options market maker exception would be retained by participants of a registered clearing agency and options market makers and provided to the Commission and SRO examiners upon request, but not subject to public availability.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed collection of information under the proposed amendment to Rule 200(g)(1) would be retained by the broker-dealer and provided to the Commission and SRO examiners upon request, but would not be subject to public availability.

G. Record Retention Period

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed alternatives to elimination of the options market maker exception do not contain any new record retention requirements. All registered broker-dealers that would be subject to the proposed alternatives are currently required to retain records in accordance with Rule 17a-4 of the Exchange Act.[118]

As discussed above, participants of a registered clearing agency include entities not registered as broker-dealers, such as banks, U.S. exchanges, and clearing agencies.[119] Although we do not believe that participants of a registered clearing agency other than broker-dealers

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118 17 CFR 240.17a-4.

119 See supra note 22.

would trigger the obligations of the proposed alternatives, all banks subject to the proposed alternatives would be required to retain records in compliance with any existing or future record retention requirements established by the banking agencies. All U.S. exchanges and clearing agencies subject to the proposed alternatives would be required to retain records in compliance with Rule 17a-1 of the Exchange Act.[120]

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) does not contain any new record retention requirements. All registered broker-dealers that would be subject to the proposed amendment are currently required to retain records in accordance with Rule 17a-4 of the Exchange Act.[121]

H. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) 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 them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Nancy M. Morris, Secretary, Securities and

120 17 CFR 240.17a-1.

121 Id. at 240.17a-4.

Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-19-07. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7-19-07, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549-1090. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VII. Consideration of Costs and Benefits of Proposed Amendments to Regulation SHO

The Commission is considering the costs and the benefits of the proposed amendments to Regulation SHO. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, 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. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Regulation SHO.

A. Elimination of the Options Market Maker Exception

1. Benefits

The proposed amendment would eliminate the options market maker exception in Rule 203(b)(3)(iii) of Regulation SHO. In particular, as a transition measure, the proposal would require that any previously-excepted fail to deliver position in a threshold security on the effective date of the amendment be closed out within 35 consecutive settlement days of the effective date of the amendment. If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on any options positions created before the security became a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

On July 14, 2006, the Commission published proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.[122] We proposed to narrow the options market maker exception at that time because we have observed a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement guidelines and we believed that these persistent fail to deliver positions were attributable, in part, to the options market maker exception in Regulation SHO.[123]

As a result of the comment process, however, we learned that commenters were concerned that the proposed amendments to the options market maker exception could be costly and difficult to implement or possibly unworkable because options market makers typically use hedges to manage the risk of an entire inventory, not just a specific options position.

We remain concerned that large and persistent fails to deliver are not being closed out due to the options market maker exception in Regulation SHO and that these fails to deliver may

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[122] See 2006 Proposing Release, 71 FR 41710.

[123] See id. at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079-15080.

have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that would have been priced differently. Moreover, sellers that fail to deliver securities on settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately depress the price of a security.

In addition, many issuers and investors continue to express concern about extended fails to deliver in connection with "naked" short selling.[124] To the extent that large and persistent fails to deliver may be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price, fails to deliver may undermine the confidence of investors.[125] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[126] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver.[127] Thus, large and persistent fails to deliver may result in an

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124 See, e.g., supra note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with "naked" short selling).

125 See, e.g., supra note 9 (citing to comment letters discussing the impact of fails to deliver on investor confidence).

126 See, e.g., supra note 10 (citing to comment letters expressing concern regarding the impact of potential "naked" short selling on capital formation).

127 See supra note 11.

increase in artificial market influences on a security's price.[128]

Also, as part of the comment process to the proposed amendments to the options market maker exception as set forth in the 2006 Proposing Release, some commenters' statements indicated to us that the current options market maker exception might not be sufficiently narrowly tailored to limit the extent to which options market makers can claim an exception to the close-out requirement of Regulation SHO. Thus, we determined to re-propose amendments to the options market maker exception that would eliminate the exception and, thereby, reduce the number of large and persistent fails to deliver in threshold securities.

Consistent with the Commission's investor protection mandate, the proposed amendment would benefit investors by facilitating the receipt of shares so that more investors receive the benefits associated with share ownership, such as the use of the shares for voting and lending purposes. The proposal could enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected. An increase in investor confidence in the market could facilitate investment.

The proposed amendment should also benefit issuers. A high level of persistent fails to deliver in a security could be perceived by potential investors negatively and could affect their decision about making a capital commitment.[129] Some issuers could believe that they have endured unwarranted reputational damage due to investors' negative perceptions regarding a security having a large fail to deliver position and becoming a threshold security.[130] Thus,

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128 See also, 2006 Proposing Release, 71 FR at 41712 (discussing the impact of large and persistent fails to deliver on the market). See also, 2003 Proposing Release, 68 FR at 62975 (discussing the impact of "naked" short selling on the market).

129 See, e.g., supra note 10 (citing to comment letters expressing concern regarding the impact of potential "naked" short selling on capital formation).

130 See, e.g., supra note 11.

issuers could believe the elimination of the options market maker exception would restore their good name. Some issuers could also believe that large and persistent fails to deliver indicate that they have been the target of potentially manipulative conduct as a result of "naked" short selling.[131] Thus, elimination of the options market maker could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

We solicit comment on any additional benefits that could be realized with the proposed amendment, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

2. Costs

To comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping systems and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, the infrastructure necessary to comply with the proposed amendment should already be in place because the proposed amendment, if adopted, would require that all fails to deliver be closed out in accordance with the 13 consecutive settlement day mandatory close-out requirement of Regulation SHO. The only fails to deliver not subject to Regulation SHO's mandatory close-out requirement would be those fails to deliver that would be previously-excepted from the close-out requirement and, therefore, eligible for the one-time 35 day phase-in period of the proposed amendment. Thus, any changes to personnel, computer hardware and software, recordkeeping or surveillance costs should be minimal.

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[131] See, e.g., supra note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with "naked" short selling).

In the 2006 Proposing Release we requested comment regarding the costs of the proposed amendments to the options market maker exception and how those costs would affect liquidity in the options markets. Commenters who opposed the proposal to narrow the options market maker exception stated that the amendments would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[132] These commenters stated that they believe the proposed amendments would likely discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[133] Moreover, these commenters stated that the reluctance of options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[134]

Although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, for the reasons discussed below, we believe that such an impact, if any, would be minimal.

First, we believe that the potential effects, if any, of a mandatory close-out requirement would be minimal because the number of securities that would be impacted by a mandatory

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[132] See, e.g., letter from CBOE, supra note 31.

[133] See id.

[134] See letter from Citigroup, supra note 31.

close-out requirement would be small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[135] Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. In addition, as noted by one commenter, a small number of securities that meet the definition of a "threshold security" have listed options, and those securities form a very small percentage of all securities that have options traded on them.[136] Moreover, the current options market maker exception only excepts from Regulation SHO's mandatory 13 consecutive settlement day close-out requirement those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established before the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established after the underlying security became a threshold security. Because the current options market maker exception has a very limited application, the overall impact of its removal on liquidity, hedging costs, spreads, and depth should be relatively small.

Second, to the extent that a mandatory close-out requirement could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that any such potential effects would likely be mitigated by the fact that even though fails to deliver that were previously-excepted from the close-out

[135] See supra note 7 (discussing the number of threshold securities as of March 31, 2007).

[136] See letter from Options Exchanges, supra note 49.

requirement of Regulation SHO would not be permitted to continue indefinitely, such fails to deliver would not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)'s 13 consecutive settlement day close-out requirement, fails to deliver in threshold securities would have an extended period of time within which to be closed out. An extended close-out requirement would provide options market makers with some flexibility in conducting their hedging activities in that it would allow them to not close out a fail to deliver position or pre-borrow to maintain a hedge in a threshold security for 13 consecutive settlement days.

Third, as noted above, Regulation SHO's current options market maker exception is limited to only those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established <u>before</u> the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established <u>after</u> the underlying security became a threshold security. In evaluating the application of the current mandatory close-out requirement of Regulation SHO for all non-excepted fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-excepted fails to deliver in threshold securities has impacted options market makers' willingness to provide liquidity in threshold securities, made it more costly for options market makers to accommodate customer orders, or resulted in wider bid-ask spreads or less depth. Similarly, all fails to deliver in threshold securities resulting from long or short sales of securities in the equities markets must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement, and we are not aware that such a requirement has impacted the willingness of market makers to make markets in securities subject to the close-out requirement, or led to decreased liquidity, wider spreads, or less depth in these securities. Thus, we believe that the impact of requiring that fails to deliver in threshold securities resulting from short sales to hedge options positions created before the security became a threshold security be closed out would similarly be minimal, if any.

Fourth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that such effects are justified by our belief, as discussed in more detail below, that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets.

Fifth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about "naked" short selling causing a drop in an issuer's stock price and that it may limit an issuer's ability to access the capital markets.[137] We believe that, by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continue to observe a small number of threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, we adopted amendments to eliminate Regulation SHO's grandfather provision that allowed fails to deliver resulting from long or short sales of equity securities to persist indefinitely if the fails to deliver occurred prior to the security becoming a threshold security.[138] We believe that once a security becomes a threshold security, fails to deliver in that security

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137 See, e.g., letter from Feeney, supra note 10.

138 See Securities Exchange Act Release No. 56212 (Aug. 7, 2007); see also 2006 Proposing Release, 71 FR at 41711-41712.

must be closed out, regardless of whether or not the fails to deliver resulted from sales of the security in connection with the options or equities markets.

Moreover, we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. We are also concerned that the current options market maker exception might allow for a regulatory arbitrage not permitted in the equities markets. For example, an options market maker who sells short to hedge put options purchased by a market participant unable to locate shares for a short sale in accordance with Rule 203(b)(2) of Regulation SHO may not have to close out any fails to deliver that result from such short sales under the current options market maker exception. The ability of options market makers to sell short and never have to close out a resulting fail to deliver position, provided the short sale was effected to hedge options positions created before the security became a threshold security, runs counter to the goal of similar treatment for fails to deliver resulting from sales of securities in the options and equities markets, because no such ability is available in the equity markets.[139]

In addition, we believe the proposed 35 consecutive settlement day phase-in period should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency, or options market makers for which they clear transactions, to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants and options market makers could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period. The 35 day phase-in period may result in some systems and surveillance-related costs,

[139] See Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

but these costs should be one-time rather than ongoing costs because the phase-in period would expire 35 settlement days after the effective date of the proposed amendment, if adopted.

Also, the proposed pre-borrow requirement for fail to deliver positions that are not closed out within the applicable time-frames set forth in the proposed amendment would result in limited, if any, costs to participants of a registered clearing agency, and options market makers for which they clear transactions. The proposed pre-borrow requirement is similar to the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted. Thus, participants of a registered clearing agency, and any options market maker for which it clears transactions, must already comply with such a requirement if a fail to deliver position has not been closed out in accordance with Regulation SHO's mandatory close-out requirement. Accordingly, these entities should already have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with the proposed pre-borrow requirement.

We seek comment about any other costs and cost reductions associated with the proposed amendment or alternative suggestions. Specifically:

- What would be the costs of the proposed elimination of the options market maker exception? How would the proposed elimination of the options market maker exception affect the liquidity of securities with options traded on them? Would the proposed elimination of the options market maker exception mean that fewer market makers would be willing to make markets in securities with options traded on them, and could the proposed amendment increase transaction costs for securities with options traded on them? Would such an effect, if any, be more severe for liquid or illiquid securities? Would it lead to fewer listed options?

- How much would this proposed amendment to the options market maker exception affect the compliance costs for small, medium, and large participants of a registered clearing agency and for options market makers (e.g., personnel or system changes)? We seek comment on the costs of compliance that could arise as a result of the proposed amendment. For instance, to comply with the proposed amendment, would these entities be required to:
    - Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
    - Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
    - Increase staffing and associated overhead costs? Would entities subject to the proposed amendment have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, e.g., would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?

- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

- Are there any costs that market participants could incur as a result of the proposed 35 consecutive settlement day phase-in period? Would the costs of a phase-in period be too significant to justify having one? Would a phase-in period create examination or surveillance difficulties? If so, how? What would be the costs and economic tradeoffs associated with longer or shorter phase-in periods?
- What would be the costs associated with including the pre-borrow requirement for the proposed amendment to the options market maker exception?

B. Alternatives to Eliminating the Options Market Maker Exception

1. Benefits

Due to the fact that large and persistent fails to deliver are not being closed out under existing delivery and settlement requirements and the fact that we are concerned that these fails to deliver may have a negative impact on the market for those securities, we believe that the options market maker exception to the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO should be eliminated.

In part, in anticipation of commenters stating that a limited options market maker exception is necessary we are requesting comment regarding two specific limited alternatives to elimination of the options market maker exception. Each of the proposed alternatives would provide for a 35 consecutive settlement day phase-in period similar to the phase-in period discussed above in connection with the proposed elimination of the options market maker exception for securities that are threshold securities on the effective date of the amendment and that have previously-excepted fail to deliver positions. The phase-in period would reduce any potential market disruption, such as increased volatility or short squeezes, from having to close-out previously-excepted fail to deliver positions because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out these fail to deliver positions at any time before the proposed 35 day phase-in period.

In addition, in response to comments about the proposed amendments to the options market maker exception in the 2006 Proposing Release that those proposed amendments would be costly and difficult to implement because portfolio hedging is the industry practice, the proposed alternatives would apply to fails to deliver resulting from short sales effected by a registered options market maker to establish or maintain a hedge on any options series, rather than an options position, created before an underlying security became a threshold security. Thus, the proposed alternatives would be more in line with industry practice and, therefore, less costly and difficult to implement than the commenters believed the proposed amendment in the 2006 Proposing Release would be.

The first alternative would require that a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series within a portfolio that were created before the security became a threshold security close out the entire fail to deliver position, including any adjustments to that position, within 35 consecutive settlement days of the security becoming a threshold security. After the 35 consecutive settlement days has expired, any additional fails to deliver would be subject to the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. In addition, the proposed first alternative would impose a pre-borrow requirement similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

The second alternative would require that a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within the earlier of: (i) 35 consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated. After the 35 or 13 consecutive settlement days has expired, any additional fails to deliver would be subject to the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. In addition, the proposed amendment would impose a pre-borrow requirement similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

Similar to elimination of the options market maker exception, by proposing to require that all fails to deliver be closed out within specific time-frames, the proposed alternatives would reduce large and persistent fails to deliver. In addition, by proposing to require that shares be delivered to a buyer within a reasonable period of time, the proposed alternatives would result in shareholders receiving the benefits of ownership. Sellers would also be less able to unilaterally convert securities contracts into undated futures-type contracts to which the buyer would not have agreed, or that would have been priced differently. In addition, the delivery requirements of the proposed alternatives would enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected.[140] An increase in investor confidence in the market could facilitate investment. The proposed alternatives could benefit issuers because investors may be more willing to commit capital where fails levels are lower.[141] In addition, some issuers could believe that a reduction in fails to deliver could reverse unwarranted reputational damage potentially caused by large and persistent fails to deliver and what they believe might be an indication of manipulative trading activities, such as "naked" short selling.[142] Thus, the proposed requirement that all fails to deliver be closed out within specific time-frames, as would be required by the proposed alternatives, could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

The proposed alternatives would also require that participants of a registered clearing agency and options market makers document that any fails to deliver in threshold securities that have not been closed out in accordance with the 13 consecutive settlement days close-out requirement of Rule 203(b)(3) of Regulation SHO qualify for the options market maker exception. The proposed alternatives would require both options market makers and participants of a registered clearing agency that rely on the options market maker exception to not close out a fail to deliver position in accordance with the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO to obtain, prepare, and keep documentation demonstrating that a fail to

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140 See, e.g., supra note 9 (citing to comment letters discussing the impact of fails to deliver on investor confidence).

141 See, e.g., supra note 10 (citing to comment letters expressing concern regarding the impact of potential "naked" short selling on capital formation).

142 See, e.g., supra note 11.

deliver position has not been closed out because it qualified for the exception. We anticipate such documentation could include, among other things, when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out.

A documentation requirement would enable the Commission and the SROs to monitor more easily whether or not the options market maker exception is being applied correctly. In addition, the information would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

We solicit comment on any additional benefits that could be realized with the proposed alternatives, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

2. Costs

To comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping, systems, and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, for the most part the infrastructure necessary to comply with the proposed alternatives should already be in place because the proposed alternatives, if adopted, would require that all fails to deliver be closed out in accordance with specific time-frames similar to the mandatory 13 consecutive settlement day close-out requirement of Regulation SHO. In addition, similar to the current options market maker exception in Regulation SHO, the proposed alternatives would only except from the mandatory close-out requirement of Rule

203(b)(3) those fails to deliver that resulted from short sales by a registered options market maker in connection with options created before the security became a threshold security.

The proposed alternatives, however, would result in some increased recordkeeping, systems, and surveillance costs. The proposed alternatives would require that participants of a registered clearing agency, and options market makers for which they clear transactions, have the necessary recordkeeping, systems, and surveillance mechanisms in place to track whether a fail to deliver position resulted from a short sale effected by a registered options market maker to maintain or establish a hedge on option series created before the security became a threshold security. In addition, under the first proposed alternative, these entities would need to have systems and surveillance mechanisms in place to ensure that such fails to deliver are closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second proposed alternative, these entities would need to have systems and surveillance mechanisms in place to determine whether the fails to deliver would be required to be closed out within the earlier of 13 consecutive settlement days of all options series within the portfolio expiring or being liquidated, or within 35 consecutive settlement days of the security becoming a threshold security. Thus, participants of a registered clearing agency, and options market makers for which they clear, could incur costs in meeting these requirements.

In addition, the proposed alternatives would allow for a one-time 35 consecutive settlement day phase-in period for previously-excepted fail to deliver positions. Although any personnel, computer hardware and software, recordkeeping, or surveillance costs, associated with complying with this proposed phase-in period would not be an ongoing cost, entities subject to the requirement could incur some one-time costs in complying with this proposed requirement.

Any costs associated with compliance with the proposed pre-borrow requirement for fail to deliver positions that are not closed out within the applicable time-frames set forth in the proposed alternatives should be limited, if any. The proposed pre-borrow requirements in the proposed alternatives are similar to the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted. Thus, participants of a registered clearing agency, and any broker-dealers for which it clears transactions, must already comply with such a requirement if a fail to deliver position has not been closed out in accordance with Regulation SHO's mandatory close-out requirement. Accordingly, these entities should already have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with the proposed pre-borrow requirement.

As discussed above in connection with costs regarding the proposed elimination of the options market maker exception, although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer orders, or result in wider bid-ask spreads or less depth,[143] we believe the mandatory close-out requirements of each of the proposed alternatives would similarly minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to the close-out requirements of the proposed alternatives, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted

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143 See, e.g., letters from CBOE, supra note 31; Citigroup, supra note 31.

by the close-out requirements of the proposed alternatives would be small. The proposed alternatives would apply only to those threshold securities with listed options[144] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series that were created before rather than after the security became a threshold security because all other fails to deliver in threshold securities are subject to Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement.

In addition, the proposed alternatives would provide options market makers with flexibility in conducting their hedging activities because they would each allow an extended period of time (i.e., 35 consecutive settlement days for purposes of Alternative 1 and 13 or 35 consecutive settlement days for purposes of Alternative 2) within which to close out all fails to deliver in threshold securities. As discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of options market makers to make markets, liquidity, hedging costs, depth, and spreads because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (i.e., 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position can remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

144 See letter from Options Exchanges, supra note 49 (discussing the number of threshold securities with listed options).

In addition, we believe the proposed 35 consecutive settlement day phase-in period should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period.

As discussed above in connection with the costs associated with elimination of the options market maker exception, to the extent that the mandatory close-out requirements of the proposed alternatives could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in securities subject to the proposed alternatives, we believe such effects are justified by our belief that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. In addition, we believe that such potential costs would be justified by the benefits, as discussed above, of requiring that all fails to deliver be closed out within specific time-frames rather than being allowed to continue indefinitely.

Although the proposed alternatives would lessen the potential negative impact on the market of large and persistent fails to deliver similar to the proposed elimination of the options market maker exception because they would require that fails to deliver in threshold securities eventually be closed out, we believe that the proposed elimination of the options market maker exception would achieve this goal more effectively because under the proposed elimination of the options market maker exception, all fails to deliver in threshold securities would have to be closed out within Regulation SHO's mandatory 13 consecutive settlement day close-out requirement. The proposed alternatives, however, would each allow a longer period of time for fail to deliver positions to be closed out. Specifically, the first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second alternative, although some fails to deliver would be required to be closed out in less than 35 consecutive settlement days, other fails to deliver would not have be closed out until 35 consecutive settlement days from the security becoming a threshold security.

The proposed alternatives would also impose recordkeeping costs not imposed by the proposed amendment to eliminate the options market maker exception. The documentation requirement of the proposed alternatives would require options market makers and participants of a registered clearing agency to obtain, prepare, and keep documentation demonstrating that a fail to deliver position has not been closed out because it was eligible for the exception. This documentation requirement could result in these entities incurring costs related to personnel, recordkeeping, systems and surveillance mechanisms. For example, as discussed in detail in Section VI.D.i. above, for purposes of the PRA, we estimate that it would take each options market maker or participant of a registered clearing agency no more than approximately 10 minutes to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception. In addition, we estimate that the total annual hour burden per year for each options market maker subject to the documentation requirement would be 3,024 burden hours. We estimate that the total annual hour burden per year for each participant of a registered clearing agency subject to the documentation requirement would be 120 burden hours.

We request specific comment on the systems changes to computer hardware and software, or surveillance costs that would be necessary to implement the proposed alternatives. Specifically:

- What would be the costs and benefits of the proposed alternatives to elimination of the options market maker exception? For instance, what would be the costs of the proposed alternatives if either of the alternatives were to reduce the willingness of options market makers to make markets in securities that could become threshold securities or in threshold securities?
- What would be the costs associated with including the pre-borrow requirement for the proposed alternatives to the options market maker exception? What would be the costs of excluding a pre-borrow requirement for these proposals?
- What costs would be associated with the documentation requirement of the proposed alternatives?
- Based on the current requirements of Regulation SHO, what have been the costs and benefits of the current options market maker exception?
- What would be the specific costs associated with any technical or operational challenges that options market makers would face in complying with the proposed alternatives?
- Would the proposed alternatives create any costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the proposed alternatives? If there were any costs associated with tracking fails to deliver would these costs justify the benefits of providing firms with additional time to close out fails to deliver resulting

from short sales effected to establish or maintain a hedge on options series that were created before the security becomes a threshold security?

- How much would the proposed alternatives affect compliance costs for small, medium, and large participants of a clearing agency or options market maker for which they clear transactions (e.g., personnel or system changes)? We seek comment on the costs of compliance that may arise. For instance, to comply with the proposed alternatives, would these entities be required to:
  - Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
  - Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
  - Increase staffing and associated overhead costs? Would entities subject to the proposed alternatives have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, e.g., would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?

- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

- Are there any costs that participants could incur as a result of the proposed 35 consecutive settlement day phase-in period? Would the costs of a phase-in period be too significant to justify having one? Would a phase-in period create examination or surveillance difficulties? If so, how? What would be the costs and economic tradeoffs associated with longer or shorter phase-in periods?

C. Proposed Amendment to Rule 200(g)(1) of Regulation SHO

1. Benefits

We are proposing for comment a documentation requirement for broker-dealers marking orders to sell "long" pursuant to Regulation SHO that would require such broker-dealers to document the present location of the securities being sold. We believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not "deemed to own" the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale "short" rather than "long."[145] We believe that this proposed documentation requirement

[145] See 17 CFR 242.200(g).

could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

We are concerned that broker-dealers marking orders "long" may not be making a determination prior to marking the order that the seller is "deemed to own" the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[146] Thus, we believe that the proposed documentation requirement would help ensure that the broker-dealer marking the sale "long" has inquired into, and determined that, the seller is "deemed to own" the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the proposed documentation requirement would enable the Commission and SROs to more easily examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is "deemed to own" the securities being sold in compliance with that rule. We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the "locate" requirement of Regulation SHO,[147] and Rule 105 of Regulation M.[148]

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[146] See id.

[147] See supra, note 92.

[148] See supra, note 93.

2. Costs

In response to our request for comment in the 2006 Proposing Release regarding a long sale documentation requirement, commenters stated that pre-trade documentation would unnecessarily impair efficiency as broker-dealers already have procedures to ensure orders are marked properly based on information provided by customers and their own books and records, and that documentation requirements would add substantial cost.[149] One commenter also stated that compliance with such pre-trade documentation requirements would require a complete revamping of front end systems.[150] Another commenter stated that the requirements would be inconsistent with the goal of fostering liquidity.[151]

Although commenters stated that pre-trade documentation for long sales would be inconsistent with the goal of fostering liquidity, would unnecessarily impair efficiency, and would add substantial cost, we believe that such costs, to the extent that there are any, would be justified by the benefits of a documentation requirement, as discussed above.

In addition, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[152] Thus, many broker-dealers should already be familiar with a documentation requirement and one

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149 See letters from MFA, supra note 75; UBS, supra note 31; Knight, supra note 75.

150 See letter from SIA, supra note 31.

151 See letter from Millennium, supra note 75.

152 Brokers and dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b) prior to the adoption of Regulation SHO.

method that could be used to comply with such a requirement. Such familiarity should help reduce any costs associated with implementing the proposed documentation requirement. In addition, unlike with former NASD Rule 3370(b), the proposed amendment would not specify the format or methodology of the proposed documentation requirement. The absence of such specifications should help reduce costs to broker-dealers that would have to comply with this proposal because broker-dealers would be able to determine the most cost effective format and methodology for meeting the proposed documentation requirement.

We believe that any costs that would arise from the proposed requirement that a broker-dealer must document the present location of securities being sold long when making the determination that a customer is deemed to own the securities being sold would be minimal because Rule 200(g)(1) currently requires that broker-dealers must ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[153] Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers could, however, need to put mechanisms in place to facilitate efficient documenting of the information required by the proposed amendment.

As discussed above in Section VI.D.ii., the paperwork burden is estimated at approximately 49 burden hours for each broker-dealer registered with the Commission, if the documentation process were automated. To the extent that broker-dealers need to automate the documentation process, we anticipate that such broker-dealers would spend varying amounts of time reprogramming systems, integrating systems, and potentially updating front-end software. Some broker-dealers may spend very little time automating the documentation process, while

[153] See 17 CFR 242.200(g)(1).

changes at other broker-dealers might be more involved. On average, we estimate that reprogramming burdens at a broker-dealer would be approximately 16 hours (or two days) with one programmer. This would cost $1,072 per broker-dealer (16 hours @ $67 per hour) or an aggregate of $6,226,176 across all broker-dealers.[154]

The Commission does not believe there are any additional costs to this proposal; however we seek any data supporting any additional costs not mentioned. In addition, we request specific comment on any systems changes to computer hardware and software, or surveillance costs that might be necessary to implement the proposed amendment. Specifically:

- What would be the costs and benefits of the proposed documentation requirement?
- Would the proposed amendment create any costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for broker-dealers to document the present location of shares being sold? If there were any costs associated with the proposed documentation requirement would these costs justify the benefits of better ensuring compliance with federal securities laws?
- How much would the proposed amendment affect compliance costs for small, medium, and large broker-dealers (e.g., personnel or system changes)? We seek comment on the costs of compliance that may arise. For instance, to document the location of shares being sold, would these entities be required to:
    - Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing

[154] The $67/hour figure for a computer programmer is based on the salary for a Senior Computer Operator from the SIA Report on Office Salaries in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

systems? How much time would be required to fully implement any new or changed systems?

- Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
- Increase staffing and associated overhead costs? Would entities subject to the proposed amendment have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, e.g., would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?
- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

VIII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[155] 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.[156] 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.

We believe the proposed amendments, including the proposed alternatives, would have minimal impact on the promotion of price efficiency. In the 2006 Proposing Release we sought comment on whether the proposals would promote price efficiency, including whether the proposals might impact liquidity and the potential for manipulative short squeezes. One commenter stated that the Commission's concern over potential short squeezes is "misplaced," as this is a risk short sellers assume when they sell short.[157] Other commenters stated, however, that the proposed amendment to the options market maker exception would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[158] These commenters stated that they believe the proposed amendments would likely discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[159] Moreover, these commenters stated that the reluctance of

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155 15 U.S.C. 78c(f).

156 15 U.S.C. 78w(a)(2).

157 See letter from H. Glenn Bagwell, Jr., dated Sept. 19, 2006.

158 See, e.g., letter from CBOE, supra note 31.

159 See id.

options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[160]

Although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer orders, or result in wider bid-ask spreads or less depth,[161] we believe that the proposed elimination of the options market maker exceptions, and the mandatory close-out requirements of the proposed alternatives, would minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to these proposals, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the elimination of the options market maker exception, or the proposed close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted by these proposals would be relatively small. The proposal would apply only to those threshold securities with listed options[162] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series (or options positions in the case of the proposed elimination of the current options market maker exception) that were created before, rather than after, the security became a threshold security because all other fails to deliver in threshold securities are currently subject to Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

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160 See letter from Citigroup, supra note 31.

161 See, e.g., letters from CBOE, supra note 31; Citigroup, supra note 31.

162 See letter from Options Exchanges, supra note 49 (discussing the number of threshold securities with listed options).

In addition, as discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of options market makers to make markets, liquidity, hedging costs, depth, and spreads of a mandatory close-out requirement because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (i.e., 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. The close-out requirements of the proposed alternatives would provide options market makers with even greater flexibility in conducting their hedging activities because they would each allow even longer periods of time than the 13 consecutive settlement days allowed by current Rule 203(b)(3) of Regulation SHO (i.e., 35 consecutive settlement days for purposes of proposed Alternative 1, and 13 or 35 consecutive settlement days for purposes of proposed Alternative 2) within which to close out all fails to deliver in threshold securities.

In addition, we believe the proposed 35 consecutive settlement day phase-in period for each of the proposals should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period.

To the extent that a mandatory close-out requirement could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in securities subject to such a requirement, we believe such effects are justified by our an issuer's stock price that may limit the issuer's ability to access the capital markets.[163] Another commenter submitted a theoretical economic study concluding that "naked" short selling is economically similar to other short selling.[164]

By requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, we believe that there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process. The reduction in fails to deliver and the resulting reduction in the number of securities on the threshold securities lists could result in increased investor confidence.

The proposed amendment to eliminate the options market maker exception and the proposed alternatives also would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. By eliminating the options market maker exception, or, alternatively, adopting a limited options market maker exception, the Commission believes the proposals would promote competition by requiring similarly situated participants of a registered clearing agency, or options market makers for which they clear transactions, to close out fails to deliver in threshold securities within similar time-frames.

The Commission requests comment on whether the proposed amendment to eliminate the options market maker exception, the proposed alternatives, and the proposed amendment to Rule 200(g) of Regulation SHO, would promote efficiency, competition, and capital formation.

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163 See, e.g., letter from Feeney, supra note 10.

164 See comment letter from J.B. Heaton, Bartlit Beck Herman Palenchar & Scott LLP, dated May 1, 2007.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[165] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

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

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

X. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),[166] regarding the proposed amendments to Rules 200 and 203 of Regulation SHO under the Exchange Act.

A. Reasons for the Proposed Action

On July 14, 2006, the Commission published proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.[167] We

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

166 5 U.S.C. 603.

167 2006 Proposing Release, 71 FR 41710.

proposed to narrow the options market maker exception at that time because we have observed a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements, and we believe that these persistent fail to deliver positions are attributable, in part, to the current options market maker exception in Regulation SHO.[168]

As a result of the comment process, however, we learned that the amendment, as proposed, could be very costly and difficult to implement or possibly unworkable because options market makers typically use hedges to manage the risk of an entire inventory, not just a specific options position. In addition, some commenters' statements indicated to us that options market makers may be interpreting the current options market maker exception more broadly than the Commission intended and possibly in violation of the exception. We also remain concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. Although high fails levels exist only for a small percentage of securities, these fails to deliver could potentially impede the orderly functioning of the market for such securities, particularly less liquid securities. For example, a significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for voting and lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a seller that fails to deliver securities on settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.

Thus, we determined to re-propose amendments to the options market maker exception that would eliminate the exception. In addition, we are requesting comment regarding two specific alternatives to our proposal to eliminate the options market maker exception that would

[168] See id. at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079-15080.

require fails to deliver in threshold securities underlying options to be closed out within specific time-frames. By re-proposing amendments to the options market maker exception we seek additional information regarding the options markets that might assist us in determining whether or not to eliminate the options market make exception.

We are also proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that broker-dealers marking orders to sell "long" document the present location of the securities. We believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not "deemed to own" the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale "short" rather than "long."[169] We believe that this proposed documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

We are concerned that broker-dealers marking orders "long" may not be making a determination prior to marking the order that the seller is "deemed to own" the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is "deemed to own" the securities being sold before marking a sell order "long."[170] Thus, we believe that the proposed documentation requirement would help ensure that the broker-dealer

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169 See 17 CFR 242.200(g).

170 See id.

marking the sale "long" has inquired into, and determined that, the seller is "deemed to own" the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the proposed documentation requirement would enable the Commission and SROs to more easily examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is "deemed to own" the securities being sold in compliance with that rule. We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the "locate" requirement of Regulation SHO,[171] and Rule 105 of Regulation M.[172]

B. Objectives

Our proposals regarding the options market maker exception are intended to further reduce the number of persistent fails to deliver in threshold securities. The proposed amendment to eliminate the options market maker exception, and the alternative proposals, are designed to help reduce persistent and large fail to deliver positions which may have a negative effect on the market in these securities and also could be used to facilitate manipulative trading strategies.

Although high fails levels exist only for a small percentage of issuers,[173] they could impede the orderly functioning of the market for such issuers, particularly issuers of less liquid securities. For example, a significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for voting and

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171 See supra, note 92.

172 See supra, note 93.

173 See supra note 7.

lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a seller that fails to deliver securities on settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that would have been priced differently.

To allow market participants sufficient time to comply with the new close-out requirements, the proposed amendment to eliminate the options market maker exception and the proposed alternatives would include a one-time 35 consecutive settlement day phase-in period following the effective date of the amendment. The phase-in period would provide participants flexibility in closing out previously-excepted fail to deliver positions.

By proposing an amendment to Rule 200(g)(1) of Regulation SHO that would require broker-dealers to document the present location of securities a customer is deemed to own, we intend to aid surveillance for compliance with the marking requirements of Rule 200(g). In addition, such a requirement would help to ensure that broker-dealers only mark orders "long" after making a determination that a customer actually owns the securities being sold.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10(a), 11A, 15, 17(a), 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78i, 78j, 78k-1, 78o, 78q, 78s, 78w(a), the Commission is proposing amendments to §§ 242.200 and 242.203 of Regulation SHO.

D. Small Entities Subject to the Rule

The entities covered by these proposals would include small entities that are participants of a registered clearing agency, including small registered options market makers for which the participant clears trades or for which it is responsible for settlement. In addition, the entities covered by these proposals would include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Most small entities subject to the proposed amendments, including the proposed alternatives, would be registered broker-dealers. Although it is impossible to quantify every type of small entity covered by these proposals, Paragraph (c)(1) of Rule 0-10[174] 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. As of 2006, the Commission estimates that there were approximately 894 registered broker-dealers that qualified as small entities as defined above.[175]

As noted above, the entities covered by these amendments will include small entities that are participants of a registered clearing agency. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur,

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174 17 CFR 240.0-10(c)(1)

175 These numbers are based on the Commission's Office of Economic Analysis's review of 2006 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

they are small in number and are usually cleaned up within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

The federal securities laws do not define what is a "small business" or "small organization" when referring to a bank. The Small Business Administration regulations define "small entities" to include banks and savings associations with total assets of $165 million or less.[176] As of May, 2007 no bank that was a participant of the NSCC was a small entity because none met this criteria.

Paragraph (e) of Rule 0-10 under the Exchange Act[177] 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 U.S. registered exchange is a small entity 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.

Paragraph (d) of Rule 0-10 under the Exchange Act[178] states that the term "small business" or "small organization," when referring to a clearing agency, means a clearing agency that: (1) compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than $200 million in funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any

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[176] See 13 CFR 121.201.

[177] 17 CFR 240.0-10(e).

[178] 17 CFR 240.0-10(d).

person (other than a natural person) that is not a small business or small organization as defined by Rule 0-10. No clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

E. Reporting, Recordkeeping, and other Compliance Requirements

The proposed amendment to eliminate the options market maker exception, and the proposed alternatives, would impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. In order to comply with Regulation SHO when it became effective in January, 2005, entities needed to modify their systems and surveillance mechanisms. Thus, the infrastructure necessary to comply with the proposed amendments regarding elimination of the options market maker exception should already be in place. Any additional changes to the infrastructure should be minimal. In addition, entities that would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO should already have systems in place to close out non-excepted fails to deliver as required by Regulation SHO. These entities, however, could be required to modify their systems and surveillance mechanisms to ensure compliance with the proposed alternatives to eliminating the options market maker exception.

These entities could also be required to put in place mechanisms to facilitate communications between participants of a registered clearing agency and options market makers to meet the documentation requirements of the proposed alternatives. We solicit comment on what new recordkeeping, reporting or compliance requirements could arise as a result of the proposed amendment to eliminate the options market maker exception and the proposed alternatives to elimination that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames.

The proposed amendment to Rule 200(g)(1) that would require that broker-dealers document the present location of securities a customer is deemed to own prior to marking an order to sell "long" could impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. We believe, however, that such costs should be minimal. Rule 200(g)(1) currently requires that broker-dealers must determine whether the customer is "deemed to own" the securities being sold before marking a sell order "long." Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers may, however, need to put mechanisms in place to facilitate efficient documenting of the information that would be required by the proposed amendment.

Moreover, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Thus, many broker-dealers that are small entities should already be familiar with a documentation requirement and with one method that could be used to comply with such a requirement. We solicit comment, however, on what new recordkeeping, reporting or compliance requirements may arise as a result of the proposed amendment to Rule 200(g)(1) of Regulation SHO.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,[179] the Commission must consider the following types of alternatives: (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.

A primary goal of the proposed amendment to eliminate the options market maker exception, and the proposed alternatives, is to reduce the number of persistent fails to deliver in threshold securities. 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 reducing fails to deliver. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposals to further clarify, consolidate or simplify the proposals for small entities. Finally, the proposals would impose performance standards rather than design standards.

H. Request for Comments

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on: (i) the number of small entities that would be affected by the proposed amendments; and (ii) the existence or nature of the potential impact of the proposed amendments on small entities. Those comments should

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179 5 U.S.C. 603(c).

specify costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the objective of the proposed amendments.

XI. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78i(h), 78j, 78k-1, 78o, 78q(a), 78q-1, 78w(a), the Commission is proposing amendments to §§ 242.200 and 242.203.

Text of the Proposed Amendments to Regulation SHO

List of Subjects

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, Part 242, of the Code of Federal Regulations is proposed to be amended as follows.

PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. 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.

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2. Section 242.200 is proposed to be amended by adding new paragraph (g)(2) to read as follows:

§ 242.200 Definition of "short sale" and marking requirements.

* * * * *

(g) * * *

(2) For purposes of paragraph (g)(1) of this section, in determining whether the seller is "deemed to own" the security being sold, the broker or dealer must document the present location of the security being sold.

3. Section 242.203 is proposed to be amended by:

a. Revising paragraph (b)(3)(iii);

b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(vii) and (b)(3)(viii);

c. Adding new paragraph (b)(3)(vi);

d. Removing the word "and" at the end of paragraph (b)(3)(vi); and

e. Revising newly designated paragraph (b)(3)(vii) by adding the word "and" after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment and which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (i.e., because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

4. Alternative 1: alternatively, Section 242.203 is proposed to be amended by:

   a. Revising paragraph (b)(3)(iii);

   b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(vii) and (b)(3)(viii);

c. Adding new paragraphs (b)(3)(vi) and (b)(3)(ix);

d. Removing the word "and" at the end of paragraph (b)(3)(vi); and

e. Revising newly designated paragraph (b)(3)(viii) by adding the word "and" after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) The provisions of paragraph (b)(3) of this section shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security;

(A) Provided, however, that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options series that were created before the security became a threshold security, the participant shall close out the fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days from the date on which the security became a threshold security by purchasing securities of like kind and quantity;

(B) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (i.e., because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales effected by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * * * *

(ix) To the extent that an amount of a fail to deliver position in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(ii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

5. Alternative 2: alternatively, Section 242.203 is proposed to be amended by:

a. Revising paragraph (b)(3)(iii);

b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(viii)and (b)(3)(ix);

c. Adding new paragraphs (b)(3)(vi), (b)(3)(vii) and (b)(3)(x);

d. Removing the word "and" at the end of paragraph (b)(3)(vi); and

e. Revising newly designated paragraph (b)(3)(ix) by adding the word "and" after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) The provisions of paragraph (b)(3) of this section shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security;

(A) Provided, however, that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options series that were created before the security became a threshold security, the participant shall close out the fail to deliver position, including any adjustments to the fail to deliver position, by purchasing securities of like kind and quantity within the earlier of: (1) 35 consecutive settlement days from the date on which the security became a threshold security, or (2) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the underlying security became a threshold security expire or are liquidated;

(B) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (i.e., because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the exception to the close-out requirement contained in paragraph (b)(3)(iii)(A) of this section has a fail to deliver position at a registered clearing agency in a threshold security for longer than the earlier of: (1) 35 consecutive settlement days from the date on which the security became a threshold security, or (2) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

(vii) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii)(B) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * * * *

(x) To the extent that an amount of a fail to deliver position in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(iii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

* * * * *

By the Commission.

Nancy M. Morris
Secretary

Dated: August 7, 2007

Γ'',

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 56215 / August 7, 2007

Admin. Proc. File No. 3-12659

In the Matter of the Application of

MICHAEL FREDERICK SIEGEL
c/o George C. Freeman, III, Esq.
Barrasso Usdin Kupperman Freeman & Sarver, LLC
909 Poydras Street, Suite 1800
New Orleans, Louisiana 70112

For Review of Action Taken by

NASD

ORDER POSTPONING ISSUANCE OF BRIEFING SCHEDULE

On June 21, 2007, NASD filed a motion styled as a request that the Commission stay the issuance of the briefing scheduling order in this appeal either for 120 days or until the time that Applicant Michael F. Siegel appeals an expected but not yet made NASD determination about the amount of restitution he must pay under NASD's decision against him, as discussed in greater detail below. On May 11, 2007, NASD issued a decision (the "May 11 Decision") finding that Siegel, an associated person of NASD member firm Rauscher Pierce Refsnes, Inc. ("Rauscher Pierce") from October 1997 until June 1999, 1/ participated in private securities transactions without providing Raushcer Pierce with prior written notice, in violation of NASD Conduct Rule 3040, 2/ and made unsuitable recommendations to four customers, in violation of NASD Conduct

1/ Rauscher Pierce Refsnes, Inc. was succeeded by Dain Rauscher Inc. and then by RBC Dain Rauscher, Inc.

2/ NASD Conduct Rule 3040 prohibits any person associated with a member firm from "participat[ing] in any manner in a private securities transaction" unless, prior to such participation, the associated person provides "written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction."

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Rule 2310(a). 3/ NASD fined Siegel $20,000 and suspended him in all capacities for six months with respect to the Rule 3040 violations, fined him $10,000 and suspended him for six months with respect to the Rule 2310(a) violations, with the two suspensions to be served consecutively, and assessed hearing and appeal costs.

NASD also ordered Siegel to pay a total of $400,300 in restitution to four customers subject to offsets described in the May 11 Decision. In the May 11 Decision, NASD referred the calculation of the precise amounts of the restitution and offsets to a subcommittee of the National Adjudicatory Council (the "NAC Subcommittee"). The NAC Subcommittee has not yet reached its decision as to the precise amounts of restitution Siegel is obligated to pay under the May 11 Decision. In the May 11 Decision, NASD declared, "Solely on the issue of the restitution amount, this decision is not a final disciplinary action within the meaning of Section 19(d)(1) of the Securities Exchange Act of 1934. All other aspects of this decision, however, including all findings of liability and other sanctions, do constitute a final disciplinary action within the meaning of Section 19(d)(1) of the Exchange Act." 4/

On June 12, 2007, Siegel filed with the Commission an application for review of the May 11 Decision. By operation of NASD Conduct Rule 9370, "[t]he filing with the Commission of an application for review by the Commission shall stay the effectiveness of any sanction, other than a bar . . . ." Consequently, Siegel's obligation to pay the ordered fines and serve the ordered suspensions is stayed during the pendency of his appeal. Siegel has declared that he "anticipates appealing [the NAC Subcommittee's restitution] decision when made."

In light of the procedural posture of this proceeding, in which Siegel has appealed the May 11 Decision while the amount of restitution that he owes under the May 11 Decision remains under consideration by NASD, NASD has filed a motion styled as a request that we stay the issuance of a briefing scheduling order in this proceeding for 120 days or until Siegel appeals the eventual restitution order of the NAC Subcommittee, whichever comes first. NASD suggests that when Siegel applies for review of the NAC Subcommittee's restitution decision, the Commission could consolidate that review with the instant review, thus enabling the Commission to address at

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3/ NASD Conduct Rule 2310(a) provides 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 upon the basis of the facts, if any, disclosed by such customer as to his security holdings and as to his financial situation and needs."

4/ Exchange Act Section 19(d)(1) provides that a self-regulatory organization shall provide the Commission with notice of "any final disciplinary sanction" imposed on any person associated with a member of the self-regulatory organization. According to Exchange Act Section 19(d)(2), any final disciplinary sanction is subject to Commission review "upon application by any person aggrieved thereby."

one time all the issues that might be raised in this proceeding. NASD represents that Siegel consents to NASD's request that we stay the issuance of the briefing scheduling order.

Although NASD has styled its motion as a request for a stay of the issuance of the briefing scheduling order, NASD's request is more appropriately considered under Commission Rule of Practice 161, which permits the Commission to postpone proceedings under certain circumstances. Absent a postponement of this proceeding, the Commission would have been required to issue the briefing scheduling order by July 2, 2007, within twenty-one days of Siegel's application for review, under Rule of Practice 450(a). Under Rule 161(b), the factors the Commission must consider in determining whether to grant a postponement are (1) the length of the proceeding to date; (2) the number of postponements, adjournments or extensions already granted; (3) the stage of the proceedings at the time of the request; (4) the impact of the request on the hearing officer's ability to complete the proceeding in the time specified by the Commission; and (5) any other such matters as justice may require.

NASD has requested postponement at the outset of this appeal, and no prior postponements of this proceeding have occurred to date. Furthermore, as the Commission has stated previously, "we do not favor" any procedures that require the "piecemeal disposition of a proceeding." 5/ As noted above, Siegel has already stated that he intends to appeal the NAC Subcommittee's restitution order once it is made. Therefore, absent a postponement of the issuance of the briefing scheduling order, the Commission would be in a position of considering two separate appeals arising from the same NASD disciplinary action. Given NASD's assurances that it "plans to move expeditiously in considering the remaining restitution issues" and Siegel's apparent consent to the postponement, a postponement of the proceeding will not prejudice either party or harm the public interest. In granting NASD's request, however, we expect in the future that NASD will not take a final disciplinary action against a member or an associated person until all elements of the case, including any restitution amounts under consideration by a NAC Subcommittee, have also been finally determined. Such an approach will best serve the public interest in administrative efficiency.

5/ Rita Villa, 53 S.E.C. 399, 404 (1998) (noting, in a decision affirming administrative law judge's use of an "abbreviated procedure" by granting respondent's motion for a "directed verdict," that we generally prefer "to avoid piecemeal appeals and to promote administrative economy" absent "extreme circumstances").

Accordingly, IT IS ORDERED that NASD's request to postpone the issuance of the briefing scheduling order in this proceeding until the earlier of either 120 days from the date of this order or the date Applicant Michael Frederick Siegel applies for review of NASD's final order requiring the payment of restitution under NASD's May 11, 2007 Decision be, and it hereby is, granted.

By the Commission.

Nancy M. Morris
Secretary

Florence E Harmon

By: Florence E Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release No. 34-56212; File No. S7-12-06]

RIN 3235-AJ57

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act"). The amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the grandfather provision of Regulation SHO. In addition, we are amending the close-out requirement of Regulation SHO for certain securities that a seller is "deemed to own." The amendments also update the market decline limitation referenced in Regulation SHO.

EFFECTIVE DATE: [insert 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Elizabeth A. Sandoe, Branch Chief, Joan M. Collopy, Special Counsel, and Lillian S. Hagen, 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: We are amending Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

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I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.[1] Among other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date[2] and to target potentially abusive "naked" short selling[3] in certain equity securities.[4] While the

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1 17 CFR 242.200. See also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) ("Adopting Release"), available at http://www.sec.gov/rules/final/34-50103.htm. For more information on Regulation SHO, see "Frequently Asked Questions" and "Key Points about Regulation SHO," available at http://www.sec.gov/spotlight/shortsales.htm.

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

2 Generally, investors must complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or "trade date plus three days"). T+3 means that when the investor purchases a security, the purchaser's payment must be received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. Because the Commission recognized that there are many legitimate reasons why broker-dealers may not be able to deliver securities on settlement date, it adopted Rule 15c6-1, which prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1. However, failure to deliver securities on T+3 does not violate the rule.

3 We have previously noted that abusive "naked" short selling, while not defined in the federal securities laws, generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle. See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) ("Proposing Release").

4 In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of Sedona Corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with Sedona stock, and depressed its price. See Rhino Advisors, Inc. & Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, SEC v. Rhino Advisors, Inc. & Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y.). See also, Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) ("2003 Proposing Release") (describing the alleged activity in the case involving stock of Sedona Corporation); Adopting Release, 69 FR at 48016, n.76.

majority of trades settle on time,[5] Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might impact the market for that security.[6] Although high fails levels exist only for a small percentage of issuers,[7] we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.

In addition, many issuers and investors continue to express concerns about extended fails

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5 According to the National Securities Clearing Corporation ("NSCC"), 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3.

6 These fails to deliver may result from either short or long sales of stock. There may be many reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. Also, broker-dealers that make a market in a security ("market makers") and who sell short thinly-traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

7 The average daily number of securities on the threshold list in March 2007 was approximately 311 securities, which comprised 0.39% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO's current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act. NASD Rule 3210, which became effective on July 3, 2006, applies the Regulation SHO close-out framework to non-reporting equity securities with aggregate fails to deliver equal to, or greater than, 10,000 shares and that have a last reported sale price during normal trading hours that would value the aggregate fail to deliver position at $50,000 or greater for five consecutive settlement days. See Exchange Act Release No. 53596 (April 4, 2006), 71 FR 18392 (April 11, 2006) (SR-NASD-2004-044). Consistent with the amendment to eliminate the grandfather provision of Regulation SHO, we anticipate the NASD would propose similar amendments to NASD Rule 3210.

to deliver in connection with "naked" short selling.[8] To the extent that large and persistent fails to deliver might be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price, fails to deliver may undermine the confidence of investors.[9] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[10] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver.[11] Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security's price.[12]

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8 See, e.g., comment letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 ("Overstock"); comment letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, Taser International, dated Sept. 18, 2006 ("Taser"); comment letter from John Royce, dated April 30, 2007; comment letter from Michael Read, dated April 29, 2007; comment letter from Robert DeVivo, dated April 26, 2007; comment letter from Ahmed Akhtar, dated April 26, 2007.

9 See, e.g., comment letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 ("NCANS"); comment letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 ("State of Connecticut") (discussing the impact of fails to deliver on investor confidence).

10 See, e.g., comment letter from Congressman Tom Feeney, Florida, U.S. House of Representatives, dated Sept. 25, 2006 ("Feeney") (expressing concern about potential "naked" short selling on capital formation, claiming that "naked" short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets); comment letter from Zix Corporation, dated Sept. 19, 2006 ("Zix") (stating that "[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company "do something" about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities").

11 Due, in part, to such concerns, issuers have taken actions to attempt to make transfer of their securities "custody only," thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company ("DTC") or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

12 See also, Proposing Release, 71 FR at 41712 (discussing the potential impact of large and persistent fails to deliver on the market). See also, 2003 Proposing Release, 68 FR at 62975 (discussing the potential impact of "naked" short selling on the market).

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to securities in which a substantial amount of fails to deliver have occurred (also known as "threshold securities").[13] As adopted in August 2004, Rule 203(b)(3) of Regulation SHO included two exceptions to the mandatory close-out requirement. The first was the "grandfather" provision, which excepted fails to deliver established prior to a security becoming a threshold security;[14] and the second was the "options market maker exception," which excepted fails to deliver in threshold securities resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.[15]

At the time of Regulation SHO's adoption, the Commission stated that it would monitor the operation of Regulation SHO, particularly whether grandfathered fail to deliver positions were being cleared up under the existing delivery and settlement requirements or whether any further regulatory action with respect to the close-out provisions of Regulation SHO was warranted.[16] In addition, with respect to the options market maker exception, the Commission

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[13] A threshold security is defined in Rule 203(c)(6) of Regulation SHO as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and is included on a list ("threshold securities list") disseminated to its members by a self-regulatory organization ("SRO"). See 17 CFR 242.203(c)(6). Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

[14] The "grandfathered" status applied in two situations: (1) to fail positions occurring before January 3, 2005, Regulation SHO's effective date; and (2) to fail positions that were established on or after January 3, 2005 but prior to the security appearing on a threshold securities list. See 17 CFR 242.203(b)(3)(i).

[15] 17 CFR 242.203(b)(3)(ii).

[16] See Adopting Release, 69 FR at 48018.

noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission's original expectations.[17]

Since Regulation SHO's effective date in January 2005, the Commission's staff ("Staff") and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.[18] However, despite this positive impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements. Allowing these persistent fails to deliver to continue indefinitely may lead to greater uncertainty about the fulfillment of the settlement obligation.[19] While some delays in closing out may be understandable and necessary, a seller should deliver shares to close out its sale within a reasonable time period.

Based, in part, on the results of examinations conducted by the Staff and SROs, as well as our desire to reduce large and persistent fails to deliver, on July 14, 2006, we proposed revisions

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[17] See id. at 48019.

[18] For example, in comparing a period prior to the effective date of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to March 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- the average daily aggregate fails to deliver declined by 29.5%;
- the average daily number of securities with aggregate fails to deliver of at least 10,000 shares declined by 5.8%;
- the average daily number of fails to deliver declined by 15.1%;
- the average age of a fail to deliver position declined by 25.5%;
- the average daily number of threshold securities declined by 39.0%; and
- the average daily fails to deliver of threshold securities declined by 52.9%.

See also, supra n. 7.

[19] See Adopting Release, 69 FR at 48016-48017; see also, 2003 Proposing Release, 68 FR at 62977-62978 (discussing the Commission's belief that the delivery requirements of proposed Regulation SHO would protect and enhance the operation, integrity and stability of the markets and the clearance and settlement system, and protect buyers of securities by curtailing "naked" short selling).

to Regulation SHO that would modify Rule 203(b)(3) by eliminating the grandfather provision and narrowing the options market maker exception.[20] The proposed amendments were intended to reduce the number of persistent fails to deliver attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception.

The proposals were based, in part, on data collected by the National Association of Securities Dealers, Inc. ("NASD"), as well as concerns about the persistence of certain securities on the threshold securities lists.[21] However, in response to commenters' concerns regarding the public availability of data relied on by the Commission, on March 26, 2007 we re-opened the comment period to the Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the NASD's findings that the NASD had submitted to the public file on March 12, 2007. In addition, the notice regarding the re-opening of the comment period directed the public's attention to brief summaries of data collected by the Commission's Office of Compliance Inspections and Examinations and the New York Stock Exchange LLC ("NYSE").[22]

The proposals included a 35 settlement day phase-in period following the effective date of the amendment intended to provide additional time to begin closing out certain previously-excepted fails to deliver. In addition, the proposals included an amendment to update the market

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20 See Proposing Release, 71 FR 41710.

21 See Proposing Release, 71 FR at 41712.

22 See Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007) ("Regulation SHO Re-Opening Release"). We received a number of comment letters in response to the Regulation SHO Re-Opening Release, most of which urged the Commission to take action on the proposed amendments to eliminate the grandfather provision and narrow the options market maker exception. Comment letters, including the comments of the NASD, are available on the Commission's Internet Web Site at http://www.sec.gov/comments/s7-12-06/s71206.shtml. See also, Memorandum from the Commission's Office of Economic Analysis regarding Fails to Deliver Pre- and Post-Regulation SHO (dated August 21, 2006), which is available on the Commission's Internet Web Site at http://www.sec.gov/spotlight/failstodeliver082106.pdf.

decline limitation referenced in Rule 200(e)(3) of Regulation SHO.[23] The Commission also included in the Proposing Release a number of requests for comment, including whether the Commission should amend Regulation SHO to extend the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act of 1933 (the "Securities Act").[24]

We received over 1,000 comment letters in response to the Proposing Release.[25] As discussed below, after considering the comments received and the purposes underlying Regulation SHO, we are adopting the amendments to the grandfather provision and the market decline limitation, with some modifications to refine provisions and address commenters' concerns. However, in a separate companion release, we are re-proposing amendments to the options market maker exception.[26] In addition, we are adopting amendments to the close-out requirement of Regulation SHO for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

II. Overview of Regulation SHO

A. Rule 203(b)(3)'s Close-out Requirement

One of Regulation SHO's primary goals is to reduce fails to deliver in those securities with a substantial amount of fails to deliver by imposing additional delivery requirements on

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[23] 17 CFR 242.200(e)(3).

[24] 17 CFR 230.144

[25] The comment letters are available on the Commission's Internet Web Site at http://www.sec.gov/comments/s7-12-06/s71206.shtml.

[26] See Exchange Act Release No. 56213 (Aug. 7, 2007)

those securities.[27] We believe that additional delivery requirements help protect and enhance the operation, integrity and stability of the markets, as well as reduce short selling abuses.

Regulation SHO requires certain persistent fail to deliver positions to be closed out. Specifically, Rule 203(b)(3)'s close-out requirement provides that a participant of a clearing agency registered with the Commission[28] must take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement ("CNS")[29] system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.[30] In addition, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, prohibits the participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing,

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[27] See Adopting Release, 69 FR at 48009.

[28] For purposes of Regulation SHO, the term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24). The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A), 78q-1 and 15 U.S.C. 78q-1(b), respectively. See also, Adopting Release, 69 FR at 48031. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

[29] The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The NSCC clears and settles the majority of equity securities trades conducted on the exchanges and over the counter. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the contraparty to both sides of the transaction. While NSCC's rules do not authorize it to require member firms to close out or otherwise resolve fails to deliver, NSCC reports to the SROs those securities with fails to deliver of 10,000 shares or more. The SROs use NSCC fails data to determine which securities are threshold securities for purposes of Regulation SHO.

[30] 17 CFR 242.203(b)(3).

or entering into a bona-fide arrangement to borrow, the security until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.[31]

B. Grandfathering under Regulation SHO

As originally adopted, Rule 203(b)(3)'s close-out requirement did not apply to positions that were established prior to the security becoming a threshold security.[32] This is known as grandfathering. Grandfathered positions included those that existed prior to the January 3, 2005 effective date of Regulation SHO, and to positions established prior to a security becoming a threshold security.[33] Regulation SHO's grandfathering provision was adopted because the Commission was concerned about creating volatility through short squeezes[34] if large pre-existing fail to deliver positions had to be closed out quickly after a security became a threshold security.

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[31] 17 CFR 242.203(b)(3)(iii). It is possible under Regulation SHO that the close out by the participant of a registered clearing agency may result in a failure to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. However, Regulation SHO prohibits a participant of a registered clearing agency from engaging in "sham close outs" by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a failure to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, which thus creates another fail to deliver position. 17 CFR 242.203(b)(3)(v); see also, Adopting Release, 69 FR at 48018 n.96. In addition, we note that borrowing securities, or otherwise entering into an agreement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement.

[32] 17 CFR 242.203(b)(3)(i).

[33] See Adopting Release, 69 FR at 48018. However, any new fails to deliver in a security on a threshold securities list are subject to the mandatory close-out provisions of Rule 203(b)(3) of Regulation SHO.

[34] The term short squeeze refers to the pressure on short sellers to cover their positions as a result of sharp price increases or difficulty in borrowing the security the sellers are short. The rush by short sellers to cover produces additional upward pressure on the price of the stock, which then can cause an even greater squeeze. Although some short squeezes may occur naturally in the market, a scheme to manipulate the price or availability of stock in order to cause a short squeeze is illegal.

C. Regulation SHO's Options Market Maker Exception

In addition, Regulation SHO's options market maker exception excepts from the close-out requirement of Rule 203(b)(3) any fail to deliver position in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security.[35] The options market maker exception was created to address concerns regarding liquidity and the pricing of options. The exception does not require that such fails be closed out.

III. Discussion of Amendments to Regulation SHO

A. Grandfather Provision

1. Proposal

To further Regulation SHO's goal of reducing persistent fails to deliver, the Commission proposed to eliminate the grandfather provision in Rule 203(b)(3)(i) of Regulation SHO.[36] In particular, the proposed amendment would require that any previously-grandfathered fails to deliver in a security that is on a threshold list on the effective date of the amendment be closed out within 35 consecutive settlement days[37] of the effective date of the amendment. In addition, similar to the pre-borrow requirement in Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position has persisted for 35 consecutive settlement days from the effective date of the amendment, the proposal would prohibit a participant, and any broker-dealer

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[35] 17 CFR 242.203(b)(3)(ii).

[36] See Proposing Release, 71 FR 41710.

[37] The Commission chose 35 settlement days because 35 days is used in the current rule (although for a different purpose) and to allow participants additional time to close out their previously-grandfathered fails to deliver, given that some participants may have large previously-excepted fails to deliver with respect to a number of securities.

for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

However, if a security becomes a threshold security after the effective date of the amendment, any fails to deliver in that security that occurred prior to the security becoming a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

2. Comments

We received a large number of comment letters regarding the proposal to eliminate the grandfather provision. The comments were from numerous entities, including issuers, retail investors, broker-dealers, SROs, associations, members of Congress, and other elected officials.

Commenters expressed both support[38] and opposition[39] to the proposal to eliminate the grandfather provision.

Some of the commenters that supported eliminating the grandfather provision stated that the proposal would restore investor confidence and that it would not cause excessive volatility.[40] For example, one commenter stated that elimination of the grandfather provision should not cause excessive volatility because, according to the commenter, the Depository Trust & Clearing Corporation ("DTCC") and market participants have said that fails to deliver are a small problem.[41] Another commenter stated that the Commission's concern over potential short

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[38] See, e.g., comment letter from Overstock, supra note 8; comment letter from Taser, supra note 8; comment letter from Barry McCarthy, Chief Financial Officer, Netflix, Inc., dated Sept. 19, 2006; comment letter from Glenn W. Rollins, President, Orkin, Inc., dated Aug. 29, 2006; comment letter from Zix, supra note 10; comment letter from Joseph P. Borg, Esq., President, North American Securities Administrators Association, Inc., dated Oct. 4, 2006 ("NASAA"); comment letter from Paul Rivett, Vice President, Fairfax Financial Holdings, Ltd., Sept. 19, 2006; comment letter from State of Connecticut, supra note 9; comment letter from John G. Gaine, President, MFA, dated Sept. 19, 2006 ("MFA"); comment letter from James J. Angel, PhD., Associate Professor of Finance, McDonough School of Business, Georgetown University, dated July 18, 2006 ("Angel"); comment letter from NCANS, supra note 9; comment letter from Simon Lorne, Chief Legal Officer, and Martin Schwartz, Chief Compliance Officer, Millennium Partners, LP, dated Oct. 10, 2006; comment letter from David C. Chavern, Capital Markets Program, U.S. Chamber of Commerce, dated Sept. 13, 2006; comment letter from Jeffrey D. Stacey, Managing Director, Jeffrey D. Stacey Associates, Ltd., dated Sept. 19, 2006; comment letter from Congressman Rodney Alexander - Louisiana, U.S. House of Representatives, dated July 28, 2006; comment letter from Senator Orin Hatch - Utah, U.S. Senate, dated Sept. 19, 2006; comment letter from Feeney, supra note 10; comment letter from Congressman Virgil Goode, Jr. - Virginia, U.S. House of Representatives, dated Sept. 13, 2006; comment letter from Congresswoman Sue Kelly - New York, U.S. House of Representatives, dated Sept. 19, 2006; letter from Congressman Jim Ryun - Kansas, U.S. House of Representatives, dated Sept. 18, 2006; comment letter from Congressman Jim Matheson - Utah, U.S. House of Representatives, dated Sept. 19, 2006; comment letter from Governor Jon M. Huntsman, Governor of Utah, dated Sept. 8, 2006; comment letter from Mark L. Shurtleff, Attorney General for the State of Utah, dated Sept. 18, 2006; and comment letter from Wayne Klein, Director, Division of Securities, State of Utah, dated Sept. 13, 2006 ("Utah Division of Securities").

[39] See, e.g., comment letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated Sept. 19, 2006 ("SIA"); comment letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association Section of Business Law, dated Sept. 27, 2006 ("ABA"); comment letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated Oct. 11, 2006 ("CBOE"); comment letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS Securities LLC, dated Sept. 22, 2006 ("UBS"); comment letter from Leonard J. Amoruso, Senior Managing Director and Chief Compliance Officer, Knight Capital Group, Inc., dated Sept. 20, 2006 ("Knight").

[40] See comment letters from MFA, supra note 38; NCANS, supra note 9; State of Connecticut, supra note 9.

[41] See comment letter from NCANS, supra note 9.

squeezes is "misplaced," as this is a risk short sellers assume when they sell short.[42] Many commenters supported the proposed 35-day phase-in period for certain previously-grandfathered fails to deliver;[43] although some commenters stated their belief that a phase-in period was unnecessary.[44]

Commenters opposing the elimination of the grandfather provision did so for various reasons. For example, one commenter stated that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.[45] Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempt to close out positions.[46] This commenter also stated that eliminating the grandfather provision would negatively impact bona fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.[47] According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.[48] Another commenter maintained that eliminating the grandfather provision would cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive "naked" short sellers.[49]

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42 See comment letter from H. Glenn Bagwell, Jr., Esq., Sept. 19, 2006.

43 See, e.g., comment letters from NCANS, supra note 9; Taser, supra note 8; Overstock, supra note 8.

44 See, e.g., comment letters from NASAA, supra note 38; Utah Division of Securities, supra note 38; Zix, supra note 10.

45 See comment letter from CBOE, supra note 39.

46 See comment letter from Knight, supra note 39.

47 See id.

48 See id.

49 See comment letter from UBS, supra note 39.

Some commenters stated that the proposal is an overly broad means of addressing the issue of substantial, persistent fails to deliver that may occur in only a small subset of threshold securities and that, in fact, the available data shows that the proposal is not necessary.[50] These commenters also stated their belief that a more targeted approach, such as tracking actual "naked" short sales, would be a more appropriate method of addressing the issue of fails to deliver. Another commenter stated that the Commission had not explained the need for the proposal and had not provided substantial evidence showing that persistent fails to deliver are primarily attributable to the grandfather provision.[51] However, as discussed in more detail below, even those commenters opposing the elimination of the grandfather provision suggested alternative proposals to elimination for the Commission to consider. For example, one commenter suggested allowing for a period longer than 13 consecutive settlement days within which to close out all fails to deliver currently excepted from the close-out requirement due to the grandfather provision.[52]

3. Adoption

After careful consideration of the comments, we are adopting the amendment to eliminate the grandfather provision as proposed. As adopted, the amendment eliminates the grandfather provision from Regulation SHO and amends Rule 203 to require that all fails to deliver in threshold securities be closed out within either 13 consecutive settlement days or, in the case of a previously-grandfathered fail to deliver position in a security that is a threshold security on the

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[50] See, e.g., comment letter from Knight, supra note 39.

[51] See comment letter from ABA, supra note 39; see also, supra note 22 (discussing the Regulation SHO Re-Opening Release).

[52] See, e.g., comment letters from CBOE, supra note 39; SIA, supra note 39; Knight, supra note 39; UBS, supra note 39. See also, Section III.A.3., discussing these alternative proposals.

effective date of the amendment, 35 consecutive settlement days from the effective date of the amendment.[53]

For the reasons discussed above and in the Proposing Release, we believe that no fail to deliver position should be left open indefinitely. While some delays in closing out may be understandable and necessary, a seller should deliver shares to close out a sale within a reasonable time period. Thus, we believe the adoption of the amendment as proposed is warranted and strikes the appropriate balance between reducing large and persistent fails to deliver in threshold securities and still providing participants flexibility and advance notice to close out the originally grandfathered fails to deliver. While the amendments may have some potential impact on liquidity, we believe the advance notice and flexibility provided by the amendments will limit any impact on liquidity of requiring market participants to close out such previously-grandfathered fails to deliver.

Commenters opposing the elimination of the grandfather provision contended that elimination of the grandfather provision could lead to increased volatility, a reduction in liquidity, and short squeezes in these securities as individuals attempt to close out positions. Although we recognize that elimination of the grandfather provision could have these potential effects, we believe the benefits of requiring that fails to deliver not be allowed to continue indefinitely justify these potential effects. In addition, we believe that such effects, if any, would be minimal.

53 In addition, similar to the proposed amendment and Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the amendment will prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. For those fails to deliver not subject to the 35 consecutive settlement day phase-in period, Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, will apply to fail to deliver positions in threshold securities that persist beyond the 13 consecutive settlement day mandatory close-out requirement.

First, we believe that the potential effects, if any, of eliminating the grandfather provision will be minimal because the number of securities that will be impacted by elimination of the grandfather provision will be relatively small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[54] Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. Moreover, the amendment only impacts those fails to deliver in threshold securities that were created before the security became a threshold security. Because the current grandfather provision has a limited application, the overall impact of its removal on liquidity, volatility, and short squeezes, is expected to be minimal, if any.

Second, to the extent that the amendment could result in a decrease in liquidity, increased volatility, or short squeezes, we believe that any such potential effects will likely be mitigated by the fact that even though fails to deliver that were previously-grandfathered from the close-out requirement of Regulation SHO will no longer be permitted to continue indefinitely, such fails to deliver will not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)'s mandatory close-out requirement, both new and previously-grandfathered fails to deliver in threshold securities will have 13 consecutive settlement days within which to be closed out.

Third, as noted above, the grandfather provision excepts from Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement only those fails to deliver created before the security became a threshold security. Thus, it does not apply to fails to deliver created after the security became a threshold security. In examining the application of the

[54] See supra note 7 (discussing the number of threshold securities as of March 31, 2007)

current mandatory close-out requirement of Regulation SHO for all non-grandfathered fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-grandfathered fails to deliver in threshold securities has negatively impacted liquidity or volatility in these securities, or resulted in short squeezes.

Fourth, to the extent that elimination of the grandfather provision results in decreased liquidity, or increased volatility in certain securities, or results in short squeezes, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Some commenters expressed concern about "naked" short selling causing a drop in an issuer's stock price, which may limit an issuer's ability to access the capital markets.[55] We believe that by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing some to continue indefinitely, there will likely be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the

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[55] See, e.g., comment letter from Feeney, supra note 10.

threshold securities lists leads to an unwarranted decline in investor confidence about the security, the amendments are expected to improve investor confidence about the security. We also believe that the amendments will lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

Alternative Proposals

Some commenters suggested alternative close-out requirements to the proposed amendment to eliminate the grandfather provision of Regulation SHO. For example, one commenter suggested that all fails to deliver in threshold securities, whether or not grandfathered, be closed out within 20 consecutive settlement days.[56] Although 20 consecutive settlement days would provide a uniform close-out requirement, we believe that it would be unwise to extend the close-out requirement to 20 consecutive settlement days because the current industry practice is to close out non-grandfathered fails to deliver in threshold securities within 13 consecutive settlement days and, for the most part, firms appear to be complying with this requirement. Also, it would extend the time in which a fail to deliver position would be permitted to persist, which is contrary to our goal of further reducing fails to deliver in threshold securities within a reasonable period of time. In addition, the current close-out requirement has led to a significant reduction in fails to deliver in threshold securities and, therefore, we do not believe it is appropriate to extend the close-out requirement beyond 13 consecutive settlement days.[57]

As another alternative to the proposed amendment, this commenter also recommended that the Commission require that all fails to deliver that exist prior to the security becoming a

56 See comment letter from SIA, supra note 39.

57 See, e.g., supra note 18 (providing data regarding the impact of Regulation SHO since adoption).

threshold security be closed out within 35 consecutive settlement days.[58] Under this alternative, all new fail to deliver positions in threshold securities would be subject to the current 13 consecutive settlement day close out requirement; however, it would allow all fails to deliver that occur prior to the security becoming a threshold security to be closed out within 35 consecutive settlement days. We believe that this two-track approach to the close out requirement of Regulation SHO would be difficult to apply and monitor for compliance.

Another option suggested by commenters was to modify the proposal to have it address only threshold securities that have a high level of persistent fails to deliver, rather than all threshold securities. Under this alternative, a previously-grandfathered fail to deliver position in a threshold security would only become subject to the mandatory close-out requirement if the threshold security has a substantial number of fails to deliver and consistently remains on the threshold list for an extended period of time. The number of securities that are threshold securities is already a small number of securities. For example, in March 2007, the average daily number of securities on the threshold list was approximately 311 securities, which comprised 0.39% of all equity securities, and 2.33% of those securities subject to Regulation SHO. The number of threshold securities with a high level of persistent fails to deliver would be an even smaller number. Thus, we do not believe that this alternative would effectively achieve the Commission's goal of further reducing fails to deliver in all threshold securities.

B. Options Market Maker Exception

The Commission proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.[59] Based on comments to the proposed

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58 See comment letter from SIA, supra note 39.

59 See Proposing Release, 71 FR 41710.

amendments, we have determined at this time to re-propose amendments to the options market maker exception that would eliminate the exception.[60] In addition, in the re-proposal we request comment regarding specific alternatives to eliminating the options market maker exception that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames. We look forward to receiving comments regarding these proposed amendments to the options market maker exception.

C. Amendments to Rule 200(e)

1. Proposal

Regulation SHO currently provides a limited exception from the requirement that a person selling a security aggregate all of the person's positions in that security to determine whether the seller has a net long position. This provision, which is contained in Rule 200(e) of Regulation SHO, allows broker-dealers to liquidate (or unwind) certain existing index arbitrage positions involving long baskets of stocks and short index futures or options without aggregating short stock positions in other proprietary accounts if, and to the extent that, those short stock positions are fully hedged.[61] The current exception, however, does not apply if the sale occurs during a period commencing at a time when the Dow Jones Industrial Average ("DJIA") has declined below its closing value on the previous trading day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day.[62] If a market decline triggers the application of Rule 200(e)(3), a broker-dealer must

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60 See Exchange Act Release No. 56213 (Aug. 7, 2007).

61 To qualify for the exception under Rule 200(e), the liquidation of the index arbitrage position must relate to a securities index that is the subject of a financial futures contract (or options on such futures) traded on a contract market, or a standardized options contract, notwithstanding that such person may not have a net long position in that security. 17 CFR 242.200(e).

62 Specifically, the exception under Rule 200(e) is limited to the following conditions: (1) the index arbitrage position involves a long basket of stock and one or more short index futures traded on a board of trade or one or

aggregate all of its positions in that security to determine whether the seller has a net long position.[63]

The reference to the DJIA in the Commission's rule was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions).[64] However, on August 24, 2005, the Commission approved an amendment to NYSE Rule 80A to use the NYSE Composite Index ("NYA") to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA.[65] As noted in the Commission's approval order, according to the NYSE, the NYA is a better reflection of market activity with respect to the S&P 500 and, therefore, is a better indicator as to when the restrictions on index arbitrage trading provided by NYSE Rule 80A should be triggered.[66]

In addition, NYSE Rule 80A provides that the two percent limitation in that rule must be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest

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more standardized options contracts; (2) such person's net short position is solely the result of one or more short positions created and maintained in the course of bona-fide arbitrage, risk arbitrage, or bona-fide hedge activities; and (3) the sale does not occur during a period commencing at the time that the DJIA has declined below its closing value on the previous day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day. Id.

The two percent market decline restriction was included in Rule 200(e)(3) so that the market could avoid incremental temporary order imbalances during volatile trading days. Regulation SHO Adopting Release, 69 FR at 48011. The two percent market decline restriction limits temporary order imbalances at the close of trading on a volatile trading day and at the opening of trading on the following day, since trading activity at these times may have a substantial effect on the market's short-term direction. The two percent safeguard also provides consistency within the equities markets. Id.

63 See 17 CFR 242.200(e)(3); Regulation SHO Adopting Release, 69 FR at 48012.

64 See 2003 Proposing Release, 68 FR at 62994-62995 (discussing proposed Rule 200 regarding netting and the liquidation of index arbitrage activities and changes to the language of the rule text to keep the language consistent with the language in NYSE Rule 80A).

65 See Exchange Act Release No. 52328 (Aug. 24, 2005), 70 FR 51398 (Aug. 30, 2005).

66 See id.

10 points, of the average closing value of the NYA for the last month of the previous quarter.[67] As adopted, Rule 200(e)(3) of Regulation SHO did not refer to the basis for determining the two percent limitation in the rule.

Because the Commission approved the change to NYSE Rule 80A to reference the NYA rather than the DJIA and because we believe that this is an appropriate index to reference for purposes of Rule 200(e)(3) of Regulation SHO, the Commission proposed to amend Rule 200(e)(3) to: (i) reference the NYA instead of the DJIA; and (ii) add language to clarify that the two percent limitation is to be calculated in accordance with NYSE Rule 80A. The proposed amendments are intended to maintain consistency with NYSE Rule 80A so that market participants need refer to only one index in connection with restrictions regarding index arbitrage trading.

2. Comments

The Commission received four comment letters addressing the proposed amendment to Rule 200(e) of Regulation SHO. Three of the four commenters supported the proposed amendment. While one of these commenters supported the amendment as proposed,[68] the other two commenters suggested revisions that would make the provision more consistent with NYSE Rule 80A by providing that the restriction be terminated at the end of the trading day rather than upon the establishment of the closing value of the NYA on the next succeeding trading day, as

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67 See id. See also, NYSE Rule 80A (Supplementary Material .10).

68 See, e.g., comment letter from UBS, supra note 39.

provided in the current rule.[69] One commenter suggested that the Commission examine whether to retain Rule 200(e) at all.[70]

3. Adoption

After considering the above comments, we are amending Rule 200(e)(3) of Regulation SHO to: (i) reference the NYA instead of the DJIA; (ii) add language to clarify how the two percent limitation is to be calculated for purposes of the market decline limitation; and (iii) provide that the market decline limitation will remain in effect for the remainder of the trading day. As adopted, Rule 200(e) will reference the NYA instead of the DJIA. In the Proposing Release, we proposed that Rule 200(e)(3) of Regulation SHO state that the two percent be calculated pursuant to NYSE Rule 80A. We have determined, however, that it is more appropriate to describe in the rule text how the two percent must be calculated rather than referring to NYSE Rule 80A. Thus, the amendments provide that the two percent limitation is to be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter. In response to commenter concerns regarding maintaining consistency with NYSE Rule 80A, we are also amending Rule 200(e) to provide that the market decline limitation will terminate at the end of the trading day rather than upon the establishment of the closing value of the NYA on the next succeeding trading day.

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69 See comment letters from SIA, supra note 39; CBOE, supra note 39.

70 See comment letter from Angel, supra note 38 (stating that in today's fast markets, there are better ways of managing volatility than "kludges" like Rule 200(e) and other circuit breakers).

D. Amendments to Rule 203 for Sales of Securities Pursuant to Rule 144

1. Proposal

In the Proposing Release we asked whether we should amend Rule 203 to extend the close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act. Currently, Regulation SHO provides for an exception from the locate requirement of Rule 203(b)(1) for situations where a broker-dealer effects a short sale on behalf of a customer that is deemed to own the security pursuant to Rule 200, although, through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date and, therefore, is a "short" sale under the marking requirements of Rule 200(g).[71] Rule 203(b)(2)(ii) of Regulation SHO provides that in such circumstances, delivery must be made on the sale as soon as all restrictions on delivery have been removed, and in any event no later than 35 days after trade date, at which time the broker-dealer that sold on behalf of the person must either borrow securities or close out the open position by purchasing securities of like kind and quantity.[72] If the security is a threshold security, however, any fails to deliver in the security must be closed out in accordance with the requirements of Rule 203(b)(3) of Regulation SHO, i.e., within 13 consecutive settlement days.[73]

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[71] Pursuant to Rule 200(g)(2) of Regulation SHO, as adopted in August 2004, generally these sales were marked "short exempt." See Adopting Release, 69 FR at 48030-48031; but cf Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348 (July 3, 2007) (removing the "short exempt" marking requirement).

[72] See 17 CFR 242.203(b)(2)(ii). In the Adopting Release, the Commission stated that it believed that 35 calendar days is a reasonable outer limit to allow for restrictions on a security to be removed if ownership is certain. In addition, the Commission noted that Section 220.8(b)(2) of Regulation T of the Federal Reserve Board allows 35 calendar days to pay for securities delivered against payment if the delivery delay is due to the mechanics of the transactions. See Adopting Release, 69 FR at 48015, n.72.

[73] See 17 CFR 242.203(b)(3).

2. Comments

The majority of commenters who responded to this request for comment supported extending the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.[74]

Commenters that supported extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act stated that these are legitimate long sale transactions that fail to settle within the normal 3-day settlement cycle only because of the time necessary to transfer the securities.[75] One commenter stated that the current requirement in Regulation SHO to close out all fails in threshold securities that remain for 13 consecutive settlement days, including fails resulting from sales of securities which the seller owns, has imposed serious unintended consequences on clearing firms and the broker-dealer and non-broker-dealer customers for which they clear.[76] Another commenter noted that these types of transactions do not reflect any of the abusive short sale transactions targeted by Regulation SHO since the seller has an ownership position in the security being sold and, therefore, no incentive to depress the price of the security.[77] In addition, commenters noted that clearing firms may have to effect buy-ins even though the security will be available for delivery as soon as the restrictions on sale have been removed.[78] Another commenter stated that

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[74] A few commenters, namely NASAA and some retail investors, opposed allowing additional time for delivery of these types of threshold securities. See, e.g., comment letter from NASAA, supra note 38.

[75] See, e.g., comment letters from UBS, supra note 39; Knight, supra note 39.

[76] For example, one commenter noted that firms have discovered in numerous instances that their CNS fail positions in threshold securities are attributable to situations where sales are effected pursuant to Rule 144 of the Securities Act; however, due to delays in getting the restricted legend removed from the certificates (or other such delays outside the seller's control), such shares are not available for a period of time after settlement date. See comment letter from SIA, supra note 39.

[77] See comment letter from UBS, supra note 39.

[78] See comment letter from SIA, supra note 39.

it believes that all sellers who actually own a security and are permitted a maximum of 35 days after trade date to deliver such securities to their broker-dealer in accordance with Rule 203(b)(2)(ii) of Regulation SHO, not just owners of securities eligible for resale under Rule 144, should be free from the risk of being bought in.[79]

However, some commenters opposed allowing a longer period for closing out fails to deliver in threshold securities sold pursuant to Rule 144 of the Securities Act. These commenters stated their belief that legended shares should not be sold until the legend has been removed.[80] Commenters also stated that, because sellers are free to borrow shares to deliver while they await receipt of their securities from the transfer agent, any additional time for delivery is unnecessary.[81] One commenter stated that given that "most 144 sellers are insiders who have received their stocks at very low prices," it is "both fair and in the interests of ensuring market integrity and confidence to expect them to bear the cost of borrowing shares until delivery of unrestricted stock."[82] Another commenter stated that the exception allows Rule 144 shares to be used as collateral for delivery failures, and stated that any errors, difficulties, inconveniences and expense in having restrictions lifted should be borne by the owner of the restricted securities.[83]

3. Adoption

While commenters raise valid concerns, we believe that adopting the amendments is justified by the benefit of permitting the orderly settlement of fails to deliver resulting from sales

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[79] See comment letter from ABA, supra note 39.

[80] See, e.g., comment letters from NASAA, supra note 38; NCANS, supra note 9.

[81] See comment letters from Utah Division of Securities, supra note 38; NASAA, supra note 38.

[82] Comment letter from NASAA, supra note 38.

[83] See comment letter from Thomas Vallarino, dated May 5, 2007.

of threshold securities pursuant to Rule 144 of the Securities Act without causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for a sizeable amount).. Thus, we are amending Rule 203 of Regulation SHO to extend the close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

In addition, because we are extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144, we are also extending the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, for these fails to deliver. Thus, if the fail to deliver position persists for 35 consecutive settlement days, the amendment will prohibit a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

Securities sold pursuant to Rule 144 of the Securities Act are formerly restricted securities that a seller is "deemed to own," as defined by Rule 200(a) of Regulation SHO. The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend and, therefore, sales of these securities frequently result in fails to deliver. Following our review of the comment letters, and based on our understanding of industry practices, we understand that such processing delays, which are often out of the seller's and broker-dealer's control, frequently result in delivery taking longer than 13 consecutive settlement days. We believe, however, that 35 consecutive settlement days will provide sufficient time for delivery of these securities.

We believe that extending the current close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of these securities will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market.

Although this amendment will allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act 35 rather than 13 consecutive settlement days in which to be closed out, these fails to deliver must be closed out within 35 consecutive settlement days and, therefore, these fails to deliver cannot continue indefinitely. Thus, we believe that this amendment is consistent with our goal of further reducing fails to deliver in threshold securities, while balancing the concerns associated with closing out fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

IV. Paperwork Reduction Act

The amendments to Regulation SHO will not impose a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[84]

V. Cost-Benefit Analysis

We are sensitive to the costs and benefits of our rules and we have considered the costs and the benefits of the amendments to Regulation SHO. In order to assist us in evaluating the costs and benefits, in the Proposing Release, we encouraged commenters to discuss any costs or benefits

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[84] 44 U.S.C. 3501 et seq.

that the amendments might impose. In particular, we requested comment on the potential costs for any modifications to both computer systems and surveillance mechanisms and for information gathering, 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. Commenters were encouraged to provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Regulation SHO. We did not receive any comments providing specific cost or benefit estimates.

A. Amendments to Rule 203(b)(3)'s Delivery Requirements

1. Amendment to Rule 203(b)(3)(i)'s Grandfather Provision

a. Benefits

As adopted, the amendment eliminates the grandfather provision from Regulation SHO and amends Rule 203 to require that all fails to deliver be closed out within either 13 consecutive settlement days or, in the case of a previously-grandfathered fails to deliver in a security that is on the threshold list on the effective date of the amendment, 35 consecutive settlement days from the effective date of the amendment.[85]

We believe the amendment strikes the appropriate balance between reducing fails to deliver in threshold securities from persisting for extended periods of time and still providing participants flexibility and advance notice to close out the previously-grandfathered fails to deliver. While some delays in closing out may be understandable and necessary, a seller should

[85] In addition, similar to the pre-borrow requirement in Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the amendment will prohibit a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

deliver shares to the buyer within a reasonable time period. Although high fails levels exist only for a small percentage of issuers,[86] we are concerned that persistent fails to deliver may have a negative effect on the market in these securities. For example, persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.

We believe the amendment will benefit investors by facilitating the receipt of shares so that more investors receive the benefits associated with share ownership. The amendment may enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities will be delivered as expected. An increase in investor confidence in the market may facilitate investment.

We believe the amendment will also benefit issuers. A high level of persistent fails to deliver in a security may be perceived by potential investors negatively and may affect their decision about making a capital commitment.[87] Some issuers may believe they have endured unwarranted reputational damage due to investors' negative perceptions regarding a security

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86 See supra note 7.

87 See, e.g., comment letter from Feeney, supra note 10.

having a large fail to deliver position and becoming a threshold security.[88] Thus, issuers may believe that elimination of the grandfather provision will restore their good name. Some issuers may also believe that large and persistent fails to deliver indicate that they have been the target of potentially manipulative conduct as a result of "naked" short sales.[89] Thus, elimination of the grandfather provision may decrease the possibility of artificial market influences and, therefore, may contribute to price efficiency.

We believe the 35 day phase-in period will reduce disruption to the market and foster greater market stability because it gives participants a sufficient length of time to effect purchases to close out grandfathered positions in an orderly manner, particularly since participants could have begun to close out grandfathered positions anytime before the 35 day phase-in period was adopted. Some of the commenters that supported eliminating the grandfather provision stated that the 35 day phase-in proposal would restore investor confidence and would not cause excessive volatility.[90]

b. Costs

In order to comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping, systems, and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, the infrastructure necessary to comply with the amendments is likely already in place. As such, any additional changes to the infrastructure will likely be minimal. In the Proposing Release, we requested specific comment on the system

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88 See, e.g., comment letter from Zix, supra note 10.

89 See, e.g., comment letters from Feeney, supra note 10; Zix, supra note 10.

90 See comment letters from MFA, supra note 38; NCANS, supra note 9; State of Connecticut, supra note 9.

changes to computer hardware and software, or surveillance costs that might be necessary to comply with this rule. One investor, in his comment letter, stated that elimination of the grandfather provision will not increase costs for surveillance and compliance but, instead, will actually reduce costs because firms will no longer have to identify and track which fails to deliver are grandfathered and which are not.[91]

We also requested comment regarding the economic costs of eliminating the grandfather provision and how this would affect the liquidity of equity securities. One commenter contended that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.[92] Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempted to close out positions.[93] This commenter also stated that eliminating the grandfather provision would negatively impact bona fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.[94] Another commenter stated that eliminating the grandfather provision would cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive "naked" short sellers.[95]

There could be some risk of market disruption in requiring market participants to close out grandfathered fails to deliver. However, we believe that any market disruption, including

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91 See comment letter from David Patch, dated July 22, 2006.

92 See, e.g., comment letter from CBOE, supra note 39.

93 See comment letter from Knight, supra note 39.

94 See id. According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.

95 See comment letter from UBS, supra note 39.

increased volatility, reduction in liquidity and potential short squeezes are justified by the benefits of reducing the number of persistent fails to deliver. In addition, we believe that such effects, if any, will be minimal.

First, we believe that these potential effects, if any, of eliminating the grandfather provision will be minimal because the number of securities that will be impacted by elimination of the grandfather provision will be relatively small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[96] Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. Moreover, the amendment only impacts those fails to deliver in threshold securities that were created before the security became a threshold security. Because the current grandfather provision has a limited application, the overall impact of its removal on liquidity, volatility, and short squeezes, is expected to be relatively small.

Second, to the extent that the amendment could result in a decrease in liquidity, increased volatility, or short squeezes, we believe that any such potential effects will likely be mitigated by the fact that even though fails to deliver that were previously-grandfathered from the close-out requirement of Regulation SHO will not be permitted to continue indefinitely, such fails to deliver will not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)'s mandatory close-out requirement, both new and previously-grandfathered fails to deliver in threshold securities will have 13 consecutive settlement days within which to be closed out.

[96] See supra note 7 (discussing the number of threshold securities as of March 31, 2007)

Third, as noted above, the grandfather provision excepts from Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement only those fails to deliver created before the security became a threshold security. Thus, it does not apply to fails to deliver created after the security became a threshold security. In examining the application of the current mandatory close-out requirement of Regulation SHO for all non-grandfathered fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-grandfathered fails to deliver in threshold securities has negatively impacted liquidity or volatility in these securities, or resulted in short squeezes.

Fourth, to the extent that elimination of the grandfather provision results in decreased liquidity, or increased volatility in certain securities, or results in short squeezes, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

2. Amendments to Rule 203 for Sales of Securities Pursuant to Rule 144

a. Benefits

The amendments to Rule 203 will extend the close out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act. In addition, because we are extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144, we are also extending the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, for these fails to deliver. Thus, if the fail to deliver position persists for 35 consecutive settlement days, the amendment will prohibit a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

Securities sold pursuant to Securities Act Rule 144 are formerly restricted securities that a seller is "deemed to own" as defined by Rule 200(a) of Regulation SHO. The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend. We understand, however, that such processing delays, which are out of the seller's and broker-dealer's control, frequently result in delivery taking longer than 13 consecutive settlement days.[97]

We believe that extending the current close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such

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[97] See, e.g., comment letter from SIA, supra note 39.

fail to deliver position by purchasing securities in the market. Thus, the amendments will reduce costs to participants and, in turn, investors.

Although this amendment will allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act 35 rather than 13 consecutive settlement days in which to be closed out, these fails to deliver must be closed out within 35 consecutive settlement days and, therefore, these fails to deliver cannot continue indefinitely. Thus, we believe that this amendment is consistent with our goal of further reducing fails to deliver in threshold securities, while balancing the concerns associated with closing out fails to deliver in threshold securities pursuant to Securities Act Rule 144.

b. Costs

We do not believe these amendments will impose any significant burden or cost on market participants. As discussed in more detail above, we believe that extending the current close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from the sale of a threshold security pursuant to Rule 144 of the Securities Act is expected to reduce costs by allowing participants of a registered clearing agency with a fail to deliver position additional time for delivery of these securities beyond the current 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

Participants may incur, however, some added costs for minor changes to their current systems to reflect the extended close-out requirement. We believe any added costs are justified by the benefits of extending the close-out requirement for these securities.

3. Amendments to Rule 200(e)(3)

a. Benefits

The amendments to the market decline limitation in Rule 200(e) of Regulation SHO will reference the NYA rather than the DJIA. The previous reference in Rule 200(e)(3) to the DJIA was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions). However, as discussed above, because the Commission approved an amendment to NYSE Rule 80A to use the NYA to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA,[98] and because we believe that this is an appropriate index to reference for purposes of Rule 200(e)(3) of Regulation SHO, we are amending Rule 200(e)(3) to reference the NYA instead of the DJIA.

In addition, the amendments provide that the two percent limitation is to be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter.[99] In addition, Rule 200(e), as amended, will provide that the market decline limitation will terminate at the end of the trading day rather than upon the establishment of the closing value of the NYA on the next succeeding trading day. These amendments are intended to maintain consistency with NYSE Rule 80A so that market participants need refer to only one index in connection with restrictions regarding index arbitrage trading.

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98 See 70 FR 51398.

99 This amendment provides consistency with how the two percent value is calculated pursuant to NYSE Rule 80A. See NYSE Rule 80A (Supplementary Material .10).

b. Costs

As discussed above, the reference in Rule 200(e)(3) of Regulation SHO to the DJIA was based, in part, on the reference in NYSE Rule 80A to the DJIA.[100] Following the Commission's approval of the amendment to NYSE Rule 80A to reference the NYA rather than the DJIA, market participants engaged in index arbitrage trading needed to reference the NYA for purposes of complying with NYSE Rule 80, and the DJIA for purposes of complying with Rule 200(e)(3) of Regulation SHO. By amending Rule 200(e)(3) to reference the NYA rather than the DJIA, market participants engaged in index arbitrage trading will need to reference only one index with respect to restrictions on such trading. Thus, we believe the amendments will not impose any significant costs or burdens on market participants.

VI. 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 is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[101] 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.[102] 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

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[100] See 2003 Proposing Release, 68 FR at 62994-62995 (discussing proposed Rule 200 regarding netting and the liquidation of index arbitrage activities and changes to the language of the rule text to keep the language consistent with the language in NYSE Rule 80A).

[101] 15 U.S.C. 78c(f).

[102] 15 U.S.C. 78w(a)(2).

comment on whether the proposed amendments are expected to promote efficiency, competition, and capital formation.

We believe the amendments will have minimal impact on the promotion of price efficiency. In the Proposing Release we sought comment on whether the proposals promote price efficiency, including whether the proposals might impact liquidity and the potential for manipulative short squeezes. One commenter stated that the Commission's concern over potential short squeezes is "misplaced," as this is a risk short sellers assume when they sell short.[103] Another commenter maintained that elimination of the grandfather provision should not cause excessive volatility because, according to the commenter, DTCC and market participants have said that fails to deliver are a small problem.[104] However, one commenter stated its belief that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.[105] Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempted to close out positions.[106] This commenter also stated that eliminating the grandfather provision would negatively impact bona fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.[107] Another commenter stated that eliminating the grandfather provision would cause

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103 See comment letter from H. Glenn Bagwell, Jr., supra note 42.

104 See comment letter from NCANS, supra note 9.

105 See comment letter from CBOE, supra note 39.

106 See comment letter from Knight, supra note 39.

107 See id. According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.

substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive "naked" short sellers.[108]

We believe 13 consecutive settlement days will be a sufficient amount of time in which to close out fail to deliver positions even in hard to borrow securities and will likely limit the potential for short squeezes, increased volatility, or reduction in liquidity. In addition, these amendments will impact only threshold securities, which comprise a small subset of all equity securities trading in the market. For example, in March 2007, the average daily number of securities on the threshold list was approximately 311 securities, which comprised 0.39% of all equity securities, and 2.33% of those securities subject to Regulation SHO. Thus, we believe that the overall market impact of the amendments will be minimal, if any.

We also believe the 35 day phase-in period for previously-grandfathered fail to deliver positions will not result in market disruption because it allows participants of a registered clearing agency an extended period of time in which to effect purchases to close out previously-grandfathered fail to deliver positions as of the effective date of the amendment, particularly because these participants could have begun to close out previously-grandfathered fail to deliver positions before adoption of the 35 day phase-in period.

In addition, we believe that the amendments will have minimal impact on the promotion of capital formation. Large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant

108 See comment letter from UBS, supra note 39.

to commit capital to an issuer they believe to be subject to such manipulative conduct. In the Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about the potential impact of "naked" short selling on capital formation claiming that "naked" short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets.[109] Another commenter submitted a theoretical economic study concluding that "naked" short selling is economically similar to other shorting.[110]

By requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, we believe that there will be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on a threshold securities list leads to an unwarranted decline in investor confidence about the security, the amendments are expected to improve investor confidence about the security. We also believe that the proposed amendments will lead to greater certainty in the settlement of securities, which should strengthen investor confidence in the settlement process.

We also believe the amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. By eliminating the grandfather provision and extending the close out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act, we believe the amendments to Regulation SHO will promote competition by requiring similarly situated participants to close out fails to deliver in threshold securities within the same time-frame or, in the case of threshold securities sold pursuant to Rule 144 of the Securities Act,

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109 See, e.g., comment letter from Feeney, supra note 10.

110 See comment letter from J.B. Heaton, Bartlit Beck Herman Palenchar & Scott LLP, dated May 1, 2007.

it will provide the same additional time-frame within which to close out fails to deliver resulting from sales of these securities. The amendments also will promote competition by maintaining consistency with NYSE Rule 80A so that broker-dealers can refer to the same index with respect to restrictions regarding index arbitrage trading. Thus, we believe that the amendments will improve the functioning of the capital markets and, thereby, will enhance investor confidence in the markets.

VII. Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),[111] regarding the amendments to Regulation SHO, Rules 200 and 203, under the Exchange Act. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and was included in the Proposing Release. We solicited comments on the IRFA.

A. Reasons for and Objectives of the Amendments

We are adopting revisions to Rules 200 and 203 of Regulation SHO. The amendments to Rule 203(b)(3) of Regulation SHO are designed to further reduce the number of persistent fails to deliver in threshold securities by eliminating the grandfather provision. We are concerned that persistent, large fail positions may have a negative effect on the market in these securities. For example, although high fails levels exist only for a small percentage of issuers, they may impede the orderly functioning of the market for such issuers, particularly issuers of less liquid securities. A significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for voting and lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a

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111 5 U.S.C. 604.

seller that fails to deliver securities on trade settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that would have been priced differently.

To allow participants sufficient time to comply with the new close-out requirements, we are including a 35 settlement day phase-in period following the effective date of the amendment. The phase-in period is intended to provide participants with flexibility and advance notice to begin closing out previously-grandfathered fail to deliver positions.

The amendment to extend the close out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act also is intended to provide participants with flexibility by allowing additional time for delivery of these securities, thereby also permitting the orderly settlement of such sales. The amendment to update the market decline limitation referenced in Rule 200(e)(3) is intended to maintain consistency with NYSE Rule 80A, and to provide for an appropriate and consistent protective measure.

B. Significant Issues Raised by Public Comment

The IRFA appeared in the Proposing Release. We requested comment on any aspect of the IRFA. In particular, we requested comment on: (i) the number of small entities that would be affected by the amendments; and (ii) the existence or nature of the potential impact of the amendments on small entities. We requested that the comments specify costs of compliance with the amendments, and suggest alternatives that would accomplish the objectives of the amendments. We did not receive any comments that responded specifically to this request. One investor, in his comment letter, however, stated that elimination of the grandfather provision would not increase costs for surveillance and compliance but, instead, will actually reduce costs because firms would no longer have to identify and track which fails to deliver are grandfathered and which are not.[112]

C. Small Entities Subject to the Amendments

The entities covered by these amendments will include small entities that are participants of a registered clearing agency, and small broker-dealers for which the participant clears trades or for which it is responsible for settlement. In addition, the entities covered by these amendments will include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Although it is impossible to quantify every type of small entity covered by these amendments, Paragraph (c)(1) of Rule 0-10 under the Exchange Act[113] 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. We estimate that as of 2006 there were approximately 894 broker-dealers that qualified as small entities as defined above.[114]

As noted above, the entities covered by these amendments will include small entities that are participants of a registered clearing agency. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers

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112 See comment letter from David Patch, supra note 91.

113 17 CFR 240.0-10(c)(1)

114 These numbers are based on the Commission's Office of Economic Analysis's review of 2006 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually cleaned up within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

The federal securities laws do not define what is a "small business" or "small organization" when referring to a bank. The Small Business Administration regulations define "small entities" to include banks and savings associations with total assets of $165 million or less.[115] As of May, 2007 no bank that was a participant of the NSCC was a small entity because none met this criteria.

Paragraph (e) of Rule 0-10 under the Exchange Act[116] 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 U.S. registered exchange is a small entity 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.

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[115] See 13 CFR 121.201.

[116] 17 CFR 240.0-10(e).

Paragraph (d) of Rule 0-10 under the Exchange Act[117] states that the term "small business" or "small organization," when referring to a clearing agency, means a clearing agency that: (1) compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than $200 million in funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) 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 clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

D. Reporting, Recordkeeping, and other Compliance Requirements

The amendments may impose some new or additional reporting, recordkeeping, or compliance costs on small entities that are participants of a clearing agency registered with the Commission.[118] In order to comply with Regulation SHO when it became effective in January 2005, small entities needed to modify their systems and surveillance mechanisms. Thus, we believe that the infrastructure necessary to comply with the amendments regarding elimination of the grandfather provision is likely already in place. Any additional changes to the infrastructure are expected to be minimal. We do not believe, at this time, that any specialized professional skills will be necessary to comply with these new requirements.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small

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117 17 CFR 240.0-10(d).

118 See discussions above in Section VII.C. and note 28, regarding participants of a registered clearing agency that are broker-dealers as opposed to non broker-dealers.

entities. In connection with the proposals, the Commission considered the following alternatives: (a) establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The primary goal of the new amendments is to reduce the number of persistent fails to deliver in threshold securities. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities will undermine the goal of reducing fails to deliver. In addition, we have concluded similarly that it is not consistent with the primary goal of the new amendments to further clarify, consolidate or simplify the new amendments for small entities. The Commission also believes that it is inconsistent with the purposes of the Exchange Act to use performance standards to specify different requirements for small entities or to exempt small entities from having to comply with the amended rules.

VIII. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10(a), 11A, 15, 17(a), 17A, 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78i(h), 78j, 78k-1, 78o, 78q(a), 78q-1, 78w(a), the Commission is adopting amendments to §§ 242.200 and 242.203.

Text of the Final Amendments to Regulation SHO

List of Subjects

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, Part 242, of the Code of Federal Regulations is amended as follows.

PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. 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.

2. Section 242.200 is amended by revising paragraph (e)(3) to read as follows:

§ 242.200 Definition of "short sale" and marking requirements.

* * * * *

(e) * * *

(3) The sale does not occur during a period commencing at the time that the NYSE Composite Index has declined by two percent or more from its closing value on the previous day and terminating upon the end of the trading day. The two percent shall be calculated at the beginning of each calendar quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYSE Composite Index for the last month of the previous quarter.

* * * * *

3. Section 242.203 is amended by:

a. Revising paragraph (b)(3)(i);

b. Redesignating paragraphs (b)(3)(ii), (b)(3)(iii), (b)(3)(iv) and (b)(3)(v) as paragraphs (b)(3)(iii), (b)(3)(iv), (b)(3)(vi) and (b)(3)(vii), respectively; and

c. Adding new paragraphs (b)(3)(ii) and (b)(3)(v).

The additions and revision read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(i) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment and which, prior to the effective date of this amendment, had been previously grandfathered from the close-out requirement in this paragraph (b)(3) (i.e., because the participant of a registered clearing agency had a fail to deliver position at a registered clearing agency on the settlement day preceding the day that the security became a threshold security), shall close out that fail to deliver position within thirty-five consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

(ii) Provided, however, that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that was sold pursuant to § 230.144 of this chapter for thirty-five consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position in the security by purchasing securities of like kind and quantity;

* * * * *

(v) If a participant of a registered clearing agency entitled to rely on the thirty-five consecutive settlement day close out requirement contained in paragraphs (b)(3)(i) or (b)(3)(ii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for thirty-five consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * * * *

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

Dated: August 7, 2007

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 228, 229, 230, 239, 240 and 249

[Release No. 33-8831; 34-56217; IC-27924; File No. S7-20-07]

RIN 3235-AJ93

CONCEPT RELEASE ON ALLOWING U.S. ISSUERS TO PREPARE FINANCIAL STATEMENTS IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comment.

SUMMARY: The Commission is publishing this Concept Release to obtain information about the extent and nature of the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board for purposes of complying with the rules and regulations of the Commission. U.S. issuers presently prepare their financial statements in accordance with generally accepted accounting principles as used in the United States, referred to as U.S. GAAP.

DATES: Comments should be submitted on or before [insert date 90 days after the date of publication in the Federal Register].

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/concept.shtml); or

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- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-20-07 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper submissions 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 S7-20-07. The 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/concepts.shtml). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Questions on this Concept Release should be directed to Gina L. Even, Business Associate, or Katrina A. Kimpel, Professional Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; Sondra L. Stokes, Associate Chief Accountant, Division of Corporation Finance at (202) 551-3400; or Richard F. Sennett, Chief Accountant, Division of Investment Management at (202) 551-6918; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTAL INFORMATION:

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I. INTRODUCTION

The Commission has long advocated reducing disparity between the accounting and disclosure practices of the United States and other countries as a means to facilitate cross-border capital formation while providing adequate disclosure for the protection of investors and the promotion of fair, orderly and efficient markets. The Commission also has encouraged the efforts of standard setters and other market participants to do the same.[1] To those ends, as part of a 1988 Policy Statement, the Commission explicitly supported the establishment of mutually acceptable international accounting standards as a critical goal to reduce regulatory impediments that result from disparate national accounting standards without compromising investor protection.[2]

Further, in 1997, the Commission noted that for issuers wishing to raise capital in more than one country, preparing more than one set of financial statements to comply with differing jurisdictional accounting requirements increased compliance costs and created inefficiencies.[3] In the study prepared pursuant to a mandate from Congress, the Commission encouraged the efforts of the International Accounting Standards Committee ("IASC"), the international accounting standard setting body at the time, to develop a core set of accounting standards that could serve as a framework for financial reporting in cross-border offerings, and indicated the Commission's intent to remain active in the development of those standards. These standards are now known as International Financial Reporting Standards ("IFRS").

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[1] See "Integrated Disclosure System for Foreign Private Issuers" Securities Act Release No. 33-6360 (November 20, 1981) (the 1981 Proposing Release).

[2] See "Regulation of the International Securities Markets" Securities Act Release No. 33-6807 (November 14, 1988) (the 1988 Policy Statement).

[3] See "Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 Report on Promoting Global Preeminance of American Securities Markets" (October 1997) available at http://www.sec.gov/news/studies/acctgsp.htm.

In 2000, the Commission issued a Concept Release seeking input on convergence to a high quality global financial reporting framework while upholding the quality of financial reporting domestically.[4] The 2000 Concept Release sought comments as to the conditions under which the Commission should accept financial statements of foreign private issuers that are prepared using IFRS, and the use of the U.S. GAAP reconciliation of IFRS financial statements.[5] The Commission has continued to monitor the international developments that were discussed in the 2000 Concept Release.

In October 2002, the Commission supported the announcement by the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB"), the successor of the IASC, of a Memorandum of Understanding, referred to as the Norwalk Agreement, to formalize their commitment to the convergence of U.S. and international accounting standards.[6] In this agreement, the two standard setting bodies acknowledged their joint commitment and pledged to use their best efforts to the development, "as soon as practicable," of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.[7] In addition to supporting the convergence efforts

[4] See SEC Concept Release "International Accounting Standards," Release No. 33-7801 (February 16, 2000) (the 2000 Concept Release) available at http://www.sec.gov/rules/concept/34-42430.htm.

[5] The term "foreign private issuer" is defined in Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. A foreign private issuer means any foreign issuer other than a foreign government except an issuer that meets the following conditions: (1) more than 50 percent of the issuer's outstanding voting securities are directly or indirectly held 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.

[6] See Financial Accounting Standards Board and International Accounting Standards Board, Memorandum of Understanding, "The Norwalk Agreement," (September 18, 2002) (the Norwalk Agreement) available at http://www.fasb.org/news/memorandum.pdf.

[7] Id.

of the IASB and the FASB, we have long worked with each board on the development of their respective standards; however, the nature of our relationship with each board differs.

In 2005, the Commission adopted an accommodation to allow foreign private issuers that are first-time adopters of IFRS to file two years rather than three years of IFRS financial statements in their Commission filings.[8] Most recently, on June 20, 2007, the Commission approved for public comment a proposal to accept from foreign private issuers financial statements prepared in accordance with the English language version of IFRS as published by the IASB without the currently required accompanying reconciliation to U.S. GAAP.[9]

Almost 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and other countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase, from a relative few in 2005 to approximately 110 in 2006, of filings with the Commission of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB.[10] The Commission expects to see this number continue to increase in the future, particularly pursuant to Canada's announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.[11]

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[8] See "First-time Application of International Financial Reporting Standards" Securities Act Release No. 33-8567 (April 12, 2005) (the 2005 Adopting Release) available at http://www.sec.gov/rules/final/33-8567.pdf.

[9] See "Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP" Securities Act Release No. 33-8818 (July 2, 2007) (the 2007 Proposing Release) available at http://www.sec.gov/rules/proposed/2007/33-8818.pdf.

[10] Another approximately 70 foreign private issuers filed financial statements that they stated were prepared in accordance with solely a jurisdictional variation of IFRS. Approximately 50 additional foreign private issuers that are incorporated in jurisdictions that have moved to IFRS included in their filings financial statements prepared in accordance with U.S. GAAP.

[11] See "Implementation Plan for Incorporating International Financial Reporting Standards into Canadian GAAP," available at http://www.acsbcanada.org/client_asset/document/3/2/7/3/5/document_8B452E12-FAF5-7113-C4CB8F89B38BC6F8.pdf?sfgdata=4.

This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint.[12] For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries' financial statements in IFRS for purposes of local regulatory or statutory filings.

In light of the ongoing convergence efforts of the IASB and the FASB and the movement outside the United States towards accepting financial statements prepared in accordance with IFRS, the Commission is seeking input in this Concept Release regarding the role of IFRS as published by the IASB as a basis of financial reporting in the U.S. public capital market by U.S. issuers. Specifically, the Commission is seeking input to better understand the nature and extent of the public's interest in giving U.S. issuers, including investment companies, the option to file with the Commission financial statements prepared in accordance with IFRS as published by the IASB.[13]

We appreciate that the U.S. public capital market has not experienced the co-existence of two sets of accounting standards for use by U.S. issuers. The Commission is issuing this Concept Release to gather input on the potential significance and effect of any such change to investors, issuers and market participants as well as to the accounting profession in general. Given the potential significance and complexity of permitting U.S. issuers to prepare financial statements in accordance with IFRS as published by the IASB for purposes of complying with

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[12] For purposes of this Concept Release, the term U.S. issuer encompasses any issuer other than a foreign private issuer reporting on Form 20-F or Form 40-F or filing a registration statement based on Form 20-F or Form 40-F. Form 20-F is the combined registration statement and annual report form for foreign private issuers under the Securities Exchange Act of 1934. It also sets forth disclosure requirements for registration statements filed by foreign private issuers under the Securities Act of 1933. Form 40-F is the combined registration statement and annual report form under the Exchange Act for Canadian foreign private issuers that file under the Mulitjurisdictional Disclosure System.

[13] The term "investment company" is defined in Section 3 of the Investment Company Act of 1940 [15 USC 80a-3].

the rules and regulations of the Commission, as contemplated in this Concept Release, we encourage all interested parties to provide comments.

II. THE EFFECT OF IFRS ON THE U.S. PUBLIC CAPITAL MARKET

A. Financial Reporting in the United States

The mission of the Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[14] In carrying out this mission, the Commission historically has looked to private-sector bodies to provide standards for financial reporting by issuers in the U.S. public capital market. Since 1973, those standards have been set by the FASB, which is the independent, private-sector body whose pronouncements the Commission has recognized as "authoritative" and "generally accepted" for purposes of the federal securities laws, absent any contrary determination by the Commission.[15] Over time, this body of standards has commonly come to be referred to as U.S. GAAP.

The FASB is overseen by the Financial Accounting Foundation ("FAF"), which has responsibility for selecting the seven full-time FASB members.[16] The FAF is an independent, non-profit organization that is run by a sixteen-member Board of Trustees. The FASB derives its funding from fees paid by issuers and has oversight of the Emerging Issues Task Force ("EITF"), which is the interpretive body for U.S. GAAP. The FASB also is supported by the Financial

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[14] See U.S. Securities and Exchange Commission 2006 Performance and Accountability Report available at http://www.sec.gov/about/secpar/secpar2006.pdf#sec1.

[15] See "Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards," Accounting Series Release No. 150 (December 20, 1973) (expressing the Commission's intent to continue to look to the private sector for leadership in establishing and improving accounting principles and standards through the FASB) and "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Securities Act Release No. 33-8221 (April 25, 2003) (the 2003 Policy Statement) available at http://www.sec.gov/rules/policy/33-8221.htm.

[16] See http://www.fasb.org/facts/bd_members.shtml.

Accounting Standards Advisory Council ("FASAC"), which is responsible for consulting with the FASB as to technical issues on the FASB's agenda and project priorities.

Consistent with the FASB's objective to increase international comparability and the quality of standards used in the United States, the FASB participates in international accounting standard setting activities. This goal is consistent with the FASB's obligation to its domestic constituents, who benefit from comparability of information across national borders.[17] The FASB pursues this objective in cooperation with the IASB, as discussed in more detail below, and with national accounting standard setters.

While the Commission consistently has looked to the private sector to set accounting standards, the federal securities laws, including the Sarbanes-Oxley Act of 2002,[18] provide the Commission with the authority to set accounting standards for public companies and other entities that file financial statements with the Commission.[19] The Commission oversees the activities of the FASB as part of its responsibilities under the securities laws. These oversight responsibilities include the Commission reviewing the FAF's and the FASB's annual budget and the FASB's accounting support fee, providing views regarding the selection of FASB members, and, in certain circumstances, referring issues relating to accounting standards to the FASB or the EITF. The Commission and its staff do not, however, prohibit the FASB from addressing

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[17] See http://www.fasb.org/intl/.

[18] See Public Company Accounting Reform and Protection (Sarbanes-Oxley Act), Pub L. No. 107-204, 116 Stat. 745 (2002) (Sarbanes-Oxley Act) available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.tst.pdf.

[19] See for example, Section 108(c) of the Sarbanes-Oxley Act, which states, "Nothing in this Act, including this section…shall be construed to impair or limit the authority of the Commission to establish accounting principles or standards for purposes of enforcement of the securities laws."

topics of its choosing and do not dictate the outcome of specific FASB projects, so long as the FASB's conclusions are in the interest of investor protection.[20]

B. Financial Reporting Outside the United States

Almost 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies. Countries that require or allow the use of IFRS by listed companies also may allow the use of IFRS for local regulatory or statutory financial reporting by non-listed companies. The European Union ("EU"), for example, has, under a regulation adopted in 2002, required companies incorporated in its Member States and whose securities are listed on an EU-regulated market to report their consolidated financial statements using endorsed IFRS beginning in 2005.[21] Other countries, including Australia[22] and New Zealand,[23] have adopted similar requirements mandating the use of IFRS by public companies. More countries have plans to adopt IFRS as their national accounting standards in the future, including Canada[24] and Israel.[25]

The Commission is aware of the transitions made by other countries to IFRS. For example, the vast majority of listed EU companies, including banks and insurance companies,

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[20] See the 2003 Policy Statement, supra note 15.

[21] See Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, Official Journal L. 243, 11/09/2002 P. 0001-0004 available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/l_243/l_24320020911en00010004.pdf.

[22] See Australia Financial Reporting Council, Bulletin 2002/4 (July 3, 2002) available at http://www.frc.gov.au/bulletins/2002/04.asp; Australia Financial Reporting Council, Bulletin 2004/3 (April 2004) available at http://www.frc.gov.au/bulletins/2004/03.asp.

[23] See Accounting Standards Review Board News Release "Stable Platform of Financial Standards Announced: NZ aligns with UK, Europe and Australia" available at http://www.asrb.co.nz/documents/24Nov2004.doc.

[24] See "Implementation Plan for Incorporating International Financial Reporting Standards into Canadian GAAP," supra note 11.

[25] See Israel Accounting Standard No. 29 "Adoption of International Financial Reporting Standards," stipulating that Israeli public companies that prepare their primary financial statements in accordance with Israeli GAAP are obliged to adopt IFRS unreservedly for years starting on January 1, 2008.

moved to IFRS in 2005 with the remainder transitioning in 2007. Australian-listed companies also moved to IFRS in 2005. Under these transition approaches, in essence all or almost all of the listed companies transitioned to IFRS at the same time. Some foreign regulators have published reports relating to the implementation of IFRS in their country. For example, the U.K. Financial Reporting Review Panel and the Autorité des Marchés Financiers of France have both published reports making observations on IFRS as applied in their jurisdictions.[26]

The actual process of adopting the evolving body of IFRS as published by the IASB in any country may be subject to a clearance process, which, in some instances, may involve regulatory or legislative approval. In some jurisdictions, the decision of policy makers has resulted in some requirements of IFRS as published by the IASB becoming optional. This results in a choice for issuers in these jurisdictions to use either their jurisdictional version of IFRS (e.g., titled "IFRS as adopted in Jurisdiction X") or IFRS as published by the IASB; however, the two may not be mutually exclusive. In addition to adopting IFRS, policy makers also may choose to retain their national accounting standard setter to, among other things, establish standards for their local private capital market and to contribute to the IFRS standard setting work.

Other countries have chosen to continue to have their own national accounting standard setter establish accounting standards applicable to entities in their jurisdiction. The national accounting standard setter also may monitor and consider the standard setting work of the IASB and, as it considers appropriate, adapt national standards so as to conform to some portions or all of IFRS as published by the IASB. For example, in the United States, the FASB and the IASB

[26] For the report of the U.K Financial Reporting Review Panel, see "Preliminary Report: IFRS Implementation" available at http://www.frc.org.uk/images/uploaded/documents/IFRS%20Implementation%20-%20preliminary.pdf. For the report of the AMF, see "Recommendations on accounting information reported in financial statements for 2006," dated December 19, 2006, available at http://www.amf-france.org/documents/general/7565_1.pdf.

have adopted a best efforts convergence approach,[27] while Japan's accounting standard setter and the IASB have ". . . a joint project to reduce differences between International Financial Reporting Standards (IFRS) and Japanese accounting standards. . . ."[28]

C. The Possible Use of IFRS by U.S. Issuers

The Commission's recent proposal to accept from foreign private issuers financial statements prepared in accordance with the English language version of IFRS as published by the IASB without a U.S. GAAP reconciliation raises the question of whether the Commission also should accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers. The Commission has identified at least two market forces that may provide incentives for some market participants to request in the future that the Commission accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers.

First, as a growing number of jurisdictions move to IFRS, more non-U.S. companies will report their financial results in accordance with IFRS. If a critical mass of non-U.S. companies in a certain industry sector or market reports in accordance with IFRS, then there may be pressure for U.S. issuers in that industry sector or market to likewise report in accordance with IFRS to enable investors to compare U.S. issuers' financial results more efficiently with those of their competitors.

Second, as more jurisdictions accept financial statements prepared in accordance with IFRS for local regulatory or statutory filing purposes, U.S issuers' subsidiaries based in these

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[27] See the Norwalk Agreement, supra note 6.

[28] Press Release, International Accounting Standards Board, "IASB and Accounting Standards Board of Japan Agree to Next Steps in Launching Joint Project for Convergence" (Jan. 21, 2005), available at http://www.iasb.org/news.

jurisdictions may be preparing and filing their local financial statements using IFRS as their basis of accounting. If U.S. issuers have a large number of subsidiaries reporting in this manner, then these U.S. issuers—most likely large, multinational corporations—may incur lower costs in preparing their consolidated financial statements using IFRS rather than U.S. GAAP. If an issuer can and does reallocate any financial statement preparation cost savings to higher earning opportunities and does not suffer a relatively greater increase in the cost of its capital as a result of using IFRS, investors will benefit in terms of a better rate of return.

The Commission anticipates that not all U.S. issuers will have incentives to use IFRS. For example, U.S. issuers without significant customers or operations outside the United States—which may tend to be smaller public companies—may not have the market incentives to prepare IFRS financial statements for the foreseeable future. Additionally, the Commission recognizes that there may be significant consequences to allowing U.S. issuers to prepare their financial statements in accordance with IFRS as published by the IASB. If the Commission were to accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers, then investors and market participants would have to be able to understand and work with both IFRS and U.S. GAAP when comparing among U.S. issuers because not all U.S. issuers are likely to elect to prepare IFRS financial statements. On a more practical level, a U.S. issuer may have contracts such as loan agreements that include covenants based upon U.S. GAAP financial measures or leases for which rental payments are a function of revenue as determined under U.S. GAAP. Similarly, U.S. issuers may use their financial statements as the basis for filings with other regulators and authorities (e.g., local and federal tax authorities, supervisory regulators) that may require U.S. GAAP financial information.

Questions

1. Do investors, U.S. issuers, and market participants believe the Commission should allow U.S. issuers to prepare financial statements in accordance with IFRS as published by the IASB?
2. What would be the effects on the U.S. public capital market of some U.S. issuers reporting in accordance with IFRS and others in accordance with U.S. GAAP? Specifically, what would be the resulting consequences and opportunities, and for whom? For example, would capital formation in the U.S. public capital market be better facilitated? Would the cost of capital be reduced? Would comparative advantages be conferred upon those U.S. issuers who move to IFRS versus those U.S. issuers who do not (or feel they can not)? Would comparative advantages be conferred upon those investors who have the resources to learn two sets of accounting principles (IFRS and U.S. GAAP) as compared to those who do not?
3. What would be the effects on the U.S. public capital market of not affording the opportunity for U.S. issuers to report in accordance with either IFRS or U.S. GAAP? Specifically, what would be the resulting consequences and opportunities, and for whom? Would capital formation in the U.S. public capital market be better facilitated? Would the cost of capital be reduced? Alternatively, are there certain types of U.S. issuers for which the Commission should not afford this opportunity?
4. To what degree would investors and other market participants desire to and be able to understand and use financial statements of U.S. issuers prepared in accordance with IFRS? Would the desire and ability of an investor to understand and use such financial statements vary with factors such as the size and nature of the investor, the value of the investment, the market capitalization of the U.S issuer, the industry to which it belongs, the trading volume of its securities, or any other factors?

5. What immediate, short-term or long-term incentives would a U.S. issuer have to prepare IFRS financial statements? Would the incentives differ by industry segment, geographic location of operations, where capital is raised, other demographic factors, or the aspect of the Commission's filing requirements to which the U.S. issuer is subject?

6. What immediate, short-term or long-term barriers would a U.S. issuer encounter in seeking to prepare IFRS financial statements? For example, would the U.S. issuer's other regulatory (e.g., banking, insurance, taxation) or contractual (e.g., loan covenants) financial reporting requirements present a barrier to moving to IFRS, and if so, to what degree?

7. Are there additional market forces that would provide incentives for market participants to want U.S. issuers to prepare IFRS financial statements?

8. Are there issues unique to whether investment companies should be given the choice of preparing financial statements in accordance with IFRS? What would the consequences be to investors and other market participants of providing investment companies with that choice?

9. Would giving U.S. issuers the opportunity to report in accordance with IFRS affect the standard setting role of the FASB? If so, why? If not, why not? What effect might there be on the development of U.S. GAAP?

D. Convergence of IFRS and U.S. GAAP

In October 2002, the FASB and the IASB announced the Norwalk Agreement, which formalized their commitment to the convergence of U.S. and international accounting standards.[29] In the Norwalk Agreement, the two bodies acknowledged their "best efforts" commitment to the development, "as soon as practicable," of high quality, compatible

[29] See the Norwalk Agreement, supra note 6.

accounting standards that could be used for both domestic and cross-border financial reporting and to the coordination of their future work programs to ensure that, once achieved, compatibility is maintained. In a 2006 Memorandum of Understanding, the FASB and the IASB indicated that a common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB and set out a work plan covering the next two years for convergence with specific long- and short-term projects.[30] Thus, convergence is the approach that for the last five years has been at work to align the financial reporting of U.S. issuers under U.S. GAAP with that of companies using IFRS. If there is a robust and active process in place for converging IFRS and U.S. GAAP, then it is likely that the current differences between them will be minimized in due course.

As part of their commitment to convergence, both the IASB and the FASB are working together on several major projects and have coordinated agendas so that major projects that one board takes up also may be taken up by the other board. Also, both boards have been working on "short-term convergence," under which convergence will occur quickly in certain areas. This process allows for incremental improvements and the opportunity to eliminate differences without rethinking an issue entirely. If the IASB and the FASB conclude that a short-term convergence project is not sufficient, they will consider a broader standard setting project. The Commission fully supports continued progress on convergence.

If U.S. issuers were permitted to prepare IFRS financial statements, then some could conclude that the convergence process would no longer be warranted because those U.S. issuers that see a benefit to reporting under IFRS would be free to do so. Consequently, there is a risk

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[30] See "A Roadmap for Convergence between IFRS and U.S. GAAP – 2006-2008 Memorandum of Understanding between the FASB and the IASB", February 27, 2006 (the 2006 Memorandum of Understanding) available at http://72.3.243.42/intl/mou_02-27-06.pdf.

that constituents of the two boards may not continue to support convergence efforts if financial statements prepared by U.S. issuers in accordance with IFRS as published by the IASB are accepted by the Commission. If convergence does not occur, the future work of the IASB and the FASB may result in standards that are significantly different or that are not timely in their development.

Questions

10. What are investors', issuers' and other market participants' opinions on the effectiveness of the processes of the IASB and the FASB for convergence? Are investors and other market participants satisfied with the convergence progress to date, and the robustness of the ongoing process for convergence?
11. How would the convergence work of the IASB and the FASB be affected, if at all, if the Commission were to accept IFRS financial statements from U.S. issuers? If the Commission were to accept IFRS financial statements from U.S. issuers, would market participants still have an incentive to support convergence work?
12. If IFRS financial statements were to be accepted from U.S. issuers and subsequently the IASB and the FASB were to reach substantially different conclusions in the convergence projects, what actions, if any, would the Commission need to take?

III. GLOBAL ACCOUNTING STANDARDS

A. The Case for a Single Set of Globally Accepted Accounting Standards

The Commission recognizes that having a widely used single set of high quality globally accepted accounting standards accepted and in place could benefit both the global capital markets and investors. To date, the efforts in the United States have encompassed convergence, which involves the content of IFRS and U.S. GAAP coming together.

Key forces favoring a single set of globally accepted accounting standards include, but are not limited to, the continued expansion of the capital markets across national borders, and the desire by countries to achieve strong, stable and liquid capital markets to fuel economic growth. A thriving capital market requires, among other things, a high degree of investor understanding and confidence. Converging towards or embracing a single set of high quality accounting standards could contribute to investor understanding and confidence.

The use of a single set of accounting standards in the preparation of financial statements could help investors understand investment opportunities better than the use of multiple differing sets of national accounting standards. Without a single set of accounting standards, global investors must incur time, costs and effort to understand companies' financial statements so that they can adequately compare investment opportunities. In addition, presenting investors with financial information that varies substantially depending on which set of accounting standards is employed can cause confusion about the actual financial results of a company and result in a correspondingly adverse effect on investor confidence and cost of capital. Investor confidence in financial reporting also is likely to be stronger if the accounting standards used have been subject to appropriate due process and have gained wide acceptance in practice.

Embracing a common set of accounting standards also can lower costs for issuers. When companies access capital markets beyond their home jurisdiction, they incur additional costs if they must prepare financial statements using different sets of accounting standards. These include the costs for company personnel and auditors to learn, keep current with and comply with the requirements of multiple jurisdictions. In addition to issuers facing lower costs, standard setters collectively worldwide also may incur lower costs because the use of resources dedicated to standards writing can potentially be reduced if fewer separate accounting models are pursued.

Question

13. Do investors, issuers and other market participants believe giving U.S. issuers the choice to prepare financial statements in accordance with IFRS as published by the IASB furthers the development of a single set of globally accepted accounting standards? Why or why not, and if so, how?

B. The International Accounting Standard Setter

The sustainability, governance and continued operation of the IASB are important factors for the development of a set of high quality, globally accepted accounting standards and are important factors in the Commission's consideration of the IASB's work. The IASB is based in London and is a stand-alone, privately funded accounting standard setting body established to develop global standards for financial reporting.[31] It is committed to "developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make

[31] For more information on the structure and operation of the IASB, see www.iasb.org.

economic decisions."[32] The IASB assumed accounting standard setting responsibilities from the IASC in 2001 as the culmination of a reorganization of the IASC.[33] The IASC had issued 41 standards through December 2000. Upon its formation, the IASB recognized those standards and thus they form part of the body of IFRS.

The IASB is overseen by the International Accounting Standards Committee Foundation ("IASC Foundation"). The IASC Foundation is based in London and is a stand-alone, not-for-profit organization, incorporated in Delaware. It is responsible for the activities of the IASB and other work that centers on IFRS, such as initiatives related to translation of IFRS from the English language, education about IFRS and the development of Extensible Business Reporting Language ("XBRL") taxonomies for IFRS. The IASC Foundation is governed by 22 trustees ("IASC Foundation Trustees") whose backgrounds are geographically diverse.

To date, the IASC Foundation has financed IASB operations largely through voluntary contributions from companies, accounting firms, international organizations and central banks. Original commitments were made for the period 2001-2005 and have been extended for an additional two years through 2007. In June 2006, the IASC Foundation Trustees agreed on four elements that should govern the establishment of a funding approach designed to enable the IASC Foundation to remain a stand-alone, private-sector organization with the necessary resources to conduct its work in a timely fashion. The IASC Foundation Trustees determined that characteristics of the new scheme for 2008 would be:

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[32] IASC Foundation Constitution, Paragraph 2a (2005) available at http://www.iasb.org/About+Us/About+the+Foundation/Constitution.htm.

[33] For more information on the reorganization, see http://archive.iasb.org.uk/uploaded_files/documents/8_210_swp_rep.pdf.

- Broad-based: Fewer than 200 companies and organizations participate in the current financing system. A sustainable long-term financing system must expand the base of support to include major participants in the world's capital markets, including official institutions, in order to ensure diversification of sources.
- Compelling: Any system must carry with it enough pressure to make free riding very difficult. This could be accomplished through a variety of means, including official support from the relevant regulatory authorities and formal approval by the collecting organizations.
- Open-ended: The financial commitments should be open-ended and not contingent on any particular action that would infringe on the independence of the IASC Foundation and the International Accounting Standards Board.
- Country-specific: The funding burden should be shared by the major economies of the world on a proportionate basis, using Gross Domestic Product as the determining factor of measurement. Each country should meet its designated target in a manner consistent with the principles above.[34]

The IASC Foundation Trustees continue to make progress in obtaining funding that satisfies those elements.

The IASC Foundation Trustees select members of the IASB to comprise "a group of people representing, within that group, the best available combination of technical expertise and diversity of international business and market experience in order to contribute to the development of high quality, global accounting standards."[35] The fourteen members of the

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[34] http://www.iasb.org/About+Us/About+the+Foundation/Future+Funding.htm.

[35] IASC Foundation Constitution, Paragraph 19 (2005) available at http://www.iasb.org/About+Us/About+the+Foundation/Constitution.htm.

IASB—twelve full-time and two part-time—serve five-year terms subject to one re-appointment. They are required to sever all employment relationships and positions that may give rise to economic incentives that might compromise a member's independent judgment in setting accounting standards. The IASB members come from eight countries and have a variety of backgrounds (e.g., auditors, users, preparers, and academics). In selecting IASB members, the IASC Foundation Trustees ensure that the IASB is not dominated by any particular constituency. Member selection is not based on geographic representation.

The IASB is free to choose and conduct projects necessary to promote convergence and develop high quality standards. The IASB solicits views and seeks input from the public throughout the standard setting process from selecting items for its agenda to developing and publishing a discussion paper and/or exposure draft and issuing a final standard. This input is derived from discussions at its project working group and roundtable meetings as well as written submissions from constituents. The IASB's meetings are open to public observers. Comment letters, summaries of comments received on discussion papers and exposure drafts are made publicly available on the IASB website.[36] This transparent process is intended to enable the IASB to obtain relevant views from interested parties, and at the same time to conclude on final standards based on its own deliberations, and without undue external pressure. The IASB has an advisory council—the Standards Advisory Council ("SAC")—that is composed of approximately 40 geographically diverse individuals drawn from countries that use IFRS and also those that do not. The IASB is assisted on IFRS interpretive matters by its International Financial Reporting Interpretations Committee ("IFRIC").

[36] See IASC Foundation Due Process Handbook for the IASB available at http://www.iasb.org/NR/rdonlyres/7D97095E-96FD-4F1F-B7F2-366527CB4FA7/0/DueProcessHandbook.pdf.

The Commission and its staff have for many years been involved in the IASB standard setting efforts and development of the interpretive guidance of IFRIC. The Commission through its staff serves as an Observer to the SAC.

The Commission staff directly participates in the development of IFRS primarily through the work of the International Organization of Securities Commissions ("IOSCO") whose membership regulates more than 90% of the world's securities markets. IOSCO is the world's largest international cooperative forum for securities regulatory agencies.[37] IOSCO has taken and continues to take an active role in the standard setting process undertaken by the IASC and now the IASB. Through membership in IOSCO's Standing Committee on Multinational Disclosure and Accounting, the Commission staff assists in writing IOSCO comment letters on exposure drafts of standards published by the IASB and serves as one of the IOSCO representatives on several of the IASB project working groups. As one of two IOSCO representatives, the Commission staff serves as a non-voting Observer to IFRIC.

Questions

14. Are investors, U.S. issuers and other market participants confident that IFRS have been, and will continue to be, issued through a robust process by a stand-alone standard setter, resulting in high quality accounting standards? Why or why not?
15. Would it make a difference to investors, U.S. issuers and other market participants whether the Commission officially recognized the accounting principles established by the IASB?
16. What are investors', U.S. issuers' and other market participants' views on how the nature of our relationship with the IASB, a relationship that is different and less direct than our

[37] For more information about IOSCO, see http://www.iosco.org.

oversight role with the FASB, affects the Commission's responsibilities under the U.S. securities laws?

C. The Commission's Previous Consideration of International Accounting Standards

For the past several decades the Commission has been actively promoting the development of a set of international accounting standards. In the 1981 Proposing Release, revisions to Form 20-F were proposed and the Commission expressed its support for the work of the IASC in formulating guidelines and international disclosure standards.[38] As part of the 1988 Policy Statement, the Commission urged "securities regulators and members of the accounting profession throughout the world [to] continue efforts to revise and adjust international accounting standards with the aim of increasing comparability and reducing cost" and reaffirmed its commitment to working with securities regulators around the world to achieve the goal of an efficient international securities market system.[39]

In a 1994 amendment to Form 20-F, the Commission accepted from foreign private issuers cash flow statements prepared in accordance with International Accounting Standards ("IAS") No. 7, Cash Flow Statements, without reconciliation to U.S. GAAP. In proposing that amendment, the Commission noted that "while there are differences between a cash flow statement prepared in accordance with IAS 7 and one prepared in accordance with U.S. GAAP...the Commission believes statements prepared in accordance with IAS 7 should provide an investor with adequate information regarding cash flows without the need for additional information or modification."[40]

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[38] See the 1981 Proposing Release, supra note 1.

[39] The 1988 Policy Statement, supra note 2.

[40] The Commission proposed these amendments in Release No. 33-7029 (November 3, 1993) and adopted them in Release No. 33-7053 (April 19, 1994) (the 1994 Adopting Release). Other examples in which the Commission

The Commission more closely examined efforts to develop high quality, comprehensive global accounting standards in a 1997 report undertaken at the direction of Congress.[41] In that report, the Commission noted that for issuers wishing to raise capital in more than one country, compliance with differing accounting requirements to be used in the preparation of financial statements increased compliance costs and created inefficiencies. As a step towards addressing these concerns and to increase the access of U.S. investors to foreign investments in the U.S. public capital market, the Commission encouraged the IASC's efforts to develop a core set of accounting standards that could serve as a framework for financial reporting in cross-border offerings, and indicated an intent to remain active in the development of those standards. In that report, the Commission indicated that its evaluation of IASC core standards would involve an assessment of whether they constituted a comprehensive body of transparent, high quality standards that could be rigorously interpreted and applied.

In February 2000, the Commission issued a Concept Release on International Accounting Standards, seeking public comment on the elements necessary to encourage convergence towards a high quality global financial reporting framework while upholding the quality of financial reporting domestically.[42] In that release, the Commission described high quality standards as consisting of a "comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors, and others who make capital allocation decisions."[43] The Commission also expressed the view that high

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amended its requirements for financial statements of foreign issuers to permit the use of certain IASC standards without reconciliation to U.S. GAAP are described in the 2000 Concept Release, supra note 4.

[41] See "Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 Report on Promoting Global Preeminence of American Securities Markets," supra note 3.

[42] See the 2000 Concept Release, supra note 4.

[43] Id.

quality accounting standards "must be supported by an infrastructure that ensures that the standards are rigorously interpreted and applied."[44]

In 2003, the Commission staff issued a study on the adoption of a principles-based accounting system, as mandated by Congress in the Sarbanes-Oxley Act.[45] The conclusion of that study was that an optimal approach to accounting standard setting would be based on a consistently applied conceptual framework and clearly stated objectives rather than solely on either rules or principles, one benefit of which would be the facilitation of greater convergence between U.S. GAAP and international accounting standards. By taking an objectives-based approach to convergence, the study noted, standard setters would be able to arrive at an agreement on a principle more quickly than would be possible for a detailed rule. The Commission staff's report to Congress interpreted convergence as a "process of continuing discovery and opportunity to learn by both U.S. and international standard setters," the benefits of which include greater comparability and improved capital formation globally.[46]

In 2004, a Deputy Chief Accountant joined a team of experienced professionals within the Office of the Chief Accountant, all devoted full-time to international work. The Commission staff tracks developments in IFRS similar to the manner in which it follows the work of the FASB and the EITF.

In 2005, the Commission adopted amendments to Form 20-F to permit foreign private issuers—for their first year of reporting under IFRS as published by the IASB—to file two years

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[44] Id.

[45] See the Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003) available at http://www.sec.gov/news/studies/principlesbasedstand.htm.

[46] Id.

rather than three years of statements of income, changes in shareholders' equity and cash flows prepared in accordance with IFRS, with appropriate related disclosure.[47] The Commission recognized that these amendments would reduce costs to foreign private issuers and encourage their continued participation in the U.S. public capital market, which would benefit investors by increasing investment possibilities and furthering the efficient allocation of capital.

In February 2006, Chairman Cox reaffirmed his commitment to the "Roadmap" that was first described by a former Chief Accountant of the Commission in April 2005.[48] The Roadmap sets forth the goal of achieving one set of high quality, globally accepted accounting standards and suggested several considerations that could affect the achievement of that goal. It also discusses the possibility for the co-existence of financial statements prepared pursuant to IFRS and U.S. GAAP in the U.S. public capital market.

In March 2007, the Commission staff held a Roundtable discussion to seek input on the potential effects of the co-existence of IFRS and U.S. GAAP financial statements in the U.S. public capital market.[49] In particular, the Roundtable participants discussed the potential effect on the U.S. public capital market if foreign private issuers have the choice to file with the Commission financial statements prepared in accordance with IFRS as published by the IASB without reconciliation to U.S. GAAP.

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[47] See the 2005 Adopting Release, supra note 8.

[48] See SEC Press Release No. 2006-17, "Accounting Standards: SEC Chairman Cox and EU Commissioner McCreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements" (Feb. 8, 2006) (SEC Press Release No. 2006-17) available at http://www.sec.gov/news/press/2006-17.htm.

[49] The transcript of this SEC Roundtable is available at http://www.sec.gov/spotlight/ifrsroadmap/ifrsroadmap-transcript.txt

As previously discussed, on June 20, 2007, the Commission voted to issue a proposal to accept from foreign private issuers their financial statements prepared in accordance with IFRS as published by the IASB without reconciliation to U.S. GAAP.[50]

IV. IFRS IMPLEMENTATION MATTERS FOR U.S. ISSUERS

A move to a financial reporting environment in the U.S. public capital market in which U.S. issuers may provide investors with financial statements prepared in accordance with IFRS as published by the IASB would be a complex endeavor. There are many elements forming the infrastructure underpinning U.S. GAAP that keep it viable and functioning effectively. As is the case with U.S. GAAP, these underpinnings also would be relevant to keep IFRS viable and functioning effectively.

Although both the 2007 Proposing Release and this Concept Release relate to the use of IFRS as published by the IASB in Commission filings, our consideration of the use of IFRS by foreign private issuers and U.S. issuers gives rise to some differing issues.[51] For example, many foreign private issuers already have experience with the application of IFRS in practice because the use of IFRS is either required or permitted in their home market. Due to their experience, they are already confronting the potential difficulties that might face U.S. issuers, including for example, education and training of the accounting and auditing profession and other specialists such as actuaries and valuation experts.

A. Education and Training

The use of IFRS by U.S. issuers would create the need for effective training and education. U.S. issuers would likely use IFRS only if they and their auditors had been thoroughly trained in IFRS and if their investors and other users of their financial statements,

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[50] See the 2007 Proposing Release, supra note 9.

[51] Id.

such as analysts and rating agencies, understood IFRS. However, the education of most accountants in the United States—be it collegiate or continuing education—includes a comprehensive curriculum around U.S. GAAP but does not include a similar curriculum around IFRS. Most specialists, such as actuaries and valuation experts, who are engaged by management to assist in measuring certain assets and liabilities likely were not taught IFRS.

Consequently, all parties would likely need to undertake comprehensive training on IFRS. Professional associations and industry groups would need to integrate IFRS into their training materials, publications, testing and certification programs. Colleges and universities would need to include IFRS in their curricula. Furthermore, eventually it may be appropriate to include IFRS in the Uniform CPA Examination.

Questions

17. In what ways might the Commission be able to assist in improving investors' ability to understand and use financial statements prepared in accordance with IFRS?
18. What are the incentives and barriers to adapting the training curricula for experienced professionals to address both IFRS and U.S. GAAP? Separate from ongoing training, how long might it take for a transition to occur? How much would it cost?
19. What are the incentives and barriers relevant to the college and university education system's ability to prepare its students for a U.S. public capital market in which U.S. issuers might report under IFRS? What are the incentives and barriers relevant to changing the content of the Uniform CPA Examination? How should the Commission address these incentives and barriers, if at all?

B. Application in Practice

To provide effective financial reporting for investors, it is important that IFRS is properly applied in practice. In its considerations about the use of IFRS by foreign private issuers, the Commission has highlighted that proper application encompasses not only faithful adherence to the requirements of the standards, but also understandable standards such that across the spectrum of issuers those requirements are consistently understood and applied. As U.S. issuers do not file with us in IFRS today, in allowing U.S. issuers to do so, we would not have direct experience to assess the extent to which IFRS would be properly applied by U.S. issuers. Rather, we would make this assessment based upon the infrastructure that is in place in the United States to foster the high quality application of IFRS as well as, indirectly, the Commission's experience with the application of IFRS by foreign private issuers.

The Commission's practical experience with IFRS began with the foreign private issuers that have reported on this basis in their filings with the Commission for several years. Further, as previously discussed, during the course of 2006, approximately 110 foreign private issuers filed with the Commission annual reports on Form 20-F that contained financial statements representing that they comply with IFRS as published by the IASB. This representation may have accompanied a representation that the financial statements comply with a jurisdictional version of IFRS. The Commission staff has conducted reviews of those IFRS financial statements as part of its normal function of reviewing the periodic reports of publicly registered companies, consistent with its practice in reviewing filings from U.S. issuers and from foreign private issuers pursuant to the provisions of the Sarbanes-Oxley Act. In conducting its reviews of IFRS financial statements, the staff made a number of comments regarding the application of IFRS, which have been brought to the attention of issuers through the comment process.[52]

In certain limited areas in which the IASB has yet to develop particular industry standards or in which IFRS permits disparate options, we have noted that the level of diversity that IFRS allows has manifested itself in the reporting practices of foreign private issuers. For example, there are two industry areas that have been identified by the IASB as lacking standards: insurance contracts and extractive activities. The IASB is in the process of developing a standard for insurance contracts to supplement IFRS 4, Insurance Contracts. IFRS 6, Exploration for and Evaluation of Mineral Resources, provides only limited guidance with respect to the accounting for exploration and evaluation activities undertaken by oil and gas and mining companies. On both of these projects, the IASB continues to make progress towards developing standards. Further, the body of IFRS does not have standards on the accounting for common control mergers, recapitalizations, reorganizations, acquisitions of minority interests and similar transactions.

With respect to investment companies, there are particular differences between IFRS and U.S. GAAP that would result in different presentations in practice. For example, IFRS does not require a schedule of investments or financial highlights; however, U.S. GAAP requires this information in an investment company's financial statements. As another example, IFRS does not provide an exemption from consolidation of subsidiaries in an investment company, whereas

[52] See http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm for a link to the comment letters the staff issued on 2005 IFRS filings as well as a report outlining some of the staff's observations about those comments.

U.S. GAAP provides exemptions from consolidating subsidiaries in certain areas which could result, for example, in different treatment for master-feeder funds.[53]

Questions

20. What issues would be encountered by U.S. issuers and auditors in the application of IFRS in practice within the context of the U.S. financial reporting environment?
21. How do differences between IFRS and U.S. GAAP bear on whether U.S. issuers, including investment companies, should be given the choice of preparing financial statements in accordance with IFRS?
22. What do issuers believe the cost of converting from U.S. GAAP to IFRS would be? How would one conclude that the benefits of converting justify those costs?

C. Auditing

The use of IFRS by U.S. issuers would affect the audit firms that are engaged both to audit a U.S. issuer's financial statements and to report on the effectiveness of its internal controls. The use of IFRS would arguably affect both the strategic decisions of those firms as well as the quality control systems that those firms employ to conduct their audits.

From a strategic perspective, audit firms would need to determine whether it would be economically desirable to make the initial and ongoing investment necessary to ensure that audits of financial statements prepared in accordance with IFRS would be competently delivered and adequately supervised. This may be particularly challenging for smaller audit firms, which would need to balance the cost of the investments necessary to provide these services with the effects on their reputation that might result if they are unable or unwilling to do so.

[53] A master-feeder fund is a two-tiered arrangement in which one or more "feeder" funds hold shares of a single "master" fund in accordance with Section 12(d)(1)(E) of the Investment Company Act of 1940.

For audit firms that believe the benefits of the investment outweigh the associated costs, elements of their systems of quality control such as their practices related to hiring, assigning personnel to engagements, professional development and advancement activities would need to be adjusted. Because U.S. auditors have less experience with IFRS than with U.S. GAAP, in the short-term, audit firms may encounter challenges in establishing policies and procedures to provide them with reasonable assurance that their personnel possess knowledge appropriate to perform audits of U.S. issuers that apply IFRS. Even with appropriate systems of quality control, however, additional auditing guidance still may be necessary for auditors to appropriately address issues related to the transition to reporting on IFRS financial statements.

Additionally, for the U.S. firms that are members of global audit networks, systems of quality control need to foster the high quality and consistent application of IFRS across national borders. If U.S. issuers were to apply IFRS, the U.S. firms of these global audit networks could be affected more than they are presently by the use of IFRS by audit clients of their foreign affiliates and by U.S. subsidiaries of those clients.

Questions

23. Would audit firms be willing to provide audit services to U.S. issuers who prepare their financial statements in accordance with IFRS? How, if at all, would allowing U.S. issuers to prepare IFRS financial statements affect the current relative market shares of audit firms?
24. What factors, if any, might lead to concern about the quality of audits of IFRS financial statements of U.S. issuers?
25. Would any amendments or additions to auditing and other assurance standards be necessary if U.S. issuers were allowed to prepare IFRS financial statements?

26. How could global consistency in the application of IFRS be facilitated by auditors of U.S. issuers?

D. Regulation

The prospect of a single set of globally accepted accounting standards must occur within the reality that securities regulators all have national—as opposed to global—mandates for carrying out their work. As a result, U.S. issuers with listings in multiple securities markets could find more than one securities regulator commenting upon their IFRS financial statements, as many other securities regulators would have substantial experience in working with IFRS financial statements. Because it is likely that not everyone will apply accounting standards consistently or appropriately, securities regulators are developing infrastructure to identify and address the application of IFRS globally. This infrastructure, which starts with IOSCO, is designed to foster the consistent and faithful application of IFRS around the world. Through its work, IOSCO continues to support the implementation and consistent application of IFRS in the global financial markets. In January 2007, IOSCO's database for cataloguing and sharing securities regulators' experiences on IFRS application around the world became operational.[54]

Further, on a bilateral basis, the Commission and the European Commission ("EC") have agreed that regulators should endeavor to avoid conflicting conclusions regarding the application and enforcement of IFRS.[55] To this end, the Commission and the Committee of European Securities Regulators ("CESR"), which the EC has charged with evaluating the implementation of IFRS in the EU, published a work plan in August 2006.[56] This work plan covers information

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[54] See IOSCO Press Release "Regulators to Share Information on International Financial Reporting Standards" available at http://www.iosco.org/news/pdf/IOSCONEWS92.pdf.

[55] See SEC Press Release No. 2006-17, supra note 48.

[56] See "SEC and CESR Launch Work Plan Focused on Financial Reporting" SEC Press Release 2006-130 (August 2, 2006) available at http://www.sec.gov/news/press/2006/2006-130.htm.

sharing regarding IFRS implementation in regular meetings of the Commission staff and CESR-Fin, the group within CESR focused on financial reporting. The SEC-CESR work plan also contemplates the confidential exchange of issuer-specific information between CESR members and the Commission, with implementing protocols. In addition, CESR has established among its members a forum and a confidential database for participants to exchange views and share experiences with IFRS.[57] These mechanisms will allow securities regulators to endeavor to avoid conflicting decisions on IFRS application matters; nonetheless, each securities regulator retains the responsibility, and accordingly the right, to make its own final decisions.

Despite these mechanisms, a question arises as to what should be done, if anything, in circumstances where neither the IASB nor IFRIC has addressed a particular IFRS accounting issue that causes significant difficulties in practice. A securities regulator, including the Commission, may find it necessary as an interim measure to state a view on such an accounting issue. This is not new, as securities regulators have long been involved in resolving issues related to national accounting standards. If such a view were stated, the securities regulator subsequently could refer the accounting issue to the IASB or IFRIC for resolution of the issue for all constituencies. Any view expressed by the regulator may be rescinded upon the IASB or the IFRIC establishing authoritative literature addressing the issue. As referenced in the 2007 Proposing Release, if the Commission and the staff were to state a view on such an accounting issue, we would not expect it to be inconsistent with IFRS as published by the IASB, the interpretations provided by IFRIC, or the definitions, recognition criteria and measurement concepts in the IASB's Framework.

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[57] See "CESR publishes key information from its database of enforcement decisions taken by EU National Enforcers of financial information (IFRS)" CESR/07-163 (April 2007) available at http://www.cesr-eu.org/index.php?page=groups&mac=0&id=13.

Question

27. Do you think that the information sharing infrastructure among securities regulators through both multilateral and bilateral platforms will improve securities regulators' ability to identify and address inconsistent and inaccurate applications of IFRS?

E. Integration with the Commission's Existing Requirements

The Commission has contemplated the operational considerations with respect to accepting financial statements prepared in accordance with IFRS from foreign private issuers and described these considerations in the 2007 Proposing Release.[58] These operational considerations may be relevant to U.S. issuers if the Commission were to undertake rulemaking to accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers. However, the use of IFRS by U.S. issuers may give rise to additional issues. Additionally, the operational considerations applicable to investment companies may differ from those applicable to other entities, including foreign private issuers.

One area of consideration relating to the potential acceptance of IFRS financial statements would be how to address requirements for a foreign issuer that does not meet the definition of a foreign private issuer. A foreign issuer that is not a foreign private issuer (and is not a sovereign entity) is generally treated the same as a U.S. incorporated issuer under our rules and therefore must follow disclosure requirements applicable to U.S. issuers. If such a foreign issuer is subject to disclosure laws in another jurisdiction, it may find that it is required to prepare both IFRS financial statements for purposes of the other jurisdiction and U.S. GAAP financial statements for purposes of filings with the Commission.

Another area of consideration relates to Regulation S-X. The Commission did give consideration to the application of the provisions of Regulation S-X in the 2007 Proposing

[58] See the 2007 Proposing Release, supra note 9.

Release, and we proposed that Regulation S-X would continue to apply to filings from foreign private issuers that include financial statements prepared in accordance with IFRS with the exception of the form and content portion of its financial statement requirements. For example, under Article 11 of Regulation S-X, issuers are required to prepare unaudited pro forma financial information to give effect as if a particular transaction, such as a significant recent or probable business combination, had occurred at the beginning of the period. In the 2007 Proposing Release, a foreign private issuer using IFRS would prepare the pro forma financial information by presenting its IFRS results and converting the financial statements of the business acquired (or to be acquired) into IFRS.

Currently U.S. issuers are subject to Regulation S-X. For example, a U.S. issuer applies Article 4 and either Article 5, 6, 7 or 9 of Regulation S-X, as applicable, in determining the form and content of its financial statements. These requirements provide a substantial degree of specificity around the items to be presented on the balance sheet and income statement. IFRS does not provide specific conventions as to the format or content of the income statement.[59]

Investment company financial statements have unique disclosure requirements. For example, Regulation S-X contains specific disclosure requirements for investment companies relating to investments in unaffiliated issuers, investments in affiliates, securities sold short, open option contracts written and investments other than securities.[60] Also, Rule 6-05 of Regulation S-X permits investment companies to include a Statement of Net Assets in lieu of the balance sheet if at least 95 percent of the investment company's total assets are represented by

[59] IAS 1, Presentation of Financial Statements, provides guidance regarding minimum required line items and provides examples to which entities may refer.

[60] See Rules 12-12 through 12-14 of Regulation S-X [17 CFR 210.12-12, 12-12A, 12-12B, 12-12C, 12-13 and 12-14.]

investments in securities of unaffiliated issuers. The non-financial statement portion of an investment company's shareholder report may require disclosures that are based on financial statement information. For example, investment companies must include an expense table and a graphical representation of holdings.[61] If investment companies were to prepare IFRS financial statements, questions related to these requirements would be relevant.

Regulation S-K contains the disclosure requirements for the non-financial statement portion of filings made with the Commission. Several non-financial statement disclosure items required by Regulation S-K make reference to specific U.S. GAAP pronouncements, including Financial Accounting Standards and interpretations thereof. For example, U.S. issuers are required to provide disclosure of off-balance sheet arrangements under Item 303(a)(4) of Regulation S-K, which expressly refers to FASB Interpretations. If U.S. issuers were to prepare IFRS financial statements, the Commission would need to consider questions related to the application of these provisions of Regulation S-K.

The Commission has provided its views and interpretations with respect to financial reporting in Accounting Series Releases ("ASRs") and Financial Reporting Releases ("FRRs"). The SEC staff has given financial reporting guidance in various forms, including Staff Accounting Bulletins ("SABs"); Industry Guides; and Staff Frequently Asked Questions Publications. If U.S. issuers were to prepare IFRS financial statements, companies may find reference to these ASRs, FRRs, SABs, Industry Guides and other forms of U.S. GAAP guidance

[61] See Items 22(d)(1), (2) of Form N-1A.

useful in the application of IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.[62]

Questions

28. If the Commission were to consider rulemaking to allow U.S. issuers to prepare IFRS financial statements, are there operational issues relative to existing Commission requirements on which additional guidance would be necessary and appropriate? Would it be appropriate to have differing applicability for U.S. issuers of the form and content provisions of Regulation S-X depending on whether they use IFRS in preparing their financial statements? Are there operational or other issues unique to investment companies? In preparing and auditing IFRS financial statements, should U.S. issuers and their auditors consider the existing guidance related to materiality and quantification of financial misstatements?
29. Should there be an accommodation for foreign issuers that are not foreign private issuers regardless of whether the Commission were to accept IFRS financial statements from U.S. issuers? Should any accommodation depend upon whether the foreign issuer is subject to the laws of another jurisdiction which requires the use of IFRS, or if the issuer had previously used IFRS financial statements in its filings with the Commission?

F. Transition and Timing

The Commission has not set out a path of the steps to any possible acceptance of financial statements from U.S. issuers prepared in accordance with IFRS as published by the IASB, nor the potential timing of any such steps. Rather, with this Concept Release, the

[62] Under IAS 8, in the absence of an IFRS standard or interpretation that specifically applies to a transaction or event, management should use its judgment in developing and applying a relevant and reliable accounting policy and look to other pronouncements in applying that judgment.

Commission seeks input to identify what would be necessary to reach an appropriate level of acceptance and understanding if the Commission were to allow U.S. issuers to prepare their financial statements in accordance with IFRS as published by the IASB. The U.S. public capital market has experienced neither the wide co-existence of financial statements prepared under two sets of accounting standards, nor a change of a group of U.S. issuers from reporting under one set of accounting standards to another. The closest we have come is experiencing the change that occurs when amendments to U.S. GAAP necessitate that all U.S. issuers change their accounting for a particular area. However, this type of change is of a lesser magnitude as it is limited to one topical area. A U.S. issuer's change to IFRS may affect many topical areas, depending upon the degree to which financial statements prepared under IFRS differ from financial statements prepared under U.S. GAAP for that U.S. issuer's facts and circumstances. A U.S. issuer's assessment and reporting of the effectiveness of its internal controls over financial reporting also would likely need to be adjusted to encompass the preparation of financial information in accordance with IFRS.

At a more detailed level, the Commission seeks input on U.S. issuers' potential first-time adoption of IFRS. Under such a change, a U.S. issuer's first set of IFRS financial statements would reflect the application of IFRS 1, First-Time Adoption of IFRS. IFRS 1 provides the requirements for transition from the prior basis of reporting, in this case U.S. GAAP, to IFRS including the restatement of and reconciliation from prior years' financial statements and the related disclosures.

Questions

30. Who do commenters think should make the decision as to whether a U.S. issuer should switch to reporting in IFRS: a company's management, its board of directors or its

shareholders? What, if any, disclosure would be warranted to inform investors of the reasons for and the timing to implement such a decision? If management were to make the decision to switch to IFRS, do investors and market participants have any concerns with respect to management's reasons for that decision?

31. When would investors be ready to operate in a U.S. public capital market environment that allows the use of either IFRS or U.S. GAAP by U.S. issuers? When would auditors be ready? How about those with other supporting roles in the U.S. public capital market (e.g., underwriters, actuaries, valuation specialists, and so forth)? Is this conclusion affected by the amount of exposure to IFRS as it is being applied in practice by non-U.S. issuers?

32. Should the Commission establish the timing for when particular U.S. issuers could have the option to switch from preparing U.S. GAAP to IFRS financial statements? Should market forces dictate when a U.S. issuer would make the choice to switch from U.S. GAAP to IFRS financial statement reporting? If the former, what would be the best basis for the Commission's determination about timing?

33. Should the opportunity, if any, to switch to IFRS reporting be available to U.S. issuers only for a particular period of time? If so, why and for what period? At the end of that period of time, could commenters foresee a scenario under which it would be appropriate for the Commission to call for all remaining U.S. issuers to move their financial reporting to IFRS?

34. What difficulties, if any, do U.S. issuers anticipate in applying IFRS 1's requirements on first-time adoption of IFRS, including the requirements for restatement of and reconciliation from previous years' U.S. GAAP financial statements?

35. Would it be appropriate for U.S. issuers that move to IFRS to be allowed to switch back to U.S. GAAP? If so, under what conditions?

V. GENERAL REQUEST FOR COMMENTS

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address and the benefits and costs relating to investors, issuers and other market participants of the possibility of accepting financial statements from U.S. issuers prepared in accordance with IFRS. Please be as specific as possible in your discussion and analysis of any additional issues. Where possible, please provide empirical data or observations to support or illustrate your comments.

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

Dated: August 7, 2007.

F...

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 8833 / August 9, 2007

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 56233 / August 9, 2007

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2629 / August 9, 2007

INVESTMENT COMPANY ACT OF 1940
Rel. No. 27927 / August 9, 2007

Admin. Proc. File No. 3-12386

In the Matter of WARREN LAMMERT, LARS SODERBERG, and LANCE NEWCOMB	ORDER DENYING PETITION FOR INTERLOCUTORY REVIEW

APPEARANCES:

Graeme W. Bush, Alexandra W. Miller, and Jill F. Dash, of Zuckerman Spaeder LLP, for Warren Lammert.

Richard Beckler and Joseph Walker, of Howrey LLP, for Lars Soderberg.

Marc B. Dorfman, Ellen M. Wheeler, and Akita N. Adkins, of Foley & Lardner LLP, for Lance Newcomb.

Polly A. Atkinson, Thomas J. Krysa, and Jeffrey E. Oraker, for the Division of Enforcement.

I.

Warren Lammert, Lars Soderberg, and Lance Newcomb, respondents in a Commission administrative proceeding, have filed an interlocutory petition that seeks dismissal of an order instituting proceedings ("OIP") issued against them. The Division of Enforcement opposes Respondents' petition. For the reasons discussed below, we decline to grant review of Respondents' interlocutory petition.

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On July 31, 2006, we issued an OIP against Lammert, a portfolio manager employed by Janus Capital Management, LLC ("Janus Capital Management"), an investment adviser, Soderberg, an officer and director of Janus Capital Management, and Newcomb, also an officer and director of Janus Capital Management. The OIP alleges that Respondents violated certain antifraud provisions of the federal securities laws or, in the alternative, willfully aided and abetted and caused Janus Capital Management's violation of certain antifraud provisions and certain affiliated transactions provisions of the federal securities laws. The OIP further alleges that these violations occurred in connection with Respondents' involvement, variously, in market timing, frequent trading, and late trading activity, which related to certain mutual funds managed by Janus Capital Management, pursuant to arrangements with broker-dealers Trautman Wasserman & Company, Inc. ("Trautman Wasserman") and Brean Murray & Company, Inc. ("Brean Murray").

On September 6, 2006, an administrative law judge issued an order setting a hearing date of February 20, 2007. The law judge ordered the Division to "make available to Respondents, pursuant to 17 C.F.R. § 201.230, its complete investigative file." 1/

Subsequently, a dispute arose between the parties regarding the extent to which the Division complied with the September 6, 2006 order. Respondents contended that the Division had failed to make available material compiled from investigations of Trautman Wasserman and Brean Murray. The Division contended that it was under no such obligation and that it did make available its complete investigative file. 2/

In a February 7, 2007 order, the law judge concluded that, pursuant to Commission Rule of Practice 230(a), "the investigative files made available to the parties in [the Trautman

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1/ See text accompanying note 10.

2/ The Trautman Wasserman investigation led to our issuance of an OIP against that broker-dealer and various individual respondents on February 5, 2007. See Trautman Wasserman & Co., Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder, and Forde Prigot, Order Instituting Proceedings, Admin. Proc. File No. 3-12559 (Feb. 5, 2007). The Trautman Wasserman OIP alleges, among other things, that Trautman Wasserman engaged in a scheme to defraud certain mutual funds through late trading and deceptive market timing activities.

The Brean Murray investigation led to our acceptance of Brean Murray's offer of settlement in which it consented to, among other things, findings that it engaged in improper late trading and market timing activities that affected certain mutual funds and that it willfully aided and abetted and caused a clearing firm's violations of Rule 22c-1 of the Investment Company Act of 1940. See Brean Murray & Co., Order Instituting Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Admin Proc. File No. 3-11836 (Feb. 17, 2005).

Wasserman and Brean Murray] proceedings should be made available to Respondents." On February 9, 2007, at a prehearing conference, the law judge clarified that she believed that "the investigative file in the Trautman [Wasserman] matter and in the Brean [Murray] matter should be made available to [R]espondents ASAP."

On that same day, Soderberg filed a motion on behalf of Respondents to dismiss the OIP. The motion argued that the Respondents had been denied due process as a result of the Division's alleged failure to comply with discovery requirements.

On February 12, 2007, during the pendency of Soderberg's motion to dismiss, the Division filed a request with the law judge for certification of her ruling that the Division was required to make available to Respondents the investigative files in the Trautman Wasserman and Brean Murray matters. The Division also requested a stay of the proceedings pending the law judge's determination of the certification request.

On February 13, 2007, the law judge issued an order denying the Division's requests and reminding the Division "that delay in making the documents available may ultimately result in an Initial Decision dismissing this proceeding against Respondents." On that same day, the Division filed a notice of its intent to provide Respondents with access to the Trautman Wasserman and Brean Murray investigative files but reserved its objection to the law judge's order to make those materials available to Respondents.

On February 14, 2007, the New York Attorney General ("NYAG") requested a stay of this proceeding, pursuant to Rule of Practice 210(c)(3), 3/ pending the outcome of a criminal proceeding against James A. Wilson, Jr., a party in the Trautman Wasserman proceeding, that is alleged to be based on many of the same facts at issue here. On February 15, 2007, the law judge issued an order granting the stay and requesting the Division to report on May 25, 2007 the status of the Wilson criminal proceeding. 4/ The law judge also ordered the Division to make available to Respondents documents from the Brean Murray investigative file and to "assist Respondents in obtaining access to Trautman Wasserman material that has already been produced to Defendant Wilson, as well as to additional material, subject to confidentiality agreements, if necessary."

3/ 17 C.F.R. § 201.210(c)(3).

4/ In a motion filed before us in the Trautman Wasserman proceeding, the NYAG represented that Wilson was tentatively scheduled to be sentenced on June 7, 2007. A potential witness in this proceeding, Scott Christian, was also scheduled for sentencing on June 25, 2007. Court records indicate that sentencing of both defendants was, in fact, completed by these dates. See People v. James A. Wilson, Jr., 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).

Also in that order, the law judge "declined to grant Respondents' request" made on February 9, 2007 to dismiss the OIP. Respondents sought reconsideration of this latter ruling on March 8, 2007. The law judge responded with an order dated March 26, 2007, in which she concluded that she was not authorized to dismiss the proceeding and that such a request "must be addressed to the Commission in the first instance."

In its April 26, 2007 opposition to this motion, the Division represented, without challenge by Respondents in their reply brief, 5/ that it has produced, and continues to produce, the Trautman Wasserman and Brean Murray files, except for a certain portion of documents that have been ordered by us to be withheld. 6/ For example, the Division represented that, among other things, it "produced the Brean investigative materials to respondents [that] consisted of more than 55 boxes of documents" and "copied several concordance databases containing Trautman investigative materials consisting of more than 400,000 documents onto a hard drive for respondents, produced subpoena and correspondence files, hard copies of documents received from third parties, and certain audiotapes of conversations of Trautman employees."

II.

Commission Rule of Practice 400(a) provides that "[p]etitions by parties for interlocutory review are disfavored" and will be granted "only in extraordinary circumstances." 7/ We adopted this language "to make clear that petitions for interlocutory review . . . rarely will be granted." 8/ Respondents argue that dismissal is warranted on several

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5/ As discussed infra, Respondents belatedly challenged one specific assertion concerning the Division's production in a June 7, 2007 supplemental brief.

6/ See infra note 16.

7/ 17 C.F.R. § 201.400(a).

8/ Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, Securities Exchange Act Rel. No. 49412 (Mar. 19, 2004), 82 SEC Docket 1744, 1749.

grounds. 9/ For the reasons discussed below, we have determined that Respondents' petition does not satisfy the standards for interlocutory review.

A. Production of Investigatory Files. Respondents claim that they have been prejudiced by the Division's alleged violation of our Rule of Practice 230 with respect to the production of documents from the Trautman Wasserman and Brean Murray files. The relevant portion of Rule 230 provides:

> Unless otherwise provided by this rule, or by order of the Commission or the hearing officer, the Division of Enforcement shall make available for inspection and copying by any party documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings. 10/

The question presented here is whether the Trautman Wasserman and Brean Murray files were obtained "in connection with" the same investigation leading to the Division's recommendation that this proceeding be instituted.

Certain events with respect to the investigation underlying this OIP are not in dispute. On September 3, 2003, the Division's Denver office opened a "matter under inquiry" regarding the Janus Mutual Fund complex ("Janus") based upon a complaint from the NYAG, alleging,

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9/ We note at the outset that our consideration of Respondents' motion has been hampered by various factors. Respondents' motion itself develops no argument, but instead incorporates by reference two pleadings before the law judge. Certain arguments developed in those pleadings rely on factual assertions concerning hearing dates and document production that were no longer true on the date Respondents filed their motion before us, and yet Respondents did not update their argument to reflect these changed circumstances.

Moreover, Rule of Practice 154(c), 17 C.F.R. § 201.154(c), limits the length of motions to 7,000 words or less. By incorporating by reference their earlier pleadings, Respondents violated this requirement.

Frequent noncompliance with the requirement of Rule 154(a), 17 C.F.R. § 201.154(a), that briefs accompanying any motion include points and authorities relied upon has further frustrated our review, as discussed in more detail, infra. Additionally, certain pleadings resort to more rhetoric than legal analysis. 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, 180, grant the law judges wide latitude to regulate the course of the proceeding and the conduct of the parties and their counsel.

10/ 17 C.F.R. § 201.230(a)(1).

among other things, certain improprieties at Janus. 11/ On September 10, 2003, we issued an omnibus formal order, NY-7220, based upon widespread allegations contained in the NYAG's complaint that involved other mutual fund complexes in addition to Janus. The omnibus formal order authorized Commission staff to issue subpoenas in order to investigate possible market-timing and late-trading activity and required that the order be used "in conjunction with a specific enforcement investigation." 12/

On September 12, 2003, the Division's Denver office opened an investigation entitled In the Matter of Janus Capital Corp., D-02597, ("Janus investigation"), to inquire into Janus's activities, using the authority of the omnibus formal order. In memoranda using the case number D-02597A, the Division recommended that we authorize a proceeding against Janus in 2004, as well as this proceeding against Respondents in 2006. 13/

The Division's New York office opened an investigation entitled In the Matter of Trautman Wasserman, NY-7277. The Division's Philadelphia office opened an investigation entitled In the Matter of Brean Murray & Co., P-01114. The Division's New York and Philadelphia offices issued subpoenas in the Trautman Wasserman and Brean Murray investigations, respectively, under the authority of the omnibus formal order, as did the Division's Denver office in connection with its investigation of Respondents.

Respondents claim that, pursuant to Rule 230, they are entitled to the Trautman Wasserman and Brean Murray investigative files because those files were compiled under the authority of the same omnibus order that authorized the investigation of Respondents' activities. Respondents allege that the Division failed "to turn over the [Trautman Wasserman and Brean Murray] documents in a timely manner" and construed Rule 230 in a "disingenuous, overly literal" fashion.

The Division counters that its production of documents

> was based on its good faith belief that it was required to produce only the Denver office's investigative file in the Janus investigation, not all the files relating to the more than 100 mutual fund investigations that used the omnibus formal order, which included the Trautman and Brean investigations conducted by the New

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11/ Matters under inquiry are informal investigations for which the Division lacks subpoena authority.

12/ See Warren Lammert, Declaration of Amy J. Norwood, Admin. Proc. File No. 3-12386 (Feb. 1, 2007), at 2.

13/ See Warren Lammert, Division of Enforcement's Response in Opposition to Respondents' Motion to Dismiss the Order Instituting Proceedings, Admin. Proc. File No. 3-12386 (Apr. 26, 2007), at 3.

> York and Philadelphia offices, respectively. The Division's good faith interpretation of Rule 230 was based on its past practices in cases involving omnibus formal orders and the absence of any contrary guidance on this issue. The Division maintained this good faith belief until the ALJ's February 7 and 9, 2007 orders requiring the Division to produce the Trautman and Brean files pursuant to Rule 230.

This issue is a matter of first impression. We note that this proceeding and the Trautman Wasserman and Brean Murray proceedings are distinct matters investigated by different Division offices located in different states, even if involving some of the same underlying facts, and even if subpoenas were issued pursuant to the same omnibus formal order. 14/ Although we do not reach the issue here, we disagree with Respondents that, under these circumstances, the Division acted in bad faith by asserting that the documents in the Trautman Wasserman and Brean Murray files were not obtained "in connection with the investigation leading to the Division's recommendation to institute proceedings." 15/

14/ Although not raised by the parties, we note that the comment to Rule 230 states that this language in the Rule "ordinarily is delineated by the investigation number . . . under which requests for documents . . . were made." This language suggests without elaboration that, in less ordinary circumstances, a different rule might apply. The comment also points out that recommendations by the Division to institute proceedings identifies the source investigation number "to which [the proceeding] relates." Ordinarily, those numbers would be the same. Here, they were not.

15/ Respondents assert that the Division's intent in failing to produce documents is irrelevant. However, United States v. Dahlstrum, 493 F. Supp. 966, 975 (C.D. Cal. 1980), cited by Respondents in their motion to dismiss before the law judge, supports a different conclusion:

> Dismissal of an indictment is required only in flagrant cases of government overreaching (citation omitted). Here, dismissal is mandated by the overwhelming evidence of the IRS's flouting of the civil summons authority granted to it by Congress. . . . [I]n view of the circumstances of this case, this Court feels compelled to dismiss the indictment with prejudice in order to preserve the interests of a taxpayer defendant subjected to this type of governmental misconduct, even though fueled only by "institutional bad faith" and not any personal bad faith.

We also note that Respondents' assertion that Dahlstrum stands for the proposition that "dismissal is the only effective deterrent when a case reaches the trial phase" is incorrect. Dahlstrum expressly is limited to the "criminal trial phase," which is inapplicable here.

(continued...)

Moreover, Respondents fail to identify any harm they may have suffered that would warrant dismissal of the case. Although it does not concede that the law judge's construction of Rule 230 is correct, the Division has agreed to produce, in accordance with the law judge's order, everything Respondents are seeking from the Trautman Wasserman and Brean Murray files. The Division has represented, and Respondents concede, that the Division has made available, and continues to make available, such material. Although it is true that there has been a delay in obtaining access to the Trautman Wasserman and Brean Murray files, the hearing is currently set for October 2007, and this affords Respondents with adequate time to review the material. 16/

We also note that Rule 230(e) provides that documents "shall be made available to the respondent for inspection and copying at the Commission office where they are ordinarily maintained, or at such other place as the parties, in writing, may agree." The record includes correspondence from counsel for Respondents stating, "We do not want to come to New York to review and instead would like simply to receive copies of all the documents that have not yet been produced to us from the Trautman investigation." 17/ Though the Division is free to accede to such a request, the additional burden it would impose would cause more delay.

Respondents argue that, because they had already accomplished much of their pre-trial preparation, they will have to expend additional resources reevaluating trial strategy as a result of the new material available to them. This contention is speculative. Because of the preliminary stage of the proceedings, it is unclear how much additional preparation might be

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15/ (...continued)
The other two cases to which Respondents cite in support of their argument that the Division's alleged misconduct warrants dismissal are similarly inapposite. See United States v. Weiss, 566 F. Supp. 1452, 1453 (C.D. Cal. 1983) (following Dahlstrum after finding the factual situation to be "virtually identical" to that case) and SEC v. Gulf & Western Indus., Inc., 502 F. Supp. 343 (D.D.C. 1980) (granting the Commission's motion to strike five of respondent's six affirmative defenses and finding that the sixth affirmative defense regarding an alleged breach of attorney-client privilege warranted further factual development).

16/ On June 1, 2007, we imposed a stay in this proceeding on the discovery of certain documents in the Trautman Wasserman investigative file that the NYAG identified as potentially prejudicial to its criminal cases against Wilson, as well as another individual who was employed by Trautman Wasserman, Scott Christian. This stay expired on June 25, 2007, based on the NYAG's representation that the two criminal proceedings were expected to conclude by that date. See supra note 4. There is no indication that Respondents have been harmed by gaining access to the materials at issue upon the expiration of that limited stay.

17/ E-mail of Graeme W. Bush to Division staff, dated April 5, 2007.

required or whether some remedy other than dismissal might be more appropriate in the event such harm is established and attributable to some error on the Division's part. Respondents cite no authority for the proposition that dismissal is warranted because one party may be required to expend more resources than it expected at the outset of a proceeding.

In a June 7, 2007 motion requesting permission to file a supplemental brief ("the June 7 submission"), Respondents made an additional argument alleging the Division's failure to fulfill its Rule 230 obligations. 18/ This late filing was necessitated, Respondents contend, by the Division's May 23, 2007 production of certain transcripts of testimony of Ryan Goldberg and Michael Grady taken on September 14, 2005. Respondents' claim that the May 23 production of Goldberg's and Grady's testimony proves that the Division's representations to counsel for Respondents that neither Goldberg nor Grady gave testimony "during the course of the Division's investigation of Brean Murray" is "false." However, the June 7 submission makes clear that the Goldberg and Grady testimony to which it refers was given in September 2005 – seven months after the proceeding against Brean Murray concluded with a settlement agreement and order making findings. 19/ The June 7 submission does not explain how testimony taken after the conclusion of the Brean Murray settlement could have been taken "during the course of the . . . investigation of Brean Murray."

The Division indicates that attorneys in our Philadelphia office mistakenly thought that Respondents were seeking testimony taken during the investigation concerning the substantive allegations in that investigation. The testimony produced on May 23, 2007 pertained to Goldberg's and Grady's then-current financial condition in connection with settlement negotiations. 20/ At some point the Denver office became aware that Goldberg and Grady had given testimony,,but withheld the testimony on the basis that it related to confidential settlement negotiations, and listed such material on its privilege log. After reviewing the materials and redacting confidential personal information such as Goldberg's and Grady's social security numbers and bank account numbers, the testimony was produced. Our review of the e-mail exchanges excerpted by the parties suggests at most a series of mis-communications among counsel. Respondents have not identified any harm as a result of the delay in producing the materials.

18/ The Division did not oppose the motion, although it responded to the supplemental brief on June 15, 2007 ("the Division's June 15 response"), and we accordingly grant the motion.

19/ See Warren Lammert, Respondents' Motion for Leave to File Supplemental Brief in Support of Motion to Dismiss the Order Instituting Proceedings, Admin. Proc. File No. 3-12386 (June 7, 2007), at 1.

20/ Neither party has identified to what these settlement negotiations pertain.

The June 7 submission also accuses the Division of making the "false" statement to the Commission in its April 26, 2007 opposition to Respondents' motion to dismiss that the Division had "produced sworn testimony from . . . [Goldberg and Grady] . . . ." Allegations that opposing counsel have made "false" statements to a tribunal are extremely serious. The record, however, does not support Respondents' claims. 21/ The Division's response makes clear that the Division had in fact produced Goldberg and Grady testimony, albeit testimony taken in the Janus investigation and in a separate injunctive matter, 22/ not the Brean Murray investigation. 23/

B. Obligations under Brady v. Maryland. Respondents also claim that they have been prejudiced by the Division's alleged disregard for its obligations under Brady v. Maryland. 24/ Respondents argue that "the Division had an independent constitutional obligation to search for and produce any Commission files that may contain exculpatory information regardless of which Commission office had possession of them." 25/ Respondents' position is not entirely clear, but it appears to be related to a separate argument, discussed infra, that the theory of liability set forth in the Trautman Wasserman OIP is inconsistent with the theory of liability set

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21/ The June 7 submission offered nothing to explain why, if Respondents believe the Division's statement to be untrue, they waited six weeks to file their supplemental brief. While we awaited the Division's response to the June 7 submission, we were puzzled by our discovery in the record that the Division had made similar statements concerning the production of testimony by Goldberg and Grady, in both a February 1, 2007 opposition filed with the law judge to Respondents' motion to compel and a letter to counsel for Respondents dated October 17, 2006, without prompting any outcry from Respondents' counsel that these statements were "false."

22/ SEC v. Treadway, 04-CV-3464 S.D.N.Y. (filed May 6, 2004).

23/ Respondents also argue that the above representation by the Division regarding Goldberg and Grady testimony is misleading. They do not explain this contention. Read in context, we do not construe the Division's April 26, 2007 representation to mean that the Goldberg and Grady testimony that had been produced as of that date was all the Goldberg and Grady testimony that might exist in the Division's files.

24/ See Commission Rule of Practice 230(b)(2), 17 C.F.R. § 201.230(b)(2), which provides that "[n]othing in this paragraph (b) authorizes the Division of Enforcement in connection with an enforcement or disciplinary proceeding to withhold, contrary to the doctrine of Brady v. Maryland, 373 U.S. 83, 87 (1963), documents that contain material exculpatory evidence."

25/ See Warren Lammert, Respondents' Motion to Reconsider the Court's Denial of Their Motion To Dismiss, Admin. Proc. File No. 3-12386 (Mar. 8, 2007), at 11 (emphasis in original).

forth in Respondents' OIP. We understand Respondents to assert that the Division has an obligation to produce material under Brady because, in Respondents' view, the theory of liability in the Trautman Wasserman OIP "negates" the theory of liability in Respondents' OIP. On this theory, Respondents conclude that the Trautman Wasserman file might somewhere contain exculpatory material.

We have held that, "[t]o trigger the obligation to disclose under Brady, the evidence must be 'material either to [the defendant's] guilt or punishment' . . . ." 26/ As we have held, Brady does not "authorize a wholesale 'fishing expedition' into investigative material." 27/ Moreover, "the purpose of the Brady rule is not to provide a defendant with a complete disclosure of all evidence . . . which might conceivably assist him in preparation of his defense." 28/ "Brady is not a discovery rule, instead, it is intended to insure that exculpatory material known to the Division is not kept from the respondent." 29/ The Division represents that it is not aware of any Brady material in any of the investigative files at issue. Respondents point to no evidence to contradict this representation.

Respondents rely on a decision by a Commodity Futures Trading Commission ("CFTC") law judge in Global Minerals & Metals Corp. 30/ to support their broader reading of the Division's Brady obligations. We note first that rulings by a CFTC law judge are not binding precedent on us. Further, Global Minerals does not stand for the proposition for which Respondents cite it. Rather, the law judge noted:

> [t]he [CFTC] has explained, "we expressly do not suggest that the Division of Enforcement must routinely cause a search to be made of other Commission divisions or offices for potentially discoverable or exculpatory . . . material where the Division has no knowledge that such material might exist and is not directed

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26/ Elizabeth Bamberg, 50 S.E.C. 201, 205 (1990) (citation omitted).

27/ See Haight & Co., 44 S.E.C. 481, 510-511 (1971) (rejecting respondents' argument that the Division of Enforcement improperly suppressed evidence favorable to their defense) (citation omitted); Orlando Joseph Jett, 52 S.E.C. 830, 830 (1996) ("[I]t is well established that the Supreme Court's Brady decision does not authorize respondents to engage in "fishing expeditions" through confidential Government materials in hopes of discovering something helpful to their defense.") (citation omitted).

28/ Rooney, Pace Inc., 48 S.E.C. 602, 606 n.7 (1986) (citing United States v. Ruggiero, 472 F.2d 599, 604 (2d Cir. 1973)).

29/ David M. Haber, Exchange Act Rel. No. APR-418 (Feb. 2, 1994), 55 SEC Docket 3333, 3334.

30/ C.F.T.C. No. 99-11, 2003 WL 23112470, at *1 (Jan. 6, 2004).

> to it by a focused and specific defense request." First Guaranty Metals, Co., C.F.T.C. No. 79-55, 1980 WL 15696 (July 2, 1980). 31/

Respondents in Global Minerals identified specific exculpatory evidence that the CFTC's Division of Enforcement was alleged to have knowledge of and withheld. The law judge concluded that the record provided sufficient reason to believe that the specific evidence may have been located in other CFTC offices because a certain individual associated with the evidence had changed positions within the CFTC. Thus, the law judge ordered the Division to search for the specific evidence in the locations that were "reasonably calculated to discover" such material. Respondents have offered no evidence to indicate that a situation similar to the Global Minerals matter exists in this proceeding. Under the circumstances, nothing suggests that a Brady violation has occurred.

C. Failure to Preserve Data and Programs. Respondents further claim that they have been prejudiced by the Division's alleged "failure to preserve crucial evidence that would support the report of its expert witness." The Division counters that "the Division's expert failed to retain a small amount of data and iterations of certain computer programs used to prepare calculations [of damages] associated with his report." We note that Respondents do not substantiate their claim that the Division is in any way responsible for the loss of evidence rather than, as the Division states, the expert. Without such substantiation, there is no support for allegations that this is the result of bad faith by the Division warranting such an extreme remedy as dismissal of the entire case. 32/

Even if we assume that Respondents' claims were true, however, we do not believe that their proffered remedy is appropriate. Our Rules of Practice provide specific procedures for addressing evidentiary issues at the hearing. Rule 321 provides that parties may object to the admission or exclusion of evidence. 33/ Rule 326 provides that parties are entitled to present oral or documentary evidence, to submit rebuttal evidence, and to conduct cross-examination. 34/ Rule 340 provides that parties shall have an opportunity to file proposed findings and conclusions together with, or as a part of, their briefs, which may further address evidentiary objections. 35/ Because the proceeding was in a preliminary stage prior to the imposition of the stay, none of these avenues has been explored by the parties yet, and Respondents do not explain why we should circumvent them here. Further, Respondents will

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31/ Global Minerals, 2003 WL 23112470, at *4 n.9.

32/ See supra note 15 (discussing relevance of bad faith in Dahlstrum).

33/ 17 C.F.R. § 201.321.

34/ 17 C.F.R. § 201.326.

35/ 17 C.F.R. § 201.340.

have an opportunity to raise any evidentiary issue in the event they should appeal any decision by the law judge. With so little information before us, we see no reason to prematurely interfere with an evidentiary issue that would be better resolved after the parties have had the opportunity to develop more information, and which is properly within the purview of the law judge to address. 36/

D. Asserted Inconsistency of Proceedings. Respondents argue that dismissal is warranted by our purported "decision to pursue two mutually inconsistent administrative proceedings relating to the same case." Respondents contend that

> [t]he Commission has inappropriately asserted that Respondents were both securities fraud victims and violators through their interactions with Trautman Wasserman. This inconsistency is most dramatically shown by the Commission's allegations that Trautman Wasserman 'employed deceptive tactics to evade mutual funds' efforts to restrict [its] customers' market timing of mutual funds.' This is in direct conflict with the Commission's allegations that Respondents' [sic] knowingly and willfully facilitated Trautman Wasserman's market timing.

We wish to emphasize preliminarily that, 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. 37/

We are at a preliminary stage of the proceeding. On the record before us, we are not persuaded that any inconsistency exists. The Division contends that it "could prove under the same set of facts both that Lammert, Soderberg, and Newcomb, knowingly permitted and improperly facilitated Trautman's known market timing activity at Janus on the one hand, and that Trautman late traded and engaged in unknown deceptive trading practices at Janus on the other." We agree. Whether certain mutual fund companies were deceived by certain individuals associated with Trautman Wasserman, as alleged in the Trautman Wasserman OIP, does not necessarily have any bearing on whether Respondents, who were associated with Janus Capital Management, an investment adviser, were involved with Trautman Wasserman's activities, as alleged in Respondents' OIP. By their very nature, mutual fund companies, acting through their boards of directors, depend on the services of third parties, such as investment advisers, transfer agents, distributors, administrators, and other providers, to conduct their

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36/ See Commission Rules of Practice 320-326, 17 C.F.R. §§ 201.320-326, which govern the evidentiary process in administrative law proceedings.

37/ See Kevin Hall, Order Denying Respondents' Motions for Summary Disposition and Oral Argument, Exchange Act Rel. No. 55987 (June 29, 2007), __ SEC Docket __ (observing that once the Commission has instituted a proceeding, the appropriate remedy for any challenge to its decision to institute is to litigate the proceeding to a final decision).

operations. It is not inconceivable that those third-party service providers could engage in misconduct unbeknownst to the mutual fund company.

Neither are we persuaded that these two proceedings are tantamount to "the same case." The Trautman Wasserman OIP is not limited to circumstances surrounding Janus, and Respondents' OIP is not limited to circumstances surrounding Trautman Wasserman. To the extent that the two proceedings appear to involve many of the same facts regarding activity relating to Janus and Trautman Wasserman, there is no indication at this stage of the proceeding that such facts will be proven or to what degree they will form the basis of the Division's allegations.

Moreover, Respondents have not offered any convincing authority that dismissal of the case against them is warranted. 38/ United States v. Gilmore, 39/ cited by Respondents, is an unpublished order issued by a district court in a criminal proceeding. The language in Gilmore quoted by Respondents ("There are situations where the Due Process Clause prohibits the government from presenting 'mutually inconsistent theories of the same case against different defendant'" 40/) is unhelpful because Respondents fail to identify the type of situation which might be covered by such a prohibition. In Gilmore, the court surmised that an example of a due process violation might include a situation where an inconsistency exists at the core of a criminal prosecutor's case against defendants for the same crime or where the evidence used at the two trials is factually inconsistent and irreconcilable. 41/ The court concluded that no such inconsistency existed in the Gilmore case. Respondents did not identify any inconsistency at the core of the Division's case, and point to no evidence that is factually inconsistent and irreconcilable.

E. Effect of Stay on Proceedings. Respondents claim that they have been prejudiced by the "indefinite" stay. The law judge, however, ordered the Division to report on May 25, 2007, and every ninety days thereafter, on the status of the Wilson proceeding and the continued appropriateness of the stay. The stay expired June 25, 2007. The law judge has scheduled the hearing to occur in October 2007.

38/ Cf. The Rockies Fund, Inc., 56 S.E.C. 1198, 1237-1238 (2003) (rejecting respondents' argument that, because the Division took an inconsistent position in a related proceeding, the Division was estopped from asserting certain charges against respondents).

39/ 2004 WL 539337 (W.D. Va. 2004) (unpublished order).

40/ Gilmore, 2004 WL 539337, at *2.

41/ Ibid.

In sum, Respondents have not demonstrated that their case involves "extraordinary circumstances," warranting dismissal of the proceeding against them.

Accordingly, IT IS ORDERED that the petition of Warren Lammert, Lars Soderberg, and Lance Newcomb to dismiss the order instituting proceedings in this matter be, and it hereby is, denied.

By the Commission.

Nancy M. Morris
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Campos
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56230 / August 9, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2667 / August 9, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12721

In the Matter of **JERRY KENT CASTLEMAN, CPA** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTION**

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 Jerry Kent Castleman ("Respondent" or "Castleman") pursuant to Rule 102(e)(3) of the Commission's Rules of Practice.[1]

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[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 ("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 Public Administrative Proceedings Pursuant to Rule 102(e)(3) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanction ("Order"), as set forth below.

III.

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

1. Castleman, age 43, is and has been a certified public accountant ("CPA") licensed to practice in the State of Texas. From March 1998 through September 2000, he was the Vice President and Chief Accounting Officer ("CAO") of Enron South America, and later the CAO of the Enron Industrial Markets division of Enron Corp. ("Enron" or the "company"). Prior to joining Enron's Corporate Accounting Unit in 1997, Castleman was an auditor at Arthur Andersen LLP.

2. Enron was, at all relevant times, an Oregon corporation with its principal place of business in Houston, Texas. Until its bankruptcy filing in December 2001, Enron was the seventh largest corporation in the United States based on reported revenue. In the previous ten years, Enron had evolved from a regional natural gas provider to a commodity trader of natural gas, electricity, and other physical commodities with retail operations in energy and other products. The Company also created and traded financial products. At all relevant times, the common stock of Enron was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the New York Stock Exchange.

3. On August 2, 2007, the U.S. District Court for the Southern District of Texas, Houston Division, entered a final judgment against Castleman, permanently enjoining him from violating Section 17(a) of the Securities Act of 1933, Sections 10(b) and 13(b)(5) of the Securities Exchange Act of 1934 and Exchange Act Rules 10b-5, 13b2-1 and 13b2-2, and from aiding and abetting violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Exchange Act Rules 12b-20, 13a-1 and 13a-13. Securities and Exchange Commission v. Jerry K. Castleman, et al., Civil Action Number 06-3226. The Court also ordered Castleman to pay $41,268.29, consisting of disgorgement of $30,000 and prejudgment interest of $11,268.29, with all but $12,000 waived, based upon Castleman's sworn financial statements and other documents and information.

4. The Commission's complaint alleged that Castleman and others participated in a transaction that defrauded Enron's security holders to enrich themselves and others. The complaint also alleges that Respondent's fraudulent conduct involved both the closing

of a sham sale pursuant to which Enron manufactured earnings, and the later unwinding of this sham sale by repurchasing the asset without reversing the previously (and improperly) recognized earnings.

IV.

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

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

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

B. After five years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission as an accountant provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Nancy M. Morris
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Campos Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8832 / August 9, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 56229 / August 9, 2007

INVESTMENT COMPANY ACT OF 1940
Release No. 27925 / August 9, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12720

In the Matter of **GENERAL AMERICAN LIFE INSURANCE COMPANY AND WILLIAM C. THATER,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b) AND 21C OF THE SECURITIES AND EXCHANGE ACT OF 1934, AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT of 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities and Exchange Act of 1934 ("Exchange Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against William C. Thater and pursuant to Section 8A of the Securities Act and Sections 9(b) and 9(f) of the Investment Company Act against General American Life Insurance Company.

II.

In anticipation of the institution of these proceedings, William C. Thater and General American Life Insurance Company ("Respondents") have submitted Offers of

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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 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities and Exchange Act of 1934 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Respondents

1. **General American Life Insurance Company ("General American")** is a St. Louis based insurance company offering, among other things, life and variable insurance products to consumers. General American is a wholly-owned subsidiary of GenAmerica Financial Corporation which is a subsidiary of MetLife, Inc., a public company and one of the world's largest financial services companies.

2. **William C. Thater ("Thater")** is a 52 year-old resident of Danbury, Connecticut. During the time of the conduct, Thater was a senior vice-president in charge of the sale of General American's private placement variable insurance products. Thater was also a registered representative associated with General American Distributors. Thater holds NASD Series 7 and Series 63 licenses. On November 3, 2003, Thater was terminated from General American as a result of the late trading arrangement discussed herein.

Overview

3. From January 2002 through November 2002 ("the relevant period"), Thater permitted and General American failed to prevent late trading of underlying mutual funds that were offered through General American's private placement variable universal life insurance ("PPVUL") policies. Specifically, on January 31, 2002, Thater entered into a written agreement, on General American letterhead, that gave a New York family exclusive late trading privileges in the mutual funds underlying the PPVUL policies that the family purchased for approximately $20 million in premium. During the relevant period, the New York family placed numerous trade requests, 79 of which they submitted, confirmed and/or cancelled after 4:00 p.m. ET. As a result of the New York family's late trading, the value of the underlying mutual funds was diluted by approximately $3.3 million.

Late Trading

4. "Late trading" is the transmission, placement, confirmation, or cancellation of orders to purchase or redeem mutual fund shares after 4:00 p.m. ET on a given day to be filled at the fund's net asset value ("NAV") calculated that same day. The daily price of mutual fund shares is generally calculated as of 4:00 p.m. ET. Orders to buy, sell or exchange mutual fund shares placed at or before 4:00 p.m. ET on a given day receive that day's NAV. Conversely, orders placed after 4:00 p.m. ET are supposed to be priced using the following trading day's NAV.

Private Placement Variable Universal Life Insurance Policies

5. PPVUL policies are unregistered securities that are to be sold only to sophisticated investors that meet certain minimum net worth requirements. PPVUL policies have both life insurance and investment components. With respect to the life insurance component, beneficiaries receive an income tax-free death benefit upon the death of the insured. With respect to the investment component, the policies accumulate income tax-free cash value through the investment of insurance premiums in the insurance company's segregated investment accounts known as "separate accounts." Through the separate accounts, which are also unregistered, PPVUL policyholders have access to a variety of underlying investment options, including mutual funds available only to investors in variable products. Such funds may have names similar to retail mutual funds and may be similarly managed. To invest in an underlying mutual fund, policyholders place transfer orders with the insurance company. On a daily basis, transfer orders for each fund are aggregated and a single omnibus order is transmitted to the mutual fund complex. The amount of the policy's death benefit and cash value are directly related to the performance of the underlying investments.

6. The PPVUL policies that General American issued to the New York family were sold through private placement memoranda ("PPMs"). PPMs are similar to prospectuses in that they address details concerning the allocation of premiums, expenses and fees charged, calculation of death benefits, loan privileges and the mechanics of transfers between investment options. In addition to PPMs, the New York family also received and signed insurance contracts that described the benefits to be provided under the insurance policies.

Thater Negotiated and Executed the Late Trading Agreement with the New York Family

7. In late 2001, the New York family asked Thater if General American would allow them to late trade mutual funds that participated in General American's PPVUL policies. On January 31, 2002, Thater and the New York family entered into a written agreement ("Agreement") on General American letterhead that provided the New York family with late trading privileges in the PPVUL policies they would thereafter purchase from General American.

8. Specifically, the trading privileges in the agreement included the ability to place transfer orders to buy or sell underlying mutual funds on each and every trading day until 5:30 p.m. Any purchase or redemption requests received prior to 5:30 p.m. would be deemed by General American to have been received prior to 4:00 p.m. and would get that day's unit price. This privilege was not to be made available to any other policyholder.

9. Following the execution of the Agreement, the New York family purchased PPVUL policies for which they paid General American approximately $20 million in premiums. The New York family was required to pay a $15,000 fee for the special trading privileges. General American issued the policies and the family began to trade. Between February 1, 2002 and November 18, 2002, seventy-nine of the New York family's transfer orders were late because they were either submitted, confirmed and/or cancelled after 4:00 p.m. ET. As a result of the New York family's late trading, the values of the subaccount mutual funds were diluted by approximately $3.3 million.

Thater Knew that Late Trading Was Not Permitted in the Mutual Funds that Participated in the PPVUL Policies

10. In January 2002, Thater negotiated, approved, and executed the Agreement allowing the New York family to submit trades after 4:00 p.m. ET.

11. In February 2002, soon after the policies were issued to the New York family, they began to late trade. Thater was aware that the New York family was engaging in this type of trading.

12. Within a week of the family's first trades, General American detected the family's late trading activities. General American's in-house counsel contacted Thater and told him to halt this conduct. However, despite this instruction, Thater made efforts to perpetuate the late trading activity. Specifically, in March 2002, Thater changed the New York family's trading arrangement to a "confirm or cancel" method where they would place trade orders before 4:00 p.m. ET but could confirm or cancel these trades after 4:00 p.m. ET. Thater continued to permit this "confirm or cancel" trading method after General American's in-house counsel advised him in late April 2002 that this method of trading would also violate the federal securities laws. Like post-4 p.m. trading, the confirm/cancel method allowed the New York family to consider post-4 p.m. market information when making their trading decisions.

13. Thater benefited from the sale of PPVUL policies to the New York family. The $20 million in life insurance policies Thater sold to the New York family represented about 50% of General American's PPVUL business for 2002. As a result of all of his sales, Thater received a salary bonus of $130,000. This bonus was $110,000 more than he received in bonus compensation for the previous year when Thater's PPVUL sales were much lower.

Certain General American Personnel Discovered the New York Family Arrangement But Their Efforts to Address the Late Trading Activity Were Insufficient

14. During the relevant period, certain General American personnel became aware of the Agreement and/or the New York family's late trading activity. While these employees at times told Thater to halt the activity, they failed to take adequate steps to investigate the activity and ensure that the late trading ceased.

15. The General American compliance officer responsible for overseeing General American's PPVUL business discovered the Agreement while the New York family was late trading, and thereafter sent a memorandum to Thater expressing concern over the special trading privileges arrangement. The compliance officer, however, never received a response from Thater and did not follow-up with Thater.

16. Further, a General American assistant vice-president in the company's operations department, which was responsible for providing administrative support for Thater's PPVUL department, was shown a draft of the Agreement before it was issued to the New York family. Moreover, after the policies became effective, the assistant vice-president also learned that General American's in-house counsel had determined that late trading was illegal. However, the operations department continued to assist with processing the New York family's trades and the assistant vice-president merely asked other General American employees to confer with Thater on this issue. He took insufficient steps to investigate the activities and ensure that any late trading ceased.

17. In addition, certain General American lawyers became aware at various times of the New York family's late trading activities. While these General American lawyers told Thater to halt the late trading, they later received red flags indicating that Thater was trying to perpetuate the New York family's late trading activity by proposing different arrangements, such as the confirm or cancel method.

General American's PPVUL Product Did Not Permit Late Trading

18. General American entered into participation agreements with the mutual fund companies that were offered through its PPVUL product. In certain participation agreements with the subaccount mutual funds, General American warranted that it would send orders for processing that were received before 4:00 p.m. ET or in accordance with mutual fund prospectuses, which did not permit late trading.

19. While making the above representations, Thater permitted the New York family to engage in late trading and General American did not take adequate steps to halt this activity.

<u>Violations</u>

20. As a result of the conduct described above, Thater willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange

Act and Rule 10b-5 thereunder. General American willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

21. As a result of the conduct described above, General American and Thater caused and willfully aided and abetted violations of Rule 22c-1 of the Investment Company Act by certain mutual funds, persons designated in such funds' prospectuses as authorized to consummate transactions in any such security, their principal underwriters, or dealers in the funds' securities, which requires such persons to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem.

Cooperation and Undertakings

22. In determining to accept General American's Offer, the Commission considered remedial acts promptly undertaken by General American and cooperation afforded to the Commission staff. General American shall continue to cooperate fully with the Commission in any and all investigations, litigation, or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, General American has undertaken:

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

b. to use their best efforts to cause their employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;

c. to use their best efforts to cause their employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

d. that in connection with any testimony of General American to be conducted by the staff of the Commission at deposition, hearing or trial pursuant to a notice or subpoena, General American:

   i. agrees that any such notice or subpoena for General American's appearance and testimony may be served by regular mail on its attorney, Neil S. Lang, Sutherland Asbill & Brennan, 1275 Pennsylvania Avenue N.W., Washington D.C. 20004-2415; and

   ii. agrees that any such notice or subpoena for General American's appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

General American also undertakes to:

23. **Distribution Plan.**

1. Within 90 days of the entry of the Order, General American shall develop a Distribution Plan to distribute fairly and proportionately to the affected mutual funds the total disgorgement and civil penalty described in Section IV.B and E. below. In developing the Distribution Plan, General American shall consult with the advisor for each affected mutual fund, or any successor fund. General American shall provide the advisor with (a) a copy of the Order, (b) the proposed amount of disgorgement and civil penalty to be paid to the affected mutual fund, and (c) a description of the methodology used to calculate that amount.

2. Within 120 days of the entry of this Order, General American shall provide to the Commission staff a copy of the Distribution Plan.

3. Within 150 days of the entry of the Order, General American shall, subject to approval of the Commission staff, submit the Distribution Plan to the Commission for the administration and distribution of disgorgement and civil penalty pursuant to Rule 1101 of the Commission's Rules of Practice.

4. Following a Commission order approving the final Distribution Plan, as provided in Rule 1104 of the Commission's Rules of Practice, General American shall take all necessary and appropriate steps to administer the final Distribution Plan including overseeing the actual distribution of the disgorgement and civil penalty to the affected mutual funds within 30 days of the Commission's approval of the Distribution Plan.

5. Within 10 days of the distribution of the disgorgement and civil penalty to the affected mutual funds, General American shall provide a written certification and proof of payment to the Commission staff of the amount paid to each affected mutual fund and the date of the payment.

6. General American shall bear the costs of administering and implementing the final Distribution Plan.

24. **Independent Compliance Consultant.**

a) General American[1] shall retain, within 90 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by General American. General American shall employ the Independent Compliance Consultant to: (a) conduct a review to determine whether the supervisory and compliance policies and procedures ("Polices and Procedures") that General American has adopted and implemented to address the conduct described in this Order are reasonably designed to detect and prevent any future late trading in any of its products; (b) determine whether and to what extent there is a need for additional or amended supervisory and compliance Policies and Procedures to detect and prevent late trading; and (c) recommend that General American adopt such additional or amended supervisory and compliance Policies and Procedures which the Independent Compliance Consultant believes are necessary to provide reasonable assurance that General American can detect and prevent late trading. General American shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to its files, books, records, and personnel as reasonably requested for the review.

b) General American shall require that, at the conclusion of the review, which in no event shall be more than 120 days after the date of entry of the Order, the Independent Compliance Consultant shall submit a Report to General American, its board of directors, and the staff of the Commission regarding the adequacy of the Policies and Procedures. The Report shall include a description of the review performed, the conclusions reached and, if necessary, the Independent Compliance Consultant's recommendations for changes in or improvements to policies and procedures of General American, and a procedure for implementing the recommended changes in or improvements to the Policies and Procedures.

c) General American shall adopt all recommendations contained in the Report of the Independent Compliance Consultant; provided, however, that within 60 days after the date of the submission of the Report ("Report Date"), General American shall in writing advise the Independent Compliance Consultant, its board of directors and the staff of the Commission of any recommendations that they consider to be unnecessary or inappropriate. With respect to any

[1] For purposes of paragraph 24, "General American" shall mean General American Life Insurance Company and its subsidiaries.

recommendation that General American considers unnecessary or inappropriate, General American need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose.

d) As to any recommendation with respect to which General American and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 120 days of the Report Date. In the event General American and the Independent Compliance Consultant are unable to agree on an alternative proposal, General American will abide by the determinations of the Independent Compliance Consultant.

e) One year from the Report Date, General American shall submit an affidavit to the Commission staff stating that it has implemented any and all actions recommended or agreed to by the Independent Consultant, or explaining the circumstances under which it has not implemented such actions.

f) General American (i) shall not have the authority to terminate the Independent Compliance Consultant, without the prior written approval of the staff of the Commission; (ii) shall compensate the Independent Compliance Consultant, and persons engaged to assist the Independent Compliance Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; (iii) shall not be in and shall not have an attorney-client relationship with the Independent Compliance Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Compliance Consultant from transmitting any information, reports, or documents to its board of directors or the Commission.

g) General American shall require the Independent Compliance Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Compliance Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with General American, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Compliance Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Compliance Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Midwest Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with General American, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

25. **Record Keeping.** General American 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 General American's compliance with the undertakings set forth above.

26. **Continuing Application of Undertakings.** The undertakings of General American herein shall continue to apply respectively to General American or its successors for as long as General American or its successors continue to offer and sell securities or until an undertaking terminates according to its terms; provided, however, that any successor to General American may petition the Commission and obtain relief from such undertakings if the successor can demonstrate that it has sufficient controls and procedures reasonably designed and implemented to detect and prevent the occurrence of the conduct summarized herein.

27. **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, in the public interest, and for the protection of investors to impose the sanctions in the Offers submitted by the Respondents.

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

A. William Thater shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Rule 22c-1 under the Investment Company Act.

B. William Thater shall, within 7 days of the entry of this Order, pay disgorgement in the amount of $100,000, prejudgment interest in the amount of $13,137.49, and a civil money penalty in the amount of $50,000, for a total of $163,137.49, to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Thater 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 Robert J. Burson, Senior Associate Regional Director, Chicago Regional Office, 175 West Jackson Street, Suite 900, Chicago, Illinois 60604.

C. William Thater 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, with the right to reapply for association after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission. Any reapplication for association by William Thater 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 William Thater, 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.

D. General American shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Rule 22c-1 under the Investment Company Act.

E. General American shall, within 7 days of the entry of this Order, pay disgorgement in the amount of $1.00 and a civil money penalty in the amount of $3.3 million to the Securities and Exchange Commission. The payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies General American 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 Robert J. Burson, Senior Associate Regional Director, Chicago Regional Office, 175 West Jackson Street, Suite 900, Chicago, Illinois 60604.

F. It is further ordered that, pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the disgorgement and penalties referenced in Section IV. B and E. above. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that it should not, after offset or reduction in any Related Investor Action based on Respondents' payment of disgorgement in this action, argue that it shall be entitled to, nor shall it further benefit by offset or reduction of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

G. General American shall comply with the undertakings enumerated in Section III.¶¶ 23-27 above.

By the Commission.

Nancy M. Morris
Secretary

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

Commissioner Atkins Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2631 / August 13, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12722

In the Matter of **RHODES ECONOMETRICS, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(e) 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(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Rhodes Econometrics, Inc. ("Rhodes Econometrics" 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, 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(e) 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. Rhodes Econometrics is an Oregon corporation formed in 1998 with its principal place of business in Lake Oswego, Oregon. C. Wesley Rhodes, Jr. ("Rhodes") is the sole owner and president of Rhodes Econometrics. Rhodes Econometrics registered with the Commission as an investment adviser on May 5, 1999.

2. On June 21, 2007, a final judgment was entered by consent against Rhodes Econometrics, permanently enjoining it from future violations of Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. C. Wesley Rhodes, Jr., et al., Civil Action Number CV06-01353-MO, in the United States District Court for the District of Oregon.

3. The Commission's complaint alleges that Rhodes, through Rhodes Econometrics and other companies Rhodes controlled, raised millions of dollars from individual investors by representing that he would invest their money in stock or bond funds or portfolios or directly in stocks and bonds. The complaint further alleges that in July 2006, Rhodes sent account statements to the individual investors showing that their balances had an aggregate value of nearly $40 million as of June 30, 2006. The complaint alleges that, contrary to representations made to investors, Rhodes had not been using the investors' money to invest in stocks and bonds and, instead, was actually misappropriating and misusing the investor funds for other purposes, including the purchase of automobiles and sports memorabilia. The complaint alleges that by the time a receiver was appointed for Rhodes Econometrics and other companies Rhodes controlled in September 2006, Rhodes and his companies had less than $2 million invested in stocks and bonds as compared to the almost $40 million that he had claimed was invested as of June 30, 2006, in the statements that he had provided to his investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(e) of the Advisers Act, that the registration of Respondent Rhodes Econometrics as an investment adviser be, and hereby is revoked.

By the Commission.

Nancy M. Morris
Secretary

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 56242 / August 13, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 2668 / August 13, 2007

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA
and
ROSEMARY MEYER, CPA

ORDER GRANTING PARTIAL PROTECTIVE ORDER

On July 3, 2007, Kevin Hall, CPA, and Rosemary Meyer, CPA, submitted a Motion seeking a protective order under Rule of Practice 322 1/ limiting disclosure of the motion, the accompanying memorandum, certain attachments and affidavits with accompanying exhibits, as well as all future briefing, filed in support of a motion for summary disposition filed by Hall and Meyer. Under Rule 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information." 2/ "A motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure." 3/ The Commission's staff has not opposed the Respondents' request for a protective order.

The Commission recognizes that the documents Respondents submitted contain sensitive information. At this stage in the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. On June 29, 2007, the Commission issued an order denying

1/ 17 C.F.R. § 201.322.

2/ 17 C.F.R. § 201.322(a).

3/ 17 C.F.R. § 201.322(b).

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Respondents' motion for summary disposition. 4/ We do not anticipate any further filings with respect to that matter.

We have determined that disclosure of certain information included in the documents now filed with us may be necessary to the resolution of the issues before the Commission and the Hearing Officer.

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the documents Hall and Meyer provided shall be disclosed only to the parties to this action, their counsel, the Hearing Officer, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.

2. All persons who receive access to these documents or the information contained in these documents shall keep them confidential and, except as provided in this Order, shall not divulge the documents or information to any person.

3. No person to whom the documents or information covered by this Order is disclosed shall make any copies or otherwise use such documents or information, except in connection with this proceeding or any appeal thereof.

4. The Office of the Secretary shall place the documents in sealed envelopes or other sealed containers marked with the title of this action, identifying each document and marked "CONFIDENTIAL."

5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the documents or to citation of particular information contained therein in testimony, oral argument, briefs, opinions, or in any other similar use directly connected with this action or any appeal thereof.

4/ Kevin Hall, Securities Exchange Act Rel. No. 55987 (Jun2 29, 2007), ___ SEC Docket ___.

6. The Commission expressly reserves the authority to reach a different conclusion regarding the confidentiality of the documents or information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.

Nancy M. Morris
Secretary

Florence E Harmon

By: Florence E Harmon
Deputy Secretary

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Commissioner Campos
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

CORRECTED

SECURITIES EXCHANGE ACT OF 1934
Release No. 56252 / August 15, 2007

INVESTMENT ADVISERS ACT OF 1940
Release No. 2634 / August 15, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12725

In the Matter of **Quattro Global Capital, LLC,** **Respondent.**	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Quattro Global Capital, LLC ("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 them and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940 (the "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. Quattro Global Capital, LLC ("Quattro"), is a registered investment adviser to a group of hedge funds (the "Funds") with assets of approximately $900 million as of June 2007. Quattro directs the Funds' investment decisions using a strategy focused on convertible debt arbitrage. Quattro, which was formed in 1998, is based in New York, New York and is closely held by its three principals.

Summary

2. This matter involves Quattro's repeated failure to file Forms 13F with the Commission between 2002 and mid-2005. Section 13(f) of the Exchange Act requires institutional investment managers who exercise investment discretion over at least $100 million of certain securities (called "Section 13(f) securities") to file a Form 13F quarterly with the Commission disclosing the Section 13(f) securities under management. The purpose of this disclosure requirement is to collect and disseminate to the public information about the holdings and investment activities of institutional money managers in order to assist investors, issuers and government regulators. Since 2001, Quattro's assets under management have exceeded the $100 million threshold in Section 13(f) securities, obligating Quattro to file a Form 13F each quarter beginning in 2002. However, Quattro failed to file any Forms 13F until July 2005, when the Commission's inspection staff began questioning Quattro about the absence of such filings.

Legal Framework

3. Section 13(f) of the Exchange Act and Rule 13f-1 thereunder require institutional investment managers who exercise investment discretion over $100 million or more of Section 13(f) securities – exchange-traded equities (including certain convertible debt securities) as described in Rule 13f-1 and as listed on the Commission's Official List of Section 13(f) Securities – to file Forms 13F with the Commission. The Form 13F must disclose the specific holdings in Section 13(f) securities under the manager's discretion as of the December quarter of the calendar year during which the $100 million threshold is reached and for the March, June and September quarters of the following year. The filings are due within 45 days of the end of each quarter.

4. The Congressional purpose in enacting Section 13(f) of the Exchange Act was "to create a central depository of historical and current data about the investment activities of institutional investment managers" to assist investors and government regulators. S. Rep. No. 94-75, 94th Cong., 2d Sess. 82-85 (1975). The information is valuable to the Commission because it "facilitate[s] consideration of the influence and impact of institutional investment managers on the securities markets and the public policy implications of that influence." Reporting by Institutional Investment Managers of Information With Respect To Accounts Over Which Investment Discretion is Exercised, Release No. 34-13396, at 1 (Mar. 22, 1977). The need for such information in the regulatory oversight of market practices is at least as acute today, when

institutional investment managers oversee in excess of $1 trillion of hedge fund investments, as it was in 1975 when Section 13(f) was enacted.

5. The information is also important to investors and issuers, as the Commission states in the instructions to Form 13F:

> The purpose of Form 13F is to provide a reporting and disclosure system to collect specific information and to disseminate such information to the public about the holdings of institutional investment managers who exercise investment discretion over certain accounts of equity securities . . . (generally, exchange traded or NASDAQ-quoted securities) having, in the aggregate, a fair market value of at least $100,000,000. We believe that investors will find Form 13F report information useful in tracking institutional investor holdings in their investments and that issuers, too, will find detail as to institutional investor holdings useful because much of their shareholder list may reflect holdings in "street name" rather than beneficial ownership.

Facts

6. Quattro began managing the Funds' assets in 1998. Beginning on the last trading day of June 2001, the fair market value of Section 13(f) securities – publicly-traded equity securities as described in Exchange Act Rule 13f-1(c) – managed by Quattro exceeded $100 million.[1]

7. Because Quattro exercised investment discretion with respect to more than $100 million worth of Section 13(f) securities on the last trading day of a month in 2001, Quattro was obligated to disclose its 2001 year-end holdings of Section 13(f) securities by filing a Form 13F with the Commission within 45 days of December 31, 2001. See Exchange Act Section 13(f); Exchange Act Rule 13f-1(a)(1). Quattro was also obligated to file additional Forms 13F as of the next three calendar quarters of 2002. Id.

8. Subsequently, Quattro's assets under management, including the Funds' holdings of Section 13(f) securities, increased steadily and by late 2004 exceeded $1 billion. Thus, from February 2002 through the present, Quattro has had a continuous obligation to file Forms 13F on a quarterly basis. Quattro failed to file any Forms 13F prior to July 2005.

9. Quattro had notice of the Form 13F filing requirement prior to July 2005. For example, the various drafts of Quattro's compliance manual, beginning in March 2004, described the Commission's Form 13F filing requirement, as did Quattro's January 2005 compliance manual,

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1 Each quarter, the Commission publishes a list of Section 13(f) securities to assist institutional investment managers in the preparation of their Form 13F filings. See Exchange Act Rule 13f-1(c).

which was implemented and distributed to all personnel at the end of January 2005.[2] Also in January 2005, Quattro's outside counsel sent a memo to all its hedge fund clients describing the Form 13F requirements and filing deadlines. That same month, Quattro's outside auditor emailed to Quattro a similar Form 13F reminder prepared by another law firm.

10. Quattro repeatedly failed to meet its statutory obligation to file reports pursuant to Section 13(f), and took no steps toward filing until questioned by the Commission's staff. In June 2005, while conducting an inspection of Quattro, the inspection staff of the Commission questioned Quattro's failure to make the required Form 13F filings. On July 20, 2005, in response to the inspection staff's questioning, Quattro made the determination to file its first Form 13F, for the quarter ending June 30, 2005.

11. In late July 2006, following further inquiry from the Enforcement Staff, Quattro filed 14 retrospective Forms 13F covering the period from 2002 to mid-2005.

Violations

12. As a result of the conduct described above, Quattro willfully violated Section 13(f)(1) of the Exchange Act and Rule 13f-1 thereunder by failing to file any Forms 13F from February 2002 to June 2005 despite its obligation to file Forms 13F on a quarterly basis during that period.[3]

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 that:

A. Pursuant to Section 203(e) of the Advisers Act, Quattro be, and hereby is, censured;

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[2] Pursuant to Advisers Act Rule 206(4)-7, all registered investment advisers were obligated to adopt and implement, by October 5, 2004, written policies and procedures reasonably designed to prevent violations of the Advisers Act. See Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204, IC-26299 (Dec. 17, 2003).

[3] "Willfully" as used in this Order means intentionally committing the act that constitutes the violation (cf. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965)), and there is no requirement that the actor also be aware that he is violating one of the Rules or securities Acts. Id.

B. Pursuant to Section 21C of the Exchange Act, Quattro cease and desist from committing or causing any violations and any future violations of Section 13(f) of the Exchange Act and Rule 13f-1 promulgated thereunder;

C. Quattro pay, within 30 days of the entry of this Order, a civil money penalty in the amount of $100,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Quattro as the Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Bruce Karpati, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, NY 10281.

By the Commission.

Nancy M. Morris
Secretary

Florence E Harmon

By: Florence E Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2633 / August 15, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12724

In the Matter of **Schultze Asset Management LLC and George J. Schultze,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Schultze Asset Management LLC and George J. Schultze (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 Sections 203(e), 203(f) and 203(k) of the Advisers Act (the "Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Respondents

1. Schultze Asset Management LLC ("SAM"), incorporated in 1998, has been registered with the Commission as an investment adviser since June 9, 2003. SAM is based in Purchase, New York and at the time of its initial registration with the Commission had assets

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under management of less than $50 million. SAM currently has approximately $733 million in assets under management, with approximately $629 million of those assets in hedge funds managed by SAM.

2. George J. Schultze ("Schultze"), age 37, is the sole principal of SAM. He lives in Rye Brook, New York.

Other Relevant Entity

3. SAMCO Distributors Inc. ("SAMCO"), incorporated by Schultze in 2001 and dissolved in 2005, had no office space other than its registered agent's office in Delaware. SAMCO's only asset was an electronic database of valuation spreadsheets that SAM sold to SAMCO for $1 pursuant to an asset sale agreement executed by Schultze on SAM and SAMCO's behalf. SAMCO then licensed the database back to SAM at a rate of $100 per hour. Schultze and SAM used SAMCO to secure soft dollar payments from broker-dealers to cover SAM's operating expenses by representing to them that the payments were for research.

Summary

4. This matter involves SAM's violations of the books and records and antifraud provisions of the Advisers Act, and Schultze's aiding and abetting of those violations. SAM misrepresented its client commission ("soft dollar") practices to an advisory client and, when asked by the Commission's Examination staff for documents pertaining to its soft dollar practices, SAM failed to produce and modified certain of those books and records.

5. Specifically, Schultze, on behalf of SAM, represented and certified three different times to an advisory client ("Client") that SAM was using client commissions generated by the account *only* for expenses covered by the safe harbor provided by Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") when, in fact, SAM knowingly used client commissions generated by the account to pay for *non*-Section 28(e) expenses, including Schultze's salary.

6. In addition, SAM, through Schultze, used SAMCO, to secure soft dollar payments from broker-dealers to cover some of SAM's operating expenses. SAMCO had no business purpose other than to provide a vehicle by which SAM and Schultze could secure soft dollars to pay SAM's operating expenses and Schultze's personal expenses. Schultze, in an attempt to conceal SAMCO's role from the Commission's Examination staff, failed to provide to the Examination staff a key agreement relating to SAMCO and then gave the staff a modified version of a second agreement.

Facts

SAM's False and Misleading Soft Dollar Representations

7. Prior to the spring of 2005, SAM, through Schultze, used soft dollars generated by transactions executed on behalf of its clients to cover its operating expenses, including salary, rent and health insurance. Such expenses were and are plainly outside of the safe harbor created by Section 28(e) of the Exchange Act, which, under certain circumstances, enables a money

manager, consistent with its fiduciary duty, to use commissions generated by client transactions to pay for certain "brokerage and research services."[1]

8. In January 2004, Schultze, on behalf of SAM, entered into an advisory contract with Client under which SAM agreed to limit its use of soft dollars from executions on Client's behalf to expenses within the Section 28(e) safe harbor, that is, to brokerage and research services. In each subsequent quarter of 2004, Schultze certified to Client in writing that it was in compliance with this soft dollar policy. Despite these representations, however, SAM willfully obtained, between 2004 and 2005, over $20,000 in soft dollars generated by transactions on behalf of Client to pay for SAM's operating expenses, including Schultze's salary – expenses that were, and are, outside the Section 28(e) safe harbor.

SAM Failed to Provide Records and Modified an Agreement

9. During an inspection in the spring of 2005, the Commission's Examination staff sought information from SAM concerning its soft dollar practices. In conducting its examination, the staff discovered references to SAMCO and asked for all agreements between SAM and SAMCO.

10. SAMCO was formed by Schultze in 2001 and, shortly thereafter, he executed an asset sale agreement transferring SAM's electronic database of valuation models – Microsoft Excel spreadsheets Schultze created to analyze investment opportunities for SAM's clients – to SAMCO in exchange for $1. SAM, through Schultze, failed to produce this agreement to the Examination staff. Also in 2001, Schultze executed a second agreement whereby SAMCO licensed the database back to SAM at a rate of $100 per hour. The licensing agreement stated that all payments made to SAMCO were to "fall within the purview of section 28(e)." SAM, through Schultze, failed to produce the original, executed licensing agreement to the Examination staff and, as described below, produced a modified version of the agreement to the Examination staff.

11. After execution of the sale and license agreements, Schultze continued, as before, conducting investment research and creating valuation spreadsheets for the benefit of SAM's clients at his home and at SAM's offices. However, SAMCO had no employees, no physical address, no clients and did not seek to obtain clients for its valuation research database. Instead, Schultze used SAMCO to secure soft dollar payments from broker-dealers to cover some of SAM's operating expenses and his own personal expenses by representing to broker-dealers that the payments were for research services. Schultze accomplished this by regularly preparing invoices from SAMCO to SAM for "Electronic Database Research Services" and then forwarding the invoices to broker-dealers for payment. The broker-dealers, in turn, paid SAMCO with soft dollars generated by brokerage transactions executed on behalf of SAM's clients. Schultze used the approximately $350,000 in soft dollar payments made to SAMCO to pay SAM's operating expenses and his own personal expenses. Those expenses were, and are, outside the safe harbor provided by Section 28(e).

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[1] See generally Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act, Release No. 34-54165 (July 18, 2006).

12. In response to the Examination staff's inquiries regarding SAMCO, Schultze tried to recast SAMCO as a vehicle to pay his salary. Thus, during the examination, SAM, through Schultze, printed out an electronic version of the 2001 licensing agreement, but with an added sentence not contained in the executed version. The added sentence stated that "all payments to [SAMCO] under this agreement will subsequently be credited to George Schultze as salary." The change was designed to cloud the true nature of SAMCO. Schultze signed this modified version of the agreement and provided it to the Examination staff as if it were the original licensing agreement.

SAM's Return of Funds and Retention of a Compliance Consultant

13. When the Examination staff continued questioning the SAMCO payments, SAM undertook certain remedial efforts. SAM voluntarily returned approximately $350,000 to its clients, representing all soft dollar payments made by broker-dealers to SAMCO. In addition, SAM voluntarily retained the services of an outside compliance consulting firm to assist SAM with fulfilling its obligations under the Advisers Act.

Violations

14. Section 206(1) of the Advisers Act prohibits an investment adviser from employing any device, scheme, or artifice to defraud any client or prospective client. Section 206(2) of the Advisers Act makes it unlawful for an adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. As a result of the conduct described above, SAM willfully violated, and Schultze willfully aided and abetted and caused SAM's violations of, Sections 206(1) and 206(2) of the Advisers Act by misrepresenting to Client that it was restricting its use of soft dollars, with respect to Client, to those expenses covered by Section 28(e) of the Exchange Act and by using soft dollar payments associated with transactions on Client's behalf to cover SAM's operating expenses, including Schultze's salary.

15. Section 204 of the Advisers Act requires that investment advisers registered with the Commission maintain and preserve such books and records as the Commission may prescribe by rule and make them available to Commission representatives during examinations. Rule 204-2(a) under the Advisers Act requires that registered investment advisers "make and keep true, accurate and current . . . (10) [a]ll written agreements (or copies thereof) . . . relating to the business of such investment adviser." As a result of the conduct described above, SAM willfully violated, and Schultze willfully aided and abetted and caused SAM's violations of, Section 204 of the Advisers Act and Rule 204-2(a)(10) promulgated thereunder by failing to maintain and provide to Commission Examination staff true, accurate or current written agreements relating to SAM's business.

Remedial Efforts

16. In determining to accept Respondents' Offers, the Commission considered the remedial acts voluntarily undertaken by SAM.

IV.

Undertakings

Respondent SAM undertakes to:

17. Mail or cause the hedge fund administrator to mail a copy of this Order to each existing investor in any hedge fund SAM manages and to each investment advisory client of SAM within 30 days following the entry of this Order. The Order shall be sent by certificate of mailing, along with a cover letter in a form not unacceptable to the staff of the Commission. Within seven calendar days after the expiration of the 30-day period following the entry of this Order, SAM shall notify Bruce Karpati, Assistant Regional Director of the New York Regional Office, in writing that this undertaking has been completed.

18. From the effective date of this Order until the expiration of 12 months, provide a copy of the Order to all prospective investors in hedge funds managed by SAM and prospective investment advisory clients of SAM not less than 48 hours prior to entering into any written or oral investment arrangement (or no later than the time of entering into such contract, if the investor has the right to terminate the contract without penalty within five business days after entering into the contract). Within one month after the expiration of this 12-month period, SAM shall notify Bruce Karpati, Assistant Regional Director of the New York Regional Office, in writing that this undertaking has been completed.

V.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 203(e) of the Advisers Act, SAM be, and hereby is, censured;

B. Pursuant to Section 203(f) of the Advisers Act, Schultze be, and hereby is, censured;

C Pursuant to Section 203(k) of the Advisers Act, SAM and Schultze cease and desist from committing or causing any violations and any future violations of Sections 204, 206(1) and 206(2) of the Advisers Act and Rule 204-2(a) promulgated thereunder;

D. SAM and Schultze, within 30 days of the entry of this Order, pay civil money penalties in the amounts of $100,000 and $50,000, respectively, to the United States Treasury. Such payments shall be: (A) made by United States postal money orders, certified checks, bank cashier's checks or bank money orders; (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 letters that identify SAM and Schultze as Respondents in these proceedings and the file number of these proceedings, copies of which cover letters and money orders or checks shall be sent to Bruce Karpati, Assistant Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, NY 10281.

E. SAM shall comply with the undertakings enumerated in paragraphs 17-18, above.

By the Commission.

Nancy M. Morris
Secretary

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 232

[Release Nos. 33-8834; 34-56256; 39-2448; IC-27928]

RIN 3235-AG96

Adoption of Updated EDGAR Filer Manual

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the Commission) is adopting revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual to reflect updates to the EDGAR system. Revisions are being made primarily to support the expansion of the current interactive data voluntary reporting program to enable mutual funds voluntarily to submit supplemental tagged information contained in the risk/return summary section of their prospectuses on Form N-1A. The EDGAR system is being upgraded to support this functionality on August 20, 2007.

The filer manual is also being revised to incorporate changes in support of several final rules previously adopted by the Commission and implemented in EDGAR. Those rules include the termination of a foreign private issuer's registration of a class of securities under Section 12(g) and duty to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act"); the electronic filing of Transfer Agent ("TA") forms TA-1, TA-2 and TA-W; and revisions to the accelerated filer definition under the Exchange Act. Other revisions were made to allow an issuer to indicate whether it is subject to reporting obligations after terminating registration of a class of equity securities under the Exchange Act and to remove references to

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submission types N-14AE and N-14AE/A for the filing of Form N-14 from "Table 3-5: Investment Company Submission Types Accepted by EDGAR" of the Filer Manual.

Revisions to the Filer Manual reflect changes within Volumes I and II, entitled EDGAR Filer Manual, Volume I: "General Information," Version 4 (August 2007) and EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 5 (August 2007) respectively. The updated manual will be incorporated by reference into the Code of Federal Regulations.

EFFECTIVE DATE: August 20, 2007. The incorporation by reference of the EDGAR Filer Manual is approved by the Director of the Federal Register as of August 20, 2007.

FOR FURTHER INFORMATION CONTACT: In the Office of Information Technology, Rick Heroux, at (202) 551-8800; in the Division of Investment Management, for questions concerning the expansion of the current interactive data voluntary reporting program, Alberto H. Zapata, Senior Counsel, or Brent J. Fields, Assistant Director, Office of Disclosure Regulation, at (202) 551-6784, and for questions concerning investment company filings, Ruth Armfield Sanders, Senior Special Counsel, Office of Legal and Disclosure, at (202) 551-6989; in the Division of Market Regulation, for questions concerning the electronic filing of Transfer Agent forms, Catherine Moore, Special Counsel, Office of Clearance and Settlement, at (202) 551-5710; and in the Division of Corporation Finance, for questions concerning the definition of accelerated filer for periodic reports, Katherine W. Hsu, Special Counsel, Office of Rulemaking, at (202) 551-3430 and for questions concerning termination of a foreign private issuer's registration, Elliot Staffin, Special Counsel, Office of International Corporate Finance, at (202) 551-3450.

SUPPLEMENTARY INFORMATION: Today we are adopting an updated EDGAR Filer Manual, Volumes I and II. The Filer Manual describes the technical formatting requirements for the preparation and submission of electronic filings through the EDGAR system.[1] It also describes the requirements for filing using EDGARLink[2] and the Online Forms/XML Web site.

The Filer Manual contains all the technical specifications for filers to submit filings using the EDGAR system. Filers must comply with the applicable provisions of the Filer Manual in order to assure the timely acceptance and processing of filings made in electronic format.[3] Filers should consult the Filer Manual in conjunction with our rules governing mandated electronic filing when preparing documents for electronic submission.[4]

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[1] We originally adopted the Filer Manual on April 1, 1993, with an effective date of April 26, 1993. Release No. 33-6986 (April 1, 1993) [58 FR 18638]. We implemented the most recent update to the Filer Manual on February 6, 2006. See Release No. 33-8656 (January 27, 2006) [71 FR 5596].

[2] This is the filer assistance software we provide filers filing on the EDGAR system.

[3] See Rule 301 of Regulation S-T (17 CFR 232.301).

[4] See Release Nos. 33-6977 (February 23, 1993) [58 FR 14628], IC-19284 (February 23, 1993) [58 FR 14848], 35-25746 (February 23, 1993) [58 FR 14999], and 33-6980 (February 23, 1993) [58 FR 15009] in which we comprehensively discuss the rules we adopted to govern mandated electronic filing. See also Release No. 33-7122 (December 19, 1994) [59 FR 67752], in which we made the EDGAR rules final and applicable to all domestic registrants; Release No. 33-7427 (July 1, 1997) [62 FR 36450], in which we adopted minor amendments to the EDGAR rules; Release No. 33-7472 (October 24, 1997) [62 FR 58647], in which we announced that, as of January 1, 1998, we would not accept in paper filings that we require filers to submit electronically; Release No. 34-40934 (January 12, 1999) [64 FR 2843], in which we made mandatory the electronic filing of Form 13F; Release No. 33-7684 (May 17, 1999) [64 FR 27888], in which we adopted amendments to implement the first stage of EDGAR modernization; Release No. 33-7855 (April 24, 2000) [65 FR 24788], in which we implemented EDGAR Release 7.0; Release No. 33-7999 (August 7, 2001) [66 FR 42941], in which we implemented EDGAR Release 7.5; Release No. 33-8007 (September 24, 2001) [66 FR 49829], in which we implemented EDGAR Release 8.0; Release No. 33-8224 (April 30, 2003) [68 FR 24345], in which we implemented EDGAR Release 8.5; Release Nos. 33-8255 (July 22, 2003) [68 FR 44876] and 33-8255A (September 4, 2003) [68 FR 53289] in which we implemented EDGAR Release 8.6; Release No. 33-8409 (April 19, 2004) [69 FR 21954] in which we implemented EDGAR Release 8.7; Release No. 33-8454 (August 6, 2004) [69 FR 49803] in which we implemented EDGAR Release 8.8; Release No. 33-8528 (February 3, 2005) [70 FR 6573] in which we implemented EDGAR Release 8.10; Release No. 33-8573 (May 19, 2005) [70 FR 30899] in which we implemented EDGAR Release 9.0; Release No. 33-8612 (September 21, 2005) [70 FR 57130] in which the Commission granted the authorization to publish the release adopting the reorganized EDGAR Filer Manual; Release No. 33-8633 (November 1, 2005) [70 FR 67350] in which we implemented EDGAR Release 9.2; and Release No 33-8656 (January 27, 2006) [71 FR 5596] in which we implemented EDGAR Release 9.3.

Revisions are being made primarily to support the final rule[5] adopted by the Commission to extend the current interactive data voluntary reporting program to enable mutual funds voluntarily to submit supplemental tagged information contained in the risk/return summary section of their prospectuses from Form N-1A using the mutual fund risk/return summary taxonomy developed by the Investment Company Institute ("ICI"). As with the voluntary interactive data program initiated by the Commission in 2005, in which companies voluntarily agree to furnish financial data as exhibit documents in eXtensible Business Reporting Language ("XBRL") format, the risk/return summary data submitted by mutual funds must also be provided as exhibit documents in XBRL format. A mutual fund submitting tagged risk/return summary information as an exhibit to Form N-1A will be required to name each document "EX-100" as specified in the EDGAR Filer Manual. In addition, the XBRL exhibit documents submitted require the use of the appropriate version of standard taxonomies supported by EDGAR. Those standard taxonomies, including the ICI's Mutual Fund Risk/Return Summary Taxonomy, are provided on the SEC's "Information for EDGAR Filers" webpage and include a listing of applicable XBRL schemas and linkbases. Core XBRL, XBRL linkbase, eXtensible Markup Language (XML), and XLink schemas and specifications are listed in the EDGAR Filer Manual, Volume II: "EDGAR Filing". A mutual fund choosing to tag its risk/return summary information also would continue to file this information in HTML or ASCII format, as currently required.

The filer manual is also being revised to incorporate changes made to support final rules previously adopted by the Commission and implemented in EDGAR. Those rules and EDGAR changes are described below.

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[5] See Release No. 33-8823 (July 11, 2007) [72 FR 39290].

- The termination of a foreign private issuer's 12(g) reporting obligations[6] regarding a class of debt securities and to cease its duty to file reports under Section 13 (a) or 15(d) of the Exchange Act;

  This revision included the addition of new submission types 15F-12B, 15F-12B/A, 15F-12G, 15F-12G/A, 15F-15D, 15F-15D/A which can be submitted using the EDGARLink software and Submission Template #3.

- The electronic filing of forms[7] TA-1, TA-2 and TA-W;

  This revision included the addition of electronic forms for the filing of the registration, annual report, and withdrawal from registration of transfer agents. The EDGARLite application was introduced as the tool for filers to use in the creation of their EDGAR submissions. Filers download the EDGARLite package from the EDGAR OnlineForms/XML Web site and install it on their desktop. EDGARLite consists of a Commercial off the Shelf (COTS) software package, Microsoft InfoPath[8] (MS InfoPath), and electronic form templates provided by the Commission. The forms are encoded in Extensible Markup Language (XML) and are submitted to EDGAR using the OnlineForms/XML Web site.

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[6] See Release No. 34-55540 (March 27, 2007) [72 FR 16934].

[7] See Release No. 34-54864 (December 4, 2006) [71 FR 74698].

[8] MS InfoPath 2003 or MS InfoPath 2007 can be used and comes with the Professional Enterprise Edition of Microsoft Office or can be purchased separately for approximately $200.

- Revisions to the accelerated filer definition[9] and accelerated periodic report filing deadlines under the Exchange Act;

The addition of a required "Accelerated Filer Status" indicator to EDGARLink submission headers for 10-K, 10-K/A, 10-KT, 10-KT/A, 20-F, and 20-F/A forms allows filers of these form types to select one of the following accelerated filer classification values: Large Accelerated Filer, Accelerated Filer, Non-accelerated Filer, and Not Applicable (should be used if a filer is filing an amendment to a Form 10-K or Form 20-F submission for a period that occurred before the accelerated filer definition went into effect). The accelerated filer classification is directly related to the filer's reporting deadline as illustrated in the following:[10]

Category of Filer	**Revised Deadlines For Filing Periodic Reports**	
	Form 10-K Deadline	**Form 10-Q Deadline**
Large Accelerated Filer ($700MM or more)	75 days for fiscal years ending before December 15, 2006 and 60 days for fiscal years ending on or after December 15, 2006	40 days
Accelerated Filer ($75MM or more and less than $700MM)	75 days	40 days
Non-accelerated Filer (less than $75MM)	90 days	45 days

Additional revisions were made to permit a domestic issuer to indicate whether reporting obligations still exist after terminating registration of a class of equity securities under the

[9] See Release No. 33-8644 (December 21, 2005) [70 FR 76626].

[10] See Release No. 33-8644 (December 21, 2005) [70 FR 76626].

Exchange Act. The addition of a required "Duty to File Reports Remains" indicator in EDGARLink submission headers for submission types15-12B, 15-12B/A, 15-12G, 15-12G/A, 15-15D and 15-15D/A allows filers of these form types to indicate whether it is still subject to reporting obligations under the Exchange Act.

Finally, we removed from "Table 3-5: Investment Company Submission Types Accepted by EDGAR" of the Filer Manual the reference to submission types N-14AE and N-14AE/A for the filing of Form N-14. All open-end investment companies, including those filed with automatic effectiveness under Rule 488 (business combinations), are to use submission types N-14 and N-14/A for these filings.

For the extension of the current interactive data voluntary reporting program to enable mutual funds voluntarily to submit supplemental tagged information contained in the risk/return summary section of their prospectuses being implemented in EDGAR Release 9.7, the EDGARLink software and submission templates will not be updated. Notice of the new release has previously been provided on the EDGAR Filing Web site and on the Commission's public Web site. The discrete updates are reflected in the updated Filer Manual Volumes.

Along with adoption of the Filer Manual, we are amending Rule 301 of Regulation S-T to provide for the incorporation by reference into the Code of Federal Regulations of today's revisions. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51.

You may obtain paper copies of the updated Filer Manual at the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1580, Washington DC 20549, on official business days between the hours of 10:00am and 3:00pm. We will post electronic format copies on the Commission's Web site; the address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You may also obtain copies from Thomson Financial, the paper document contractor for the Commission, at (800) 638-8241.

Since the Filer Manual relates solely to agency procedures or practice, publication for notice and comment is not required under the Administrative Procedure Act (APA)[11]. It follows that the requirements of the Regulatory Flexibility Act[12] do not apply.

The effective date for the updated Filer Manual and the rule amendments is August 20, 2007. In accordance with the APA[13], we find that there is good cause to establish an effective date less than 30 days after publication of these rules. The EDGAR system upgrade to Release 9.7 is scheduled to become available on August 20, 2007. The Commission believes that it is necessary to coordinate the effectiveness of the updated Filer Manual with the scheduled system upgrade.

Statutory Basis

We are adopting the amendments to Regulation S-T under Sections 6, 7, 8, 10, and 19(a) of the Securities Act of 1933,[14] Sections 3, 12, 13, 14, 15, 23, and 35A of the Exchange Act ,[15] Section 319 of the Trust Indenture Act of 1939,[16] and Sections 8, 30, 31, and 38 of the Investment Company Act of 1940.[17]

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11 5 U.S.C. 553(b).

12 5 U.S.C. 601- 612.

13 5 U.S.C. 553(d)(3).

14 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a).

15 15 U.S.C. 78c, 78l, 78m, 78n, 78o, 78w, and 78ll.

16 15 U.S.C. 77sss.

17 15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37.

List of Subjects in 17 CFR Part 232

Incorporation by reference, Reporting and recordkeeping requirements, Securities.

TEXT OF THE AMENDMENT

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 232 - REGULATION S-T—GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

1. The authority citation for Part 232 continues to read in part 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), 79t(a), 80a-8, 80a-29, 80a-30, 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

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2. Section 232.301 is revised to read as follows:

§232.301 EDGAR Filer Manual.

Filers must prepare electronic filings in the manner prescribed by the EDGAR Filer Manual, promulgated by the Commission, which sets out the technical formatting requirements for electronic submissions. The requirements for becoming an EDGAR Filer and updating company data are set forth in the updated EDGAR Filer Manual, Volume I: "General Information," Version 4 (August 2007). The requirements for filing on EDGAR are set forth in the updated EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 5 (August 2007). Additional provisions applicable to Form N-SAR filers are set forth in the EDGAR Filer Manual, Volume III: "N-SAR Supplement," Version 1 (September 2005). All of these provisions have been incorporated by reference into the Code of Federal Regulations, which action was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51. You must comply with these requirements in order for documents to be timely received and accepted. You can obtain paper copies of the EDGAR Filer Manual from the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00am and 3:00pm, or by calling Thomson Financial at (800) 638-8241. Electronic copies are available on the Commission's Web site. The address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You can also photocopy the document at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call 202–741–6030, or go to: http://www.archives.gov/federal_register/code_of_federal_regulations/ibr_locations.html.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

August 15, 2007

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8835 / August 15, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 56260 / August 15, 2007

In the Matter of MERCURY INTERACTIVE, LLC (f/k/a MERCURY INTERACTIVE CORPORATION), Respondent.	**ORDER UNDER SECTION 27A(b) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b) OF THE SECURITIES EXCHANGE ACT OF 1934, GRANTING WAIVERS OF THE DISQUALIFICATION PROVISIONS OF SECTION 27A(b)(1)(A)(ii) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b)(1)(A)(ii) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO HEWLETT-PACKARD COMPANY**

Hewlett-Packard Company ("HP") has submitted a letter, dated July 12, 2007, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from the settlement by Mercury Interactive, LLC (f/k/a Mercury Interactive Corporation) ("Mercury") of a civil action against it. Mercury is a wholly-owned subsidiary of HP. On May 31, 2007, the Commission filed a settled federal court action against Mercury in the United States District Court for the Northern District of California. In its complaint, the Commission alleged that Mercury violated (among other provisions) Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. Without admitting or denying the allegations, Mercury consented to a final judgment that enjoins it from committing future violations of these (and other) provisions, and orders it to pay a civil penalty in the amount of $28 million (the "Consent and Final Judgment").

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward-looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial . . . order arising out of a government action that . . . prohibits future violations of the antifraud provisions of the federal securities laws."

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Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications apply except "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.

Because the violations alleged in the civil action were committed at Mercury before HP acquired Mercury, and because the civil action does not involve allegations of misconduct by HP or name or seek to add HP as a party for relief or other purposes, or require undertakings by or involving HP as part of the Consent and Judgment, the Commission has determined that HP's request for a waiver of the disqualifications resulting from the Consent and 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 a waiver from the disqualification provisions of 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to HP resulting from the entry of the Consent and Final Judgment is hereby granted.

By the Commission.

Nancy M. Morris
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

r: Commissioner Atkins
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2635 / August 16, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12726

In the Matter of **JOSEPH A. FROHNA,** **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 Joseph A. Frohna ("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. Respondent is forty-three years old and resides in Waukesha, Wisconsin. From February 1995 to March 2004, Respondent was associated with U.S. Bancorp Asset Management, Inc. ("USBAM"), an investment adviser registered with the Commission. During the relevant time period, Respondent was employed by USBAM as, among other things, the portfolio manager of First American Investment Funds, Inc.'s Micro Cap Fund (the "Fund").

2. On August 7, 2007, a final judgment was entered by consent against Respondent, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. Joseph A. Frohna, et al., Civil Action Number 07-C-0702, in the United States District Court for the Eastern District of Wisconsin.

3. The Commission's complaint alleged that, on April 3, 2002, Respondent received nonpublic information about a joint bio-equivalence study (the "Bio-Equivalence Study") on a drug that Genentech, Inc. was developing with XOMA, Ltd. ("XOMA"). Specifically, Respondent learned from his brother, who led the Bio-Equivalence Study, that the study was not going well. Respondent previously knew the Bio-Equivalence Study was being conducted in order to obtain Food and Drug Administration approval of a drug critical to the short term success of XOMA. Based on this information, the next day Respondent directed the Fund that he managed to aggressively sell all of its XOMA shares. The following day, April 5, 2002, XOMA and Genentech issued a press release announcing that the Bio-Equivalence Study had been unsuccessful. That day, XOMA's stock price declined 42 percent. The Fund avoided a total of $954,776 in losses by selling all of its XOMA shares the day before this announcement.

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 that:

Respondent be, and hereby is, suspended from association with any investment adviser for a period of twelve months, effective on the second Monday following the entry of this Order. Respondent shall provide to the Commission, within 20 days after the end of the twelve month suspension period described above, an affidavit that he has complied fully with the suspension.

By the Commission.

Nancy M. Morris
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Atkins
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56283 / August 17, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12728

In the Matter of **BRIAN LEE,** **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 Brian Lee ("Lee" 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.

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

1. During the relevant time period, Lee allegedly was a 50 percent owner of First Choice Productions, Inc. ("First Choice"), a California corporation with its principal place of business in La Jolla, California. Lee has never been registered with the Commission pursuant to Section 15(b) of the Exchange Act. Lee currently is a resident of Los Angeles, California.

2. On August 8, 2007, a final judgment was entered by consent against Lee without admitting or denying the allegations of the Complaint, permanently enjoining him from future violations of Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder and Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933 in the civil action entitled Securities and Exchange Commission v. Brian Lee, et al., Civil Action Number 03-CV-1957-JAH(CAB), in the United States District Court for the Southern District of California.

3. The Commission's complaint alleged that Lee and others sold unregistered securities in Zandria Entertainment Networks, Inc. ("ZEN") to investors nationwide using the mails or other interstate means without being registered as brokers or dealers with the Commission. Lee and others allegedly sold ZEN securities through First Choice, a telemarketing company owned by Lee and another individual. The Complaint alleged, among other things, that Lee and others made material misrepresentations to investors when selling ZEN securities, which included misrepresentations regarding the amount of commissions collected from investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Lee 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

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Atkins
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56282 / August 17, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12727

In the Matter of TODD DIROBERTO, 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 Todd DiRoberto ("DiRoberto" 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.

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

1. During the relevant time period, DiRoberto was a 50 percent owner of First Choice Productions, Inc. ("First Choice"), a California corporation with its principal place of business in La Jolla, California. DiRoberto has never been registered with the Commission pursuant to Section 15(b) of the Exchange Act. DiRoberto currently is a resident of San Diego, California.

2. On August 8, 2007, a final judgment was entered by consent against DiRoberto, permanently enjoining him from future violations of Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder and Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933 in the civil action entitled Securities and Exchange Commission v. Brian Lee, et al., Civil Action Number 03-CV-1957-JAH(CAB), in the United States District Court for the Southern District of California.

3. The Commission's complaint alleged that DiRoberto and others sold unregistered securities in Zandria Entertainment Networks, Inc. ("ZEN") to investors nationwide using the mails or other interstate means without being registered as brokers or dealers with the Commission. DiRoberto and others sold ZEN securities through First Choice, a telemarketing company owned by DiRoberto and another individual. The Complaint alleged, among other things, that DiRoberto and others made material misrepresentations to investors when selling ZEN securities, which included misrepresentations regarding the amount of commissions collected from investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent DiRoberto 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

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- 56275; File No. SR-CBOE-2007-26)

August 17, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change to List and Trade Credit Default Basket Options, as Modified by Amendment No. 3, and Designating Credit Default Basket Options as Standardized Options under Rule 9b-1 of the Securities Exchange Act of 1934

I. Introduction

On April 5, 2007, 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 options[3] based on the occurrence of credit events in the debt securities of one or more issuers, referred to as credit default basket options. On June 15, 2007, CBOE filed Amendment No. 1 to the proposed rule change; on June 19, 2007, CBOE withdrew Amendment No. 1 and filed Amendment No. 2 to the proposed rule change; and on June 21, 2007, CBOE withdrew Amendment No. 2 and filed Amendment No. 3 to the proposed rule change.[4] The proposed rule change, as modified by Amendment No. 3, was published for comment in the Federal Register on June 28, 2007 for a 15-day comment period.[5] The Commission received no comments on the proposal. This order

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 A binary option is a style of option having only two possible payoff outcomes: either a fixed amount or nothing at all.

4 Amendment No. 3 replaced the original filing in its entirety.

5 See Securities Exchange Act Release No. 55938 (June 21, 2007), 72 FR 35523 ("CBOE Proposal").

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approves the proposed rule change, as modified by Amendment No. 3, and designates credit default basket options as "standardized options" pursuant to Rule 9b-1 under the Act.[6]

II. Description of the CBOE Proposal

A. Generally

On June 6, 2007, the Commission approved a proposal by CBOE to list and trade credit default options, which are cash-settled binary options that are automatically exercised upon the occurrence of specified credit events or expire worthless.[7] CBOE now proposes to list and trade credit default basket options, which are cash-settled binary options based on a basket of at least two Reference Entities (described below). This proposal would add new rules applicable to credit default basket options and amend certain existing rules applicable to credit default options to make them applicable to credit default basket options.

Credit default options are referenced to debt securities issued by a specified public company ("Reference Entity")[8] and either have a fixed payout or expire worthless, depending upon whether a credit event occurs during the life of the option. Upon confirmation of a credit

6 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 of "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).

7 See Securities Exchange Act Release No. 55871, 72 FR 32372 (June 12, 2007) (SR-CBOE-2006-84) (approving CBOE's proposal to list and trade credit default options) ("Credit Default Option Approval Order"). See also Securities Exchange Act Release No. 55919 (June 18, 2007), 72 FR 34498 (June 22, 2007) (SR-CBOE-2007-62) (making various technical changes to CBOE's credit default option rules).

8 Proposed CBOE Rule 29.1(f) also includes as a "Reference Entity" the guarantor of the debt security underlying the credit default option. For purposes of credit default basket options, Reference Entities are referred to as "Basket Components." See proposed CBOE Rule 29.1(h).

event prior to the last day of trading of a credit default option series,[9] the options positions existing as of that time are automatically exercised and the holders of long options positions receive a fixed cash payment of $100,000 per contract.[10] If no credit event is confirmed during the life of the option, the final settlement price is $0.

Credit default basket options are like credit default options, but instead of being based on the debt securities of one Reference Entity, they are based on the debt securities of two or more Reference Entities, or Basket Components. There would be two types of credit default basket options: (i) multiple payout credit default basket options that automatically pay holders a cash settlement amount each time a credit event is confirmed in a Basket Component during the life of the option, after which the applicable Basket Component would be removed from the basket, or expire worthless if no credit events are confirmed during the life of the option; and (ii) single payout credit default basket options that automatically pay holders a single cash settlement amount when the first credit event is confirmed in any Basket Component, or expire worthless if no credit event for any Basket Component is confirmed during the life of the option.[11] Unlike a

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9 CBOE Rule 29.9(c) (to be relettered CBOE Rule 29.9(d)) 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.

10 However, the settlement amount could be adjusted pursuant to proposed CBOE Rule 29.4.

11 Credit events that trigger an automatic pay out include a failure to make payment pursuant to the terms of an underlying debt security and any other event of default specified by CBOE at the time it initially lists a particular class of credit default basket options. For each Basket Component, the events of default that CBOE may specify must be defined in accordance with the terms of the specific debt security underlying the Basket Component (each a "Reference Obligation") or any other debt securities of the Basket Component other than non-recourse indebtedness (collectively with the Reference Obligation, "Relevant Obligations"). See proposed CBOE Rules 29.1(c) and 29.2A.

multiple payout credit default basket option, a single payout credit default basket option ceases trading after confirmation of the first credit event.

The cash payout for credit default basket options is calculated differently than for credit default options. For both types of credit default basket options, each time a credit event is confirmed during the life of the option, the holder of the option would receive a cash payment per contract that is equal to one minus the Basket Component recovery rate specified by the Exchange at listing, multiplied by the notional face value of the applicable Basket Component.[12] For example, if there is a credit event in a Basket Component with notional face value of $10,000 and a recovery rate of 40%, the cash payment per contract would be $6,000.[13] As with credit default options, if no credit event is confirmed during the life of the option, the final settlement price would be $0.

B. Listing Standards

Like credit default options, credit default basket options must conform to the initial and continued listing standards under proposed CBOE Chapter XXIX.[14] CBOE is proposing to list and trade only credit default basket options overlying debt securities of multiple Reference Entities each having at least one class of securities that is registered under the Act and is an "NMS stock"[15] as defined in Rule 600 of Regulation NMS under the Act.[16] Any registered

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12 At the time of listing, the Exchange will designate the notional face value and recovery rate of each Basket Component. See proposed CBOE Rule 29.2A (setting forth the requirements for the designation and terms of credit default basket options); and proposed CBOE Rules 29.1(a)(ii) and (j) (setting forth the definitions for "cash settlement amount" for credit default basket options and "Notional Face Value of Basket Component," respectively).

13 $10,000 x (1 – 0.40) = $6,000.

14 CBOE is amending Chapter XXIX to make it applicable to all "Credit Options," which would include credit default options and credit default basket options.

15 "NMS stock" means any security, or class of securities, other than an option for which

equity security issued by the Reference Entity also would have to satisfy the requirements of CBOE Rule 5.4, which requires, among other things, that an equity security underlying an option be itself widely held and actively traded.[17] This requirement is designed to ensure that the issuer's securities enjoy widespread investor interest. The requirement that each Reference Entity be an issuer or guarantor of registered NMS stock will help ensure that investors have access to comprehensive public information about the Reference Entity, including the registration statement filed under the Securities Act of 1933 ("Securities Act") and other periodic reports.[18]

Also, as with credit default options, a credit default basket 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.[19] The

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transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. See 17 CFR 242.600(b)(46) and (47).

16 See proposed CBOE Rule 5.3.11.

17 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: (i) 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); (ii) there are fewer than 1,600 holders of the underlying security; (iii) the trading volume (in all markets in which the underlying security is traded) was less than 1,800,000 shares in the preceding 12 months; (iv) 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 (v) the underlying security ceases to be an NMS stock.

18 Section 13 of the Act, 15 U.S.C. 78m, provides that any issuer of a security registered pursuant to Section 12 of the Act, 15 U.S.C. 78l, must file with the Commission annual reports and information and documents necessary to keep reasonably current the information in its Section 12 registration statement.

19 For a single payout credit default basket option, if a credit event is confirmed, the expiration date would be the second business day after the confirmation of the first credit event. For a multiple payout credit default basket option, if a credit event is confirmed in

Exchange usually would open one to four series for each year up to 10.25 years from the current expiration.[20]

C. Trading

The trading rules for credit default basket options would be consistent with those applicable to credit default options. Specifically, credit default basket options would trade on CBOE's Hybrid Trading System from 8:30 a.m. to 3:00 p.m. (Central Time)[21] 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 would apply to credit default options.[22] Also, credit default basket options would be eligible for trading as Flexible Exchange Options ("FLEX Options"). A FLEX Option that is a credit default basket option would be cash-settled and the exercise-by-exception provisions of OCC Rule 805[23] would not apply. Market-makers would be appointed to credit default options pursuant to CBOE's existing requirements,[24] as supplemented by proposed CBOE Rule 29.17. Additionally, CBOE represents 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 basket options.

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every Basket Component, the expiration date would be the second business day after the confirmation of the last credit event. For either type of credit default basket options, if a Redemption Event is confirmed in all Basket Components, the expiration date would be the second business day after the last confirmation date. See proposed CBOE Rules 29.1(d)(ii) and (e)(ii). See also proposed CBOE Rule 29.4.

20 See proposed CBOE Rule 29.2A(b)(1) and (2).

21 See proposed CBOE Rule 29.11.

22 See proposed CBOE Rules 29.11-29.15, 29.16, and 29.19.

23 OCC Rule 805 sets forth the expiration date exercise procedures for options cleared and settled by the OCC.

24 See Chapter VIII of CBOE's rules.

Once a particular credit default basket 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 class 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 class. The proposed trading rules for credit default basket options are designed to create an environment that takes into account the small number of transactions likely to occur, while providing price improvement and the transparency benefits of competitive floor bidding, as compared to the over-the-counter ("OTC") market.

Upon the confirmation of the first credit event (in the case of a single payout credit default basket option), a credit event in every Basket Component (in the case of a multiple payout credit default basket option), or the redemption of all Relevant Obligations (in the case of either type of credit default basket option), the applicable credit default basket option class would cease trading. In addition, CBOE's trading halt procedures applicable to equity options would apply to credit default basket options.[25] When determining whether to institute a trading halt in credit default basket options, CBOE floor officials would consider whether current quotations for a Relevant Obligation or other securities of a Reference Entity are unavailable or have become unreliable.[26] The Exchange's board of directors would also have the power to impose restrictions on transactions or exercises in one or more series of credit default basket options as the board, in its judgment, determines advisable in the interests of maintaining a fair

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25 See CBOE Rules 6.3 and 6.3B; proposed CBOE Rule 29.13.

26 See id.

and orderly market or otherwise deems advisable in the public interest or for the protection of investors.[27]

D. Clearance and Settlement

Like credit default options, credit default basket options do not have an exercise price, and thus by their terms, do not meet the definition of "standardized options" for purposes of Rule 9b-1 under the Act.[28] However, as discussed herein, the Commission today is using its authority pursuant to Rule 9b-1 to designate credit default basket options as "standardized options" under Rule 9b-1. Consequently, credit default basket option transactions will be eligible for clearance and settlement by the OCC in accordance with procedures that are substantially similar to existing systems and procedures for the clearance and settlement of exchange-traded options.[29]

E. Adjustments

Like credit default options, both types of credit default basket options would be subject to adjustments in two circumstances.[30] First, if a Basket Component is succeeded by another entity in accordance with the terms of the underlying debt securities, the Exchange will specify a new recovery rate and basket weight for each successor Basket Component. The newly specified weights would equal the weight of the original Basket Component. To the extent necessary and

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27 See proposed CBOE Rule 29.8.

28 17 CFR 240.9b-1.

29 On April 20, 2007, the OCC filed with the Commission, a proposed rule change to enable it to clear and settle credit default basket options proposed to be listed by CBOE. On June 14, 2007, the OCC filed Amendment No. 1 to the proposal. The proposed rule change, as amended, was published for comment in the Federal Register on June 27, 2007. Securities Exchange Act Release No. 55939 (June 21, 2007), 72 FR 35291 (SR-OCC-2007-06) (the "OCC Proposal"). The Commission has not yet taken action on the OCC proposal. The Commission also notes that the Options Disclosure Document ("ODD") was recently amended to incorporate disclosure related to both credit default options and credit default basket options. See Securities Exchange Act Release No. 55921 (June 18, 2007), 72 FR 34495 (June 22, 2007) (SR-ODD-2007-03).

30 See CBOE proposed Rule 29.4.

appropriate for the protection of investors and the public interest, all other terms and conditions of the options would be the same as the original credit default basket options.

Second, if the Reference Obligation of a Basket Component is redeemed or matures during the life of the credit default basket option, the Exchange would specify another debt security of the Reference Entity as the new Reference Obligation for that Basket Component. If all debt securities of a Basket Component (i.e., all Relevant Obligations) are redeemed during the life of the credit default basket option, that Basket Component would be removed from the basket.

F. Position Limits

Pursuant to proposed CBOE Rule 29.5, credit default basket options would be subject to a position limit equal to 50,000 contracts on the same side of the market. Credit default basket options would not be aggregated with option contracts on the same underlying security and would not be subject to the hedge exemption to CBOE's standard position limits. Instead, the following hedge strategies and positions would be exempt from CBOE's position limits: (i) a credit default basket option position "hedged" or "covered" by an appropriate amount of cash to meet the cash settlement amount obligation; and (ii) a credit default basket option position "hedged" or "covered" by an amount of any of the Basket Component's debt securities, instruments, or interests sufficient to meet: (A) in the case of a single payout credit default option, the cash settlement amount obligation that would be the greatest if any of the Basket Components of that option were to experience a credit event; or (B) in the case of a multiple payout credit default option, the sum of the sum of each Basket Component's cash settlement amount.[31] Also, CBOE's market-maker and firm facilitation exemptions to position limits would apply.[32]

G. Margin

The margin (both initial and maintenance) required for writing short and long positions in credit default basket options would be as follows:[33]

- For a qualified customer[34] carrying a long position in a credit default basket option, the margin requirement would be 15% of the current market value of the credit default basket option.
- For a non-qualified customer carrying a long position in a credit default basket option, the margin requirement would be 100% of the current market value of the credit default basket option.
- For a qualified customer carrying a short position in a multiple payout credit default basket option, the margin requirement would be the lesser of the current market value of the credit default basket option plus 15% of the sum of each Basket Component's cash settlement amount, or the sum of each Basket Component's cash settlement amount.

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31 See proposed CBOE Rule 29.5.

32 Proposed CBOE Rule 29.5 would require 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 an exemption would be granted. With respect to CBOE's firm facilitation exemption (CBOE Rule 4.11.06), proposed CBOE Rule 29.5 would provide that the aggregate exemption position could not exceed three times the standard limit of 50,000 contracts.

33 See proposed CBOE Rule 12.3(l).

34 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.

- For a non-qualified customer carrying a short position in a multiple payout credit default basket option, the margin requirement would be the sum of each Basket Component's cash settlement amount.
- For a qualified customer carrying a short position in a single payout credit default basket option, the margin requirement would be the lesser of the current market value of the credit default basket option plus 15% of the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event, or the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event.
- For a non-qualified customer carrying a short position in a single payout credit default basket option, the margin requirement would be the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event.

These requirements may be satisfied by a deposit of cash or marginable securities.

A credit default option carried short in a customer's account would be deemed a covered position, and eligible for the cash account, provided any one of the following is held in the account at the time the option is written or is received into the account promptly thereafter: (i) for multiple payout credit default basket options, cash or cash equivalents equal to 100% of the sum of each Basket Component's cash settlement amount; (ii) for single payout credit default basket options, cash or cash equivalents equal to 100% of the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event; or (iii) 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. The Exchange represents that, in accordance with proposed CBOE Rule 12.3(a)(4), 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.

Lastly, pursuant to proposed CBOE Rule 12.5, a credit default basket option that is carried for the account of a qualified customer 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 basket options prior to listing and trading such options.

III. 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.[35] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[36] 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

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35 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).

36 15 U.S.C. 78f(b)(5).

general to protect investors and the public interest. CBOE's proposal, by enabling it to list and trade securities heretofore existing only in 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.

In connection with its earlier approval of credit default options, the Commission found that the credit default options proposed by CBOE are securities because they are options based on the value of a security or securities and because they are options on an interest in, or based on the value of an interest in, a security or securities.[37] Under an analysis similar to that applied to credit default options, and after careful consideration of the terms of the two types of credit default basket options, the Commission finds that the credit default basket options proposed by CBOE are securities. Specifically, the Commission finds that credit default basket options are options based on the value of securities or a group or index of securities and are options on an interest in or based on the value of an interest in, securities or a group or index of securities and, therefore, are securities under Section 3(a)(10) of the Act.[38]

As a threshold matter, the Commission finds that credit default basket options are options, not futures contracts. Generally speaking an option grants the holder the right, but not the obligation, to buy or sell a specific quantity, at a specific price, on or before a specified future date.[39] Courts have highlighted three characteristics in particular that distinguish options from futures contracts: (i) an options-buyer pays to the seller a nonrefundable premium; (ii) an options-buyer has

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37 See Credit Default Option Approval Order, supra note 7.

38 15 U.S.C. 78c(a)(10).

39 See British American Commodity Options v. Bagley, 552 F.2d 482, 484-85 (2d Cir. 1977).

rights but no further obligations under the contract; and (iii) an options-seller bears all the risk exposure.[40] Examining credit default basket options in light of these characteristics, it is clear that credit default basket options are options. First, the buyer of a credit default basket option pays to the seller a nonrefundable premium. Second, the buyer of a credit default basket option has rights but no further obligations under the contract. Third, the buyer of a credit default basket option has no further risk exposure under the contract and the seller bears all the risk of the credit event occurring.

Although credit default basket options differ from classic options in certain respects, these differences do not affect the economic substance of the contract. First, credit default basket options are cash-settled and do not allow for physical delivery. It is well established, however, that cash-settled options based on prices of securities are options "on" such securities.[41] Second, credit default basket options are automatically exercised, unlike a classic option that generally gives the option-holder the right but not the obligation to exercise if the option is in the money. In the case of cash-settled options, such as credit default basket options, however, giving the option-holder the right to decline to accept the cash upon the occurrence of an event of default would be economically meaningless.[42] For this reason, under OCC rules, index option contracts are automatically exercised if they are in-the-money at expiration, and equity options contracts are automatically exercised if they are in-the-money by specified amounts. Third, the payout for a credit default basket option is fixed in advance and binary in nature, while in a classic option the payout can increase or decrease continuously in direct correlation with the price movement of the underlying instrument. The same is true, of course, of the payout of a

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40 See CFTC v. U.S. Metals Depository Co., 468 F.Supp. 1149, 1154 (S.D.N.Y. 1979); and United States v. Bein, 728 F.2d 107, 112 (2d Cir. 1984).

41 See Caiola v. Citibank, N.A., New York, 295 F.3d 312, 326 (2d Cir. 2002).

42 See Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F.Supp.2d 580, 595-97 (S.D.N.Y. 2005).

futures contract. Thus, the fixed payout of credit default basket options does not weigh in favor of classifying them as either futures or options.

In short, even though the potential payout of a credit default basket option is cash-settled, automatically exercised, and fixed in advance, the buyer of a credit default basket option still pays a fixed premium for the possibility of receiving a greater amount – which is the essence of optionality.[43]

Furthermore, the Commission finds that credit default basket options are securities under Section 3(a)(10) of the Act.[44] Specifically, credit default basket options are options based on the value of securities or a group or index of securities and are options on an interest in, or based on

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43 See Brief of Amicus Curiae The Securities and Exchange Commission, at 24, Caiola v. Citibank, N.A., New York, 295 F.3d 312 (2d Cir. 2002) (01-7545) ("Simply put, Caiola paid a little for the chance to get a lot").

44 The Commission wishes to make clear that because credit default basket 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. Also, certain OTC credit default swaps (whether single-name or basket) are not securities. The finding that credit default basket options are securities because they are options based on the value of securities or a group or index of securities might suggest that single-name or basket OTC credit default swaps are also options based on the value of a security or group or index of 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. Of course, OTC credit default swaps that involve terms similar to credit default basket 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.

the value of an interest in, securities or a group or index of securities. In coming to these conclusions, the Commission carefully considered the terms of the credit default basket options, using an analytical approach similar to that which the Commission applied to credit default options.

The Commission also believes that the listing and trading rules proposed by CBOE for credit default basket options are substantially similar to the listing and trading rules for credit default options, and are likewise reasonable and consistent with the Act. As with a credit default option, a credit default basket option must be based on Reference Obligations issued by entities that issue or guarantee 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 Entities that may be necessary to price a credit default basket option appropriately.

The Commission believes that the proposed position limits and margin rules for credit default basket options are reasonable and consistent with the Act. The proposed position limit of 50,000 contracts in any credit default basket 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:

- The Exchange will have in place adequate surveillance procedures to monitor trading in credit default basket 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 basket default options as proposed.

This approval order is based on CBOE's representations.

For the foregoing reasons, the Commission finds that the proposed rule is consistent with the Act.

IV. Designation of Credit Default Basket 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 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.[45] 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.[46]

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.[47] The Commission specifically reserved in Rule 9b-1 the ability to designate as

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45 See 17 CFR 240.9b-1(d)(1).

46 See 17 CFR 240.9b-1(d)(2).

47 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

standardized options other securities "that the Commission believes should be included within the options disclosure framework."[48]

The Commission hereby designates credit default basket options, as defined in the OCC Proposal,[49] as standardized options for purposes of Rule 9b-1 under the Act. Like credit default options, credit default basket options do not meet the definition of "standardized options," because they do not have an exercise price.[50] However, they resemble standardized options in

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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 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).

48 See Securities Exchange Act Release No. 19055 and Securities Act Release No. 6426 (September 16, 1982), 47 FR 41950, 41954 (September 23, 1982).

49 For purposes of its proposal, OCC would define the term "credit default basket option" as an option that is based on a basket comprised of at least two reference entities and that is either a "multiple payout credit default basket option" or a "single payout credit default basket option." A "multiple payout credit default basket option" would mean a credit default basket option that automatically pays an exercise settlement amount each time a credit event is confirmed with respect to any one of the reference entities prior to expiration of the option. A "single payout credit default basket option" would be automatically exercised and pay a single exercise settlement amount only when the first credit event is confirmed with respect to a reference entity prior to expiration of the option. 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 basket 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 any one of the issuers or guarantors of the reference obligation(s) that underlie a credit default basket option. See proposed Section 1.R.(1) of Article XIV of the OCC By-Laws.

"Reference obligation" would mean any debt security the terms of which are used to define the occurrence of a credit event with respect to the reference entity that is its issuer or guarantor for a class of credit default basket options, as provided in the rules of the listing exchange. See id.

50 See Credit Default Options Approval Order at Section VI (designating credit default options as standardized options for purposes of Rule 9b-1 under the Act).

other significant respects. Credit default basket options have underlying securities and an expiration date. Like other standardized options, credit default basket 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 basket options are designed to provide market participants with the ability to hedge their exposure to underlying securities. The fact that credit default basket options lack a specified exercise 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 basket options supports the view that adding credit default basket options to the standardized option disclosure framework is reasonable.

Therefore, the Commission hereby designates credit default basket options, such as those proposed by CBOE, as standardized options for purposes of Rule 9b-1 under the Act.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[51] that the proposed rule change (SR-CBOE-2007-26), as modified by Amendment No. 3, be and hereby is approved.

IT IS FURTHER ORDERED, pursuant to Rule 9b-1(a)(4) under the Act, that credit default basket options, as defined in proposed rule change SR-OCC-2007-06, are designated as standardized options.

By the Commission.

Florence E. Harmon
Deputy Secretary

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51 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC - 27931; 812-13259]

American International Group, Inc., et al.; Temporary Order and Notice of Application

August 20, 2007

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

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

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against American International Group, Inc. ("AIG") on February 17, 2006 by the United States District Court for the Southern District of New York (" Injunction"), from August 20, 2007, until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: AIG, AIG Annuity Life Insurance Corporation ("AIG Annuity"), AIG Annuity Insurance Company ("AIG Annuity"), AIG Equity Sales Corp. ("AIG Equity"), AIG Global Investment Corp. ("AIGGIC"), AIG Life Insurance Company ("AIG Life"), AIG SunAmerica Asset Management Corp. ("SunAmerica Asset Management"), AIG SunAmerica Capital Services, Inc. ("SunAmerica Capital"), AIG SunAmerica Life Assurance Company ("ASLAC"), American General Distributors, Inc. ("AM Distributors"), American General Equity Services Corp.("AM Equity"), American General Life Insurance Company ("AM Life"), American International Life Assurance Company of New York ("AILAC"), Brazos Capital Management, L.P. ("Brazos"), First SunAmerica Life Insurance Company ("First SunAmerica"), The United

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States Life Insurance Company in the City of New York ("US Life"), and The Variable Annuity Life Insurance Company ("VALIC") (collectively, "Applicants").[1]

Filing Dates: The application was filed on February 10, 2006, and amended on August 16, 2007.

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on September 14, 2007, and should be accompanied by proof of service on applicants, in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicants c/o Anastasia Kelly, American International Group, Inc., 70 Pine Street, New York, New York 10270.

For Further Information Contact: Julia Kim Gilmer, Branch Chief, at 202-551-6871 or Nadya B. Roytblat, Assistant Director, at 202-551-6821 (Division of Investment Management, Office of Investment Company Regulation).

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

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1 Applicants request that any relief granted pursuant to the application also apply to any other company of which AIG is or may become an affiliated person (included in the defined term "Applicants").

Applicants' Representations:

1. AIG, through its subsidiaries, offers property and casualty and life insurance products to commercial, institutional and individual customers worldwide. AIG's global businesses also include financial services and asset management. The other Applicants are wholly owned subsidiaries of AIG. AIGGIC, SunAmerica Asset Management, Brazos, and VALIC are investment advisers registered under the Investment Advisers Act of 1940 ("Advisers Act") and serve as investment adviser or subadviser ("Adviser Applicants") to certain registered investment companies ("Funds"). AIG Equity, SunAmerica Capital, AM Distributors, and AM Equity are broker-dealers registered under the Securities Exchange Act of 1934 ("Exchange Act") and serve as a principal underwriter to open-end Funds and Funds that are unit investment trusts ("UITs"). AIG Annuity, AIG Life, ASLAC, AM Life, AILAC, First SunAmerica and US Life serve as depositors to various Funds.

2. On February 17, 2006, the United States District Court for the Southern District of New York entered the Injunction against AIG in a matter brought by the Commission.[2] The Commission alleged in the complaint ("Complaint") that AIG violated sections 10(b), 13(a), 13(b)(2) and 13(b)(5) of the Exchange Act and rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-1 thereunder, and section 17(a) of the Securities Act of 1933, by making intentionally misleading statements in its financial statements ("Conduct"). Without admitting or denying any of the allegations in the Complaint, except as to jurisdiction, AIG consented to the entry of the Injunction and to pay penalties and disgorgement of $800 million.[3]

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2 Securities and Exchange Commission v. American International Group, Inc., 06 Civ. 1000 (LAP) (S.D.N.Y., filed Feb. 17, 2006).

3 AIG also agreed to comply with certain undertakings relating to its internal controls over financial reporting; the organization and reporting structure of AIG's internal audit department and disclosure committee; the policies, procedures and effectiveness of AIG's regulatory,

Applicants' Legal Analysis:

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from engaging in or continuing any conduct or practice in connection with the purchase or sale of a security from acting, among other things, as an investment adviser or depositor of any registered investment company or a principal underwriter for any registered open-end investment company, registered unit investment trust, or registered face-amount certificate company. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company, any affiliated person of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include any person directly or indirectly controlling, controlled by, or under common control, with the other person. Applicants state that AIG is an affiliated person of each of the other Applicants within the meaning of section 2(a)(3). Applicants state that, as a result of the Injunction, they would be subject to the prohibitions of section 9(a).

2. Section 9(c) of the Act provides that the Commission shall grant an application for an exemption from the disqualification provisions of section 9(a) of the Act if it is established that these provisions, as applied to Applicants, are unduly or disproportionately severe or that the conduct of the Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption. Applicants have filed an application pursuant to section 9(c) seeking a temporary and permanent order exempting them from the disqualification provisions of section 9(a).[4]

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compliance and legal functions; AIG's records management and retention policies and procedures; and AIG's whistleblower procedures.

[4] Applicants have received orders granting a temporary exemption from section 9(a) of the Act with respect to the Injunction until August 21, 2007. Investment Company Act Release Nos. 27227 (Feb. 21, 2006) (granting a temporary exemption until August 21, 2006); 27446 (Aug. 18,

3. Applicants believe that they meet the standards for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that it would not be against the public interest or the protection of investors to grant the requested exemption from section 9(a). The Conduct did not involve any of the Applicants acting in the capacity of investment adviser, subadviser, depositor or principal underwriter for any Fund. Applicants state that with the exception of index Funds, none of the Funds advised by the Adviser Applicants holds any securities issued by AIG.

4. Applicants state that their inability to continue to provide advisory and underwriting services to the Funds and to serve as depositor to Funds would result in potentially severe hardships for the Funds and their shareholders. Applicants also state that they have distributed written materials, including an offer to meet in person to discuss the materials, to the boards of directors of the Funds (the "Boards"), includi ng the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of such Funds, and their independent legal counsel as defined in rule 0-1(a)(6) under the Act, if any, regarding the Injunction, any impact on the Funds, and the application. Applicants state that they have provided the Boards with all information concerning the Injunction and the application that is necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

5. Applicants also state that, if they were barred from providing services to the Funds, the effect on their businesses and employees would be severe. Applicants state that they have committed substantial resources to establish an expertise in advising, subadvising,

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2006) (extending the temporary exemption to February 16, 2007); 27700 (Feb. 16, 2007) (extending the temporary exemption to August 21, 2007).

and distributing the Funds, and acting as a depositor to Funds. Applicants further state that prohibiting them from providing advisory and distribution services to the Funds would adversely affect not only the viability of their businesses, but also the livelihoods of their employees. Applicants state that they have previously received one order under section 9(c) of the Act.[5]

Applicants' Condition:

Applicants agree that any order granting the requested relief will be subject to the following condition:

Any temporary exemption granted pursuant to the application shall be without prejudice to, and shall not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings involving or against, the Applicants, including without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application, or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

Temporary Order:

The Commission has considered the matter and finds that Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

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5 AIG Annuity Life Insurance Company, et al., Investment Company Act Release Nos. 26690 (Dec. 8, 2004) (notice) and 26718 (Jan. 4, 2005) (order).

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that Applicants are granted a temporary exemption from the provisions of section 9(a), solely with respect to the Injunction, subject to the condition in the application, from August 20, 2007, until the Commission takes final action on their application for a permanent order.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2637 / August 21, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12732

In the Matter of **JOHN HUNTING WHITTIER,** **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 John Hunting Whittier ("Respondent" or "Whittier").

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 (the "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. Whittier owned and controlled Wood River Capital Management, L.L.C., which served as the investment adviser to two hedge funds, Wood River Partners, L.P. ("Wood River Partners") and Wood River Partners Offshore, Ltd. ("Wood River Offshore"). Whittier, 40 years old, is a resident of Hailey, Idaho.

2. On August 6, 2007, a final judgment was entered by consent against Whittier, 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, Section 13(d) of the Exchange Act and Rules 13d-1 and 13d-2 thereunder, Section 16(a) of the Exchange Act and Rules 16a-2 and 16a-3 thereunder and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Wood River Capital Management, et al., Civil Action Number 05-CV-8713, in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that, in connection with the purchase and sale of securities, Whittier made material misrepresentations to investors regarding the oversight and diversification of the Wood River Partners and Wood River Offshore hedge funds, amassed a position in a small-cap stock (Endwave Corp.) which exceeded more than forty percent of Endwave's outstanding shares, but failed to file the stock ownership reports that were required to be filed when the position exceeded five percent and then ten percent of Endwave's outstanding shares. The Commission's Complaint also alleged that, as president of the investment adviser to the Wood River Offshore hedge fund, Whittier's material misrepresentations also defrauded his advisory client, the board of directors of that fund, and prospective clients.

IV.

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

Accordingly, it is hereby ORDERED that:

Pursuant to Section 203(f) of the Advisers Act, Respondent Whittier 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

[011]

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2636 / August 21, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12731

In the Matter of **JOHN M. FIFE,** **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 John M. Fife ("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. Fife was the principal and sole member of Clarion Management, LLC ("Clarion Management"). Clarion Management, LLC was the unregistered investment adviser for Clarion Capital, LP ('Clarion Capital"), a hedge fund formed exclusively for the purpose of market timing through variable annuities. Fife, age 46, is a resident of Chicago, Illinois.

2. On August 9, 2007, a final judgment was entered by consent against Fife, permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. John M. Fife, et al., No. 07-CV-0347, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that in 2002 and 2003 Fife and Clarion Management engaged in a fraudulent scheme to purchase variable annuity contracts issued by the Lincoln National Life Insurance Company ("Lincoln") in order to engage in market timing in international mutual funds for the benefit of Clarion Capital. Fife and Clarion Management's scheme involved using fictitious family trusts actually owned by Clarion Capital to purchase from Lincoln what Clarion Capital otherwise could not have purchased in its own name. By purchasing Lincoln variable annuity contracts through trusts, Fife and Clarion Management concealed from Lincoln that the true owner of the contracts was Clarion Capital. When Fife and Clarion Management's market timing for Clarion Capital in the Lincoln variable annuity contracts became excessive, Lincoln restricted trading in those contracts. Fife and Clarion Management then used deceptive means to purchase more variable annuity contracts for market timing, including using previously unused trusts and trustees with mailing addresses in different parts of Chicago. As part of their fraudulent scheme, Fife and Clarion Management then continued to engage in market timing for the benefit of Clarion Capital in the new variable annuity contracts.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Fife be, and hereby is barred from association with any investment adviser, with the right to reapply for association after 18 months to the appropriate self-regulatory organization, or if there is none, to the Commission;

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

Commissioners Atkins & Nazareth Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8837 / August 21, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 56296 / August 21, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-11293

In the Matter of

RUBIN INVESTMENT GROUP, INC.,
SCOTT HALPERIN,
DANIEL RUBIN,
ANDREW SAKSA, and
ROBERT LOMONACO,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO SCOTT HALPERIN

I.

On October 2, 2003, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Scott Halperin ("Halperin" or "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 the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of

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the Securities Act of 1933, and Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Scott Halperin ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

These proceedings arise out of two fraudulent schemes to improperly acquire and promote the stock of two publicly-traded companies, The Classica Group, Inc. ("Classica") and Marx Toys & Entertainment Corp. ("MRXT"). In exchange for acquiring a large amount of purportedly unrestricted stock, illegally issued pursuant to Form S-8 registration statements filed by Classica and MRXT, Halperin and others improperly promoted and manipulated the share price of Classica and MRXT stock.

Respondent

1. **Halperin,** 45, resides in Manalapan, New Jersey. During the relevant time, he was chairman of the board and chief executive officer of Classica, and the former chairman of the board for "stereoscape.com, inc." which was the predecessor company to MRXT.

Other Relevant Entities

2. **Classica** is a New York corporation, headquartered in Sayreville, New Jersey, that purports to engage in two principal businesses. The first is designing, building, and selling of microwave heat processing equipment for pasteurization, sterilization, drying, and sanitizing in the food and pharmaceutical industries. The second is producing and importing specialty cheeses and Italian foods. During the relevant time period, Classica's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, and trades in Classica's common stock shares were quoted on the NASDAQ Small Cap Market. Classica's stock traded for under $5 per share and was a penny stock as defined by Rule 3a51-1 of the Exchange Act.

3. **MRXT** is a Nevada corporation, with executive offices located in Sebring, Ohio, that purports to be in the business of selling collectible action figures and play sets through the Internet and via telemarketing. During the relevant time period, MRXT's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, and trades in MRXT's common stock shares were quoted on the OTC

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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.

Bulletin Board. MRXT's stock traded for under $5 per share and was a penny stock as defined by Rule 3a51-1 of the Exchange Act.

4. **Rubin Investment Group** ("RIG") is a California corporation with offices in New York, New York, Los Angeles, California and Lake Helen, Florida. RIG purports to be an investment bank, and is not registered with the Commission.

Background

5. In or around August 2003, Halperin caused Classica to file a Form S-8 Registration Statement with the Commission, purporting to register shares issuable pursuant to a stock option plan. The stock option plan states that it "is intended to provide valuable incentive for our employees by providing an opportunity for investment in our Common Stock, as an inducement for such individuals to remain with us, thereby encouraging them to increase their efforts to make the our [sic] business more successful."

6. In or around August 2003, Halperin caused Classica to enter into a purported "merger and acquisition advisor agreement" with RIG ("Classica Agreement") for the stated purpose of "possibly effecting an acquisition of or other business combination with one or more companies" in exchange for discounted shares of Classica stock. At the same time, Halperin caused Classica to issue RIG approximately 1.8 million shares of stock, registered pursuant to Classica's Form S-8 Registration Statement.

7. In or around August 2003, Halperin caused MRXT to file a Form S-8 Registration Statement with the Commission, purporting to register shares issuable pursuant to a stock option plan. The stock option plan states that it "is intended to provide valuable incentive for our employees by providing an opportunity for investment in our Common Stock, as an inducement for such individuals to remain with us, thereby encouraging them to increase their efforts to make the our [sic] business more successful."

8. In or around August 2003, at Halperin's direction, MRXT and RIG entered into an agreement ("MRXT Agreement"), whereby RIG would provide "merger and acquisition advisory and consulting services" to MRXT in exchange for discounted shares of MRXT stock. MRXT issued to RIG approximately 6.8 million shares of stock and, to Halperin and others, approximately 1.2 million shares. The shares were registered pursuant to MRXT's Form S-8 Registration Statement.

9. Despite the terms of the Classica and MRXT Agreements, the terms of MRXT's and Classica's Form S-8 registration statements filed with the Commission, and

the requirements of Commission Form S-8,[2] Halperin, Classica's chief executive officer and chairman of the board, as well as MRXT's former chairman of the board, knew: that RIG was a corporate entity, not a natural person, and therefore RIG was barred from receiving Form S-8 shares; that RIG did not intend to provide *bona fide* services to Classica or MRXT; and that RIG and others engaged in efforts both to promote MRXT and Classica to potential investors and to raise capital for the issuers in exchange for the discounted Form S-8 shares RIG received. Halperin also knew that RIG and others engaged in efforts to artificially inflate the price of Classica's and MRXT's stock in exchange for the Form S-8 shares, and that the Form S-8 registration statements contained or incorporated by reference materially false or misleading statements and omissions which concealed the true nature of RIG's mission and the attendant compensation.

10. Through his conduct, Respondent participated in the offering of common stock of MRXT and Classica, "penny stocks" as that term is used in Section 15(b)(6) and as defined by Section 3(a)(51) of the Exchange Act and Rule 3a51-1 thereunder.

11. As a result of the conduct described above, Respondent willfully violated, and caused the violation of, Sections 5(a) and 5(c) of the Securities Act, which prohibit the offer and sale of securities through the mails or in interstate commerce, unless a registration statement is filed or in effect as to such securities or unless an exemption from registration is available. Respondent also willfully violated, and caused the violation of, 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 or sale of securities or in connection with the purchase or sale of 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 Halperin's Offer.

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

A. Respondent Halperin cease and desist from committing or causing any violations and any future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

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2 Form S-8 is available for the issuance of stock to consultants only if the following conditions are met: (i) the consultant is a natural person, (ii) the consultant provides *bona fide* services to the registrant; and (iii) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the registrant's securities. See General Instruction A.1(a) to Form S-8.

B. Respondent Halperin be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

C. Pursuant to Section 21C(f) of the Exchange Act, Respondent Halperin be, and hereby is, barred from acting as a director or officer of any issuer having a class of securities registered with the Commission pursuant to Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56301 / August 22, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2669 / August 22, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12733

In the Matter of	
Kenneth W. DiFonzo, CPA,	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**
Respondent.	

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 Kenneth W. DiFonzo ("DiFonzo" or "Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, DiFonzo 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, DiFonzo consents to the entry of this

[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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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. DiFonzo, age 55, resides in Newport Beach, California. DiFonzo was ConAgra Foods Inc.'s Corporate Controller from May 1994 through February 1999. From February 1999 until May 2004, DiFonzo held other senior positions with ConAgra. From May 2004 to September 2005, DiFonzo served in an advisory capacity at ConAgra regarding various operational/management issues. Since September 1, 2005, DiFonzo has served as a consultant to ConAgra. DiFonzo is a Certified Public Accountant licensed in Illinois; however, his license has become inactive. For approximately eight years (1973 to 1981), DiFonzo worked as an auditor in public accounting, rising to the position of Senior Manager.

2. ConAgra, a Delaware corporation with headquarters in Omaha, Nebraska, is a diversified international food company. ConAgra's common stock is registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and during the relevant time period, traded on the New York Stock Exchange. ConAgra's fiscal year ends on the last Sunday in May of each year.

3. On June 29, 2007, the Commission filed a complaint against DiFonzo in SEC v. Kenneth W. DiFonzo (Civil Action No. 07-cv-1374). On August 15, 2007, the Court entered a final judgment against DiFonzo which permanently enjoined DiFonzo, by consent, from future violations of Exchange Act Rule 13b2-1, and from aiding and abetting 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. DiFonzo was also ordered to disgorge (a) $139,988, plus prejudgment interest of $65,590, and (b) $136,296, representing the market value, determined as of the date the Commission accepts DiFonzo's settlement offer, of 5,048 shares of ConAgra common stock; and to divest 20,192 of unexercised ConAgra stock options. It is understood that 8,712 ConAgra stock options had previously been divested on September 20, 2006 pursuant to this settlement agreement and that the balance to be divested pursuant to this Offer is 11,480 options.

4. The Commission's complaint alleged, among other things, that during fiscal year 1999, DiFonzo directed certain improper accounting practices at ConAgra relating to the establishment and use of excess reserves in FY 1999. The complaint alleged that DiFonzo knew, or should have known, that ConAgra improperly accounted for excess reserves in FY 1999. According to the allegations in the complaint, as a result of the accounting practices, which were not in accordance with Generally Accepted Accounting Principles ("GAAP"), certain of ConAgra's filings with the Commission in fiscal year 1999 were materially false and misleading because they misstated ConAgra's reported income before income taxes and overstated its reported net income and earnings per share. The complaint also alleged that had ConAgra's accounting for its reserves been in accordance with GAAP, it would have reduced its excess reserves in earlier periods, which would have resulted in a corresponding increase in ConAgra's income before income taxes in those earlier periods. Additionally, the complaint alleged that DiFonzo violated,

and aided and abetted violations of, the provisions of the federal securities laws as described in Section III.3 above.

IV.

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

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

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

B. After one (1) year from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of, or potential defects in, the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependant on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Nancy M. Morris
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2638 / August 22, 2007

INVESTMENT COMPANY ACT OF 1940
Release No. 27932 / August 22, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12734

In the Matter of

MICHAEL CARL HOFFMAN,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Michael Carl Hoffman ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. These proceedings arise out of a practice known as "late trading" in mutual fund shares by the hedge fund Respondent co-managed, known as Ilytat. From 2000 through September 2002, Ilytat repeatedly engaged in late trading – placing orders to buy, redeem, or exchange mutual fund shares after the 4:00 p.m. Eastern time market close while still receiving the current day's mutual fund price. Respondent's business partner discovered that Ilytat could late trade and began the practice. By engaging in late trading, Respondent's hedge fund, Ilytat, profited from market events that occurred after 4:00 p.m. but were not reflected in the price Ilytat paid for the mutual fund shares. Ilytat made use of a loophole in its clearing broker's mutual fund order entry system by placing approximately 2,700 late trades in various mutual funds (representing about 84% of Ilytat's mutual fund trades), allowing it to receive a price to which it was not entitled. Ilytat's late trading caused dilution to other mutual fund investors because Ilytat received stale prices for the mutual fund shares it trades. That is, Ilytat's late trading allowed it to receive a price to which it was not entitled, resulting in a transfer of money from the mutual funds and their shareholders to Ilytat.

Respondent

2. Respondent, age 44, lives in San Francisco, California. He started the Ilytat hedge fund in 1998 and co-managed it until it closed it in 2002. Respondent was also an investor in Ilytat.

Related Entities

3. Ilytat was founded by Hoffman in 1998 and operated until August 2002, investing largely in domestic mutual funds and domestic and international equities. A business partner joined Respondent in managing Ilytat in 1999. In May 2001, Ilytat had approximately $130 million in assets. Ilytat's investment adviser, Ilytat, LLC, was registered with the State of California as an investment adviser and maintained its only office in San Francisco. Hoffman and his partner were members of Ilytat, LLC.

4. Bear, Stearns Securities Corp. ("Bear Stearns") is a broker-dealer registered with the Commission that served as prime broker for Ilytat during the relevant period, providing Ilytat with trade processing, clearance, financing, and other services.

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[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.

Facts

5. The price of a mutual fund's shares is based on the value of the securities (and other assets) held by the mutual fund, and each fund is required by the Commission's regulations to calculate each trading day the value of the fund's holdings, or net asset value ("NAV"). Generally, the funds in which Ilytat traded calculated the price of their shares as of the close of the major United States securities exchanges and markets (4:00 p.m. Eastern time). As the Commission's regulations further require, the price received by the investor for shares of the fund is the price the fund next calculates after receipt of the order. Consequently, trades placed by an ordinary investor after 4:00 p.m. Eastern time in the funds Ilytat traded received the NAV next calculated by the mutual fund *after* the investor placed the order, which was the NAV calculated as of 4:00 p.m. on the following trading day.

6. In or around late 1999 or early 2000, Bear Stearns provided Ilytat with access to a proprietary software system, known as the Mutual Fund Routing System ("MFRS"), which was part of a computer network that automatically forwarded mutual fund orders to the appropriate mutual funds for processing. Direct access to MFRS allowed Ilytat personnel to enter mutual fund orders directly into MFRS, bypassing human intervention by anyone at Bear Stearns.

7. Ilytat entered orders into MFRS after 4:00 p.m., which were sent to mutual funds for processing as if they were entered before 4:00 p.m. Thus, Ilytat placed trades for mutual fund shares after 4:00 p.m. through its direct access to MFRS and still received prices for the shares based on that day's NAV, instead of the next day's NAV (the price an ordinary mutual fund investor would have received).

8. Dealer agreements between Bear Stearns and various mutual funds stipulated that Bear Stearns would process trades at the appropriate pre- or post-4:00 p.m. price. In addition, mutual funds relied on Bear Stearns as a distributor to sell their shares at the appropriate price, which was the next day's NAV for trades placed after 4:00 p.m. Furthermore, mutual funds included disclosures in their prospectuses informing shareholders that the price they were entitled to receive in purchasing, redeeming, and exchanging their shares was the NAV next calculated after placing their orders.

9. Respondent learned that orders Ilytat placed to trade mutual fund shares after 4:00 p.m. would still receive that day's NAV, instead of the next day's NAV (as ordinary mutual fund investors would have received). Indeed, Ilytat used the MFRS system in order to receive a price to which it was not entitled. By placing orders after 4:00 p.m. while receiving prices for fund shares based on a fund's pre-4:00 p.m. NAV, Ilytat exploited its access to information announced after 4:00 p.m. that could affect securities prices. Respondent explained Ilytat's ability to thus late trade to a representative of at least one Ilytat investor.

10. From late November 2000 through September 2002, when Ilytat closed, Ilytat placed approximately 2,700 trades into MFRS after 4:00 p.m., or about 84% of the approximately 3,300 mutual fund trades entered into MFRS on behalf of Ilytat during that time,

each of which improperly received prices based on the same day's NAV. These trades, for the purchase, redemption, or exchange of securities issued by investment companies registered with the Commission pursuant to Section 8(a) of the Investment Company Act, were entered into MFRS after 4:00 p.m. but were priced as if the orders were entered before 4:00 p.m.

11. Respondent, by using the ability to enter trades after 4:00 p.m., which he understood would be priced as if entered before 4:00 p.m., caused Bear Stearns to fail to price the mutual fund shares at a price based on the NAV next calculated after Bear Stearns received the order from Ilytat.

12. As a result of the conduct described above, Respondent willfully aided and abetted and caused Bear Stearns' violations of Rule 22c-1(a), as adopted under Section 22(c) of the Investment Company Act, which requires certain mutual funds, persons designated in such issuers' prospectuses as authorized to consummate transactions in any such security, their principal underwriters, or dealers in the funds' securities, to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem.

IV.

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

Accordingly, pursuant to Section 203(f) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Hoffman cease and desist from committing or causing any violations and any future violations of Rule 22c-1(a) under the Investment Company Act;

B. Respondent Hoffman be, and hereby is barred from association with any investment adviser, with the right to reapply for association after eighteen (18) months to the appropriate self-regulatory organization, or if there is none, to the Commission;

C. Respondent Hoffman be, and hereby is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, with the right to reapply for association after eighteen (18) months to the appropriate self-regulatory organization, or if there is none, to the Commission;

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.

E. IT IS FURTHERED ORDERED Respondent shall, within 120 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Michael Carl Hoffman 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 Helane L. Morrison, Regional Director, Securities and Exchange Commission, San Francisco Regional Office, 44 Montgomery Street, Suite 2600, San Francisco, California 94104-4691.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Campos
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2639 / August 23, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12737

In the Matter of **FOLGER NOLAN FLEMING DOUGLAS CAPITAL MANAGEMENT, INC., NEIL C. FOLGER and DAVID M. BROWN,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Folger Nolan Fleming Douglas Capital Management, Inc., Neil C. Folger and David M. Brown (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have each submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

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III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Summary

1. This matter concerns disclosure and best execution violations, and failure to make and keep certain books and records, by Folger Nolan Fleming Douglas Capital Management, Inc. ("Folger Nolan Capital Management"), a registered investment adviser formerly known as Folger Nolan Fleming Douglas, Incorporated ("Folger Nolan"). From January 1, 2002, through April 1, 2004, Folger Nolan Capital Management was a division within Folger Nolan which, at the time, was a dually registered broker-dealer and investment adviser. During this time period, the general practice of registered representatives associated with Folger Nolan's broker-dealer was to refer existing customers seeking investment advisory services to Folger Nolan's registered investment adviser ("referred clients"). Folger Nolan entered into agreements with these advisory clients to send their trades through Folger Nolan's broker-dealer. Folger Nolan charged these referred clients commission rates that averaged more than twice that of advisory clients not referred from Folger Nolan's broker-dealer ("non-referred clients"), without disclosing to clients other custody and execution options such as using a lower cost discount broker. In addition, Folger Nolan did not disclose the firm's potential conflict of interest in receiving referrals from registered representatives, specifically that the investment adviser might be reluctant to recommend a lower cost broker-dealer to avoid jeopardizing the flow of future referrals.

2. As a result, referred clients paid significantly higher commissions with little corresponding benefit, and therefore Folger Nolan violated its duty to seek to obtain best execution for its clients. By failing to disclose its potential conflict of interest and other brokerage options, and by failing to seek to obtain best execution, Folger Nolan breached its fiduciary duty to its clients and thereby violated Section 206(2) of the Advisers Act, and caused its clients to pay excess commissions of at least $213,528.

3. Folger Nolan also failed to make and keep records of agreements with certain of its advisory clients evidencing their selection of Folger Nolan's brokerage unit for custody and trade execution in violation of Section 204 of the Advisers Act and Rule 204-2(a)(10) thereunder. Respondents Neil C. Folger and David M. Brown, both Senior Vice Presidents and Portfolio Managers at Folger Nolan, were responsible for making and keeping the agreements and, therefore, aided and abetted and caused the books and records violations.

Respondents

4. **Folger Nolan Fleming Douglas Capital Management, Inc.**, incorporated in January 2006, and located in the District of Columbia, is a registered investment adviser and wholly-owned subsidiary of a holding company that, in turn, is wholly owned by Folger Nolan

Fleming Douglas, Incorporated, a registered broker-dealer. Prior to forming a separate legal entity to provide advisory services in January 2006, Folger Nolan had been a dually registered broker-dealer and investment adviser providing investment advisory services through a separate division since 1978. Folger Nolan Capital Management has over 250 client accounts with more than $316 million in assets under management. The majority of its clients have longstanding relationships with registered representatives of Folger Nolan's broker-dealer.

5. **Neil C. Folger**, age 45, resides in Bethesda, Maryland. He is a Senior Vice President and Portfolio Manager of Folger Nolan Capital Management.

6. **David M. Brown,** age 45, resides in Vienna, Virginia. He is also a Senior Vice President and Portfolio Manager of Folger Nolan Capital Management.

Facts

7. From 1978 until January 2006, Folger Nolan was a dually registered broker-dealer and investment adviser, primarily conducting business out of one office. The firm initially began offering investment advisory services principally to serve the needs of existing Folger Nolan brokerage customers. As a dually registered entity, Folger Nolan typically received a management fee of one percent on advisory client assets under management of up to $1 million and 50 basis points on assets over $1 million, and also received brokerage commissions on advisory client trades placed through the firm's broker-dealer.

8. During the relevant time period, Folger and Brown were portfolio managers at the investment adviser, and they jointly oversaw the day-to-day operations of the investment adviser.

9. The general practice of registered representatives associated with Folger Nolan's broker-dealer was to refer customers seeking investment advisory services to Folger Nolan's investment adviser. Nearly all of Folger Nolan's advisory clients were referred from registered representatives associated with its broker-dealer and had been customers for many years.

10. From at least January 1, 2002 to April 1, 2004, Folger Nolan entered into agreements with its advisory clients to designate a broker-dealer for the custody of assets and execution of trades. Custody and trade execution for referred clients remained at Folger Nolan on similar terms as had previously been negotiated between the referred client and the registered representative. With few exceptions, almost all non-referred advisory clients also agreed to the selection of Folger Nolan's broker-dealer for custody and trade execution but, as described in this Order, these clients paid lower commissions.

11. Although Folger Nolan's referred and non-referred advisory clients selected Folger Nolan's broker-dealer for custody and trade execution, during the relevant time period Folger Nolan failed to adequately explain the full range of factors that should be considered by a client in selecting a broker that would enable clients to make an informed selection, including the possibility of placing trades through a lower cost discount brokerage firm.

12. Folger Nolan did offer non-referred advisory clients a "house account" commission rate on trades placed through its broker-dealer, which was significantly less than the full service commission rate typically charged to customers of its broker-dealer and which was comparable to the published rates of a major discount broker. However, Folger Nolan did not offer the "house account" rate to referred clients. As a result, referred clients paid an average commission rate per share of more than twice that of non-referred clients.. Despite the higher rate, referred clients did not receive better quality execution, nor did they receive better trading prices than non-referred clients.

13. Moreover, during the relevant time period, Folger Nolan failed to disclose to the referred clients that the firm had a potential conflict of interest between its interest in continuing to receive future referrals from registered representatives associated with its broker-dealer and its duty to seek to obtain best execution for its advisory clients.

14. Folger Nolan did not conduct any systematic review of execution quality for its clients. Despite the disparity in execution costs between referred and non-referred clients, prior to April 2004, Folger Nolan did not reevaluate its advisory clients' brokerage placement or commission charges unless the client raised an objection. Members of Folger Nolan's advisory group met regularly with clients to review portfolios and objectives, but did not periodically and systematically review brokerage arrangements for purposes of analyzing each client's quality of trade execution.

15. As a result of Folger Nolan's failure to disclose the availability of other brokerage options, its failure to disclose its conflict of interest in receiving referrals, and its failure to review its clients' quality of trade execution, Folger Nolan's referred clients paid at least $213,528 more in commissions than they otherwise would have paid if their trades had been placed through a discount broker or through the Folger Nolan broker-dealer but based on the house account commission schedule.

16. The Commission staff requested that Folger Nolan produce the brokerage agreements it had entered into with its advisory clients designating Folger Nolan's broker-dealer for custody of assets and trade execution. However, Folger Nolan only produced written agreements for fewer than one-half of its clients. Folger and Brown were jointly responsible for entering into agreements with new clients and ensuring that those agreements were adequately maintained.

17. Upon being informed by the Commission's staff of its disclosure and best execution failures, Folger Nolan revised its disclosures and implemented enhancements to its systems, policies and procedures to monitor price and execution quality on client transactions.

Violations

18. As a result of the conduct described above, Folger Nolan Capital Management, formerly Folger Nolan, willfully[1] violated Section 206(2) of the Advisers Act, which prohibits conduct by an investment adviser that operates as a fraud or deceit.

19. As a result of the conduct described above, Folger Nolan Capital Management, formerly Folger Nolan, willfully violated Section 204 of the Advisers Act, and Rule 204-2(a)(10) promulgated thereunder, which require that investment advisers registered with the Commission make and keep certain books and records. Rule 204-2(a)(10) requires that registered investment advisers "make and keep true, accurate and current . . . [a]ll written agreements . . . entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such."

20. As a result of the conduct described above, Folger and Brown willfully aided and abetted and caused Folger Nolan Capital Management's violations of Section 204 of the Advisers Act, and Rule 204-2(a)(10) promulgated thereunder. Folger and Brown willfully aided and abetted and caused Folger Nolan Capital Management to fail to maintain accurate or current written agreements relating to the brokerage arrangements of its clients.

Remedial Efforts

21. In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

Undertakings

22. Respondents undertake pursuant to Rule 1101 of the Commission's Rules on Fair Fund and Disgorgement Plans [17 C.F.R. 201.1101], and in consultation with the staff of the Commission, to develop a plan to distribute the disgorgement and prejudgment interest as provided for in the Order ("Distribution Plan"), which shall be submitted to the Commission within 60 days for notice in accordance with Rule 1103 [17 C.F.R. 201.1103]. Following a Commission order approving a Distribution Plan, as provided in Rule 1104 [17 C.F.R. 201.1104], Respondents shall take all necessary and appropriate steps to assist the Commission-appointed Administrator of the final Distribution Plan. Respondents shall bear the costs of administering and implementing the final Distribution Plan on a joint and several basis.

23. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth in paragraph 22, above.

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[1] "Willfully" as used in this Order means intentionally committing the act which constitutes the violation. Cf. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

IV.

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

Accordingly, pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. The Respondents are hereby censured.

B. Respondent Folger Nolan Capital Management cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 204 of the Advisers Act and Rule 204-2(a)(10) promulgated thereunder.

C. Respondents Folger and Brown cease and desist from committing or causing any violations and any future violations of Section 204 of the Advisers Act and Rule 204-2(a)(10) promulgated thereunder.

D. It is further ordered that Respondent Folger Nolan Capital Management shall, within ten days of the entry of this Order, pay disgorgement in the amount of $213,528 and prejudgment interest in the amount of $31,393, for a total amount of $244,921 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 Folger Nolan Capital Management 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 Daniel M. Hawke, Securities and Exchange Commission, Philadelphia District Office, Mellon Independence Center, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

E. It is further ordered that Respondent Folger Nolan Capital Management shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Folger Nolan Capital Management 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 Daniel M. Hawke, Securities and Exchange Commission, Philadelphia District Office, Mellon Independence Center, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

F. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction in any Related Investor Action based on Respondent Folger Nolan Capital Management's payment of disgorgement in this action, argue that they are entitled to, nor shall they further benefit by offset or reduction of any part of Respondent Folger Nolan Capital Management's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

G. Respondents shall comply with the undertakings enumerated in Paragraph 22 above.

By the Commission.

Nancy M. Morris
Secretary

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
August 23, 2007

IN THE MATTER OF **Environmental Safeguards, Inc.,** **Garden Botanika, Inc.,** **Northwestern Steel & Wire Co.,** **Paul Harris Stores, Inc.,** **Ultra Motorcycle Co.,** **UStel, Inc., and** **Yarc Systems Corp.** **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 Environmental Safeguards, Inc. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Garden Botanika, Inc. because it has not filed any periodic reports since it filed a Form 10-Q for the period ended October 28, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Northwestern Steel & Wire Co. because it has not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Paul Harris Stores, Inc. because it has not filed any periodic reports since it filed a Form 10-Q for the period ended October 28, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Ultra Motorcycle Co. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001.

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It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of UStel, Inc. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1998.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Yarc Systems Corp. because it has not filed any periodic reports since it filed a Form 10-KSB for the period ended January 31, 2000.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed companies is suspended for the period from 9:30 a.m. EDT on August 23, 2007, through 11:59 p.m. EDT on September 6, 2007.

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
August 23, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12735

In the Matter of **Environmental Safeguards, Inc.,** **Garden Botanika, Inc.,** **Jay Jacobs, Inc.,** **Northwestern Steel & Wire Co.,** **Paul Harris Stores, Inc.,** **Ultra Motorcycle Co.,** **UStel, Inc., and** **Yarc Systems Corp.,** **Respondents.**	**ORDER INSTITUTING 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. Environmental Safeguards, Inc. ("Environmental Safeguards") (CIK No. 1017616) is a Nevada corporation located in Houston, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Environmental Safeguards 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 30, 2004, which reported a net loss of $1,462,000 for the prior six months. As of August 20, 2007, the company's common stock (symbol "ELSF") was quoted on the Pink Sheets, had thirteen market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

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2. Garden Botanika, Inc. ("Garden Botanika") (CIK No. 892335) is an inactive Washington corporation located in Redmond, Washington with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Garden Botanika 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 October 28, 2000, which reported a net loss of $7,553,000 for the prior nine months. On April 20, 1999, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of Washington, and the case was closed on March 31, 2004. As of August 20, 2007, the company's common stock (symbol "GBOTQ") was quoted on the Pink Sheets, had four market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

3. Jay Jacobs, Inc. ("Jay Jacobs") (CIK No. 812127) is a dissolved Washington corporation located in Seattle, Washington with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Jay Jacobs 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 October 31, 1998, which reported a net loss of $4,445,000 for the prior nine months. On September 3, 1999, the company and its wholly-owned subsidiary, J.J. Distribution Company, filed separate Chapter 11 petitions in the U.S. Bankruptcy Court for the Western District of Washington, which were converted to Chapter 7, and the cases were closed on April 27, 2005.

4. Northwestern Steel and Wire Co. ("Northwestern Steel") (CIK No. 73093) is an Illinois corporation located in Sterling, Illinois with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Northwestern Steel 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 January 31, 2001, which reported a net loss of $29,420,000 for the prior six months. On December 19, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, which was converted to Chapter 7, and is pending. As of August 20, 2007, the company's common stock (symbol "NWSW") was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

5. Paul Harris Stores, Inc. ("Paul Harris") (CIK No. 45791) is a dissolved Indiana corporation located in Indianapolis, Indiana with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Paul Harris 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 October 28, 2000, which reported a net loss of $40,335,000 for the prior thirty-nine weeks. On October 16, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Indiana, which is still pending. As of August 20, 2007, the company's common stock (symbol "PAUHQ") was quoted on the Pink Sheets, had four market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

6. Ultra Motorcycle Co. ("Ultra Motorcycle") (CIK No. 805907) is a suspended California corporation located in Mira Loma, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Ultra Motorcycle 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 March 31, 2001, which reported a net loss of $437,132 for the prior three months. On May 21, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Central District of California, which was converted to Chapter 7, and is still pending.

7. UStel, Inc. ("UStel") (CIK No. 919274) is an inactive Minnesota corporation located in Seattle, Washington with a class of equity securities and redeemable warrants registered with the Commission pursuant to Exchange Act Section 12(g). UStel 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, 1998, which reported a net loss of $8,890,029 for the prior nine months. On March 10, 1999, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of Washington, which was converted to Chapter 7, and the case was closed on August 17, 2006. As of August 20, 2007, the company's common stock (symbol "USTL") was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

8. Yarc Systems Corp. ("Yarc Systems") (CIK No. 843650) is a suspended California corporation located in Thousand Oaks, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Yarc Systems is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended January 31, 2000, which reported a net loss of $540,923. On April 17, 2001, the company filed a Chapter 7 bankruptcy proceeding in the U.S. Bankruptcy Court for the Central District of California, and the case was closed on December 26, 2003. As of August 20, 2007, the company's common stock (symbol "YARCQ") was quoted on the Pink Sheets, had three market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

9. 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), 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 valid address on file with the Commission as required by Commission rules, did not receive such letters.

10. 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).

11. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

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

A. Whether the allegations contained in Section II 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 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 Respondents 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)].

them?

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 ~~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 Respondents personally or by certified or Express Mail, or by other means permitted by the Commission's Rules of Practice.

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

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice.

Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

Attachment

Chart of Delinquent Filings by *Environmental Safeguards, Inc., et al.*

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Environmental Safeguards, Inc.					
	10-QSB	09/30/04	11/15/04	Not filed	33
	10-KSB	12/31/04	03/31/05	Not filed	29
	10-QSB	03/31/05	05/16/05	Not filed	27
	10-QSB	06/30/05	08/15/05	Not filed	24
	10-QSB	09/30/05	11/14/05	Not filed	21
	10-KSB	12/31/05	03/31/06	Not filed	17
	10-QSB	03/31/06	05/15/06	Not filed	15
	10-QSB	06/30/06	08/14/06	Not filed	12
	10-QSB	09/30/06	11/14/06	Not filed	9
	10-KSB	12/31/06	04/02/07	Not filed	4
	10-QSB	03/31/07	05/15/07	Not filed	3
	10-QSB	06/30/07	08/14/07	Not filed	0
Total Filings Delinquent	12				
Garden Botanika, Inc.					
	10-K	02/03/01	05/04/01	Not filed	75
	10-Q	05/05/01	06/19/01	Not filed	74
	10-Q	08/04/01	09/18/01	Not filed	71
	10-Q	11/03/01	12/18/01	Not filed	68
	10-K	02/02/02	05/03/02	Not filed	63
	10-Q	05/04/02	06/18/02	Not filed	62
	10-Q	08/03/02	09/17/02	Not filed	59
	10-Q	11/02/02	12/17/02	Not filed	56
	10-K	02/01/03	05/02/03	Not filed	51
	10-Q	05/03/03	06/17/03	Not filed	50
	10-Q	08/02/03	09/16/03	Not filed	47
	10-Q	11/01/03	12/16/03	Not filed	44
	10-K	01/31/04	04/30/04	Not filed	40
	10-Q	05/01/04	06/15/04	Not filed	38
	10-Q	07/31/04	09/14/04	Not filed	35
	10-Q	10/30/04	12/14/04	Not filed	32
	10-K	01/29/05	04/29/05	Not filed	28
	10-Q	04/30/05	06/14/05	Not filed	26
	10-Q	07/30/05	09/13/05	Not filed	23
	10-Q	10/29/05	12/13/05	Not filed	20
	10-K	01/28/06	04/28/06	Not filed	16
	10-Q	04/29/06	06/13/06	Not filed	14
	10-Q	07/29/06	09/12/06	Not filed	11

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Garden Botanika, Inc.					
	10-Q	10/28/06	12/12/06	Not filed	8
	10-K	01/27/07	04/27/07	Not filed	4
	10-Q	04/28/07	06/12/07	Not filed	2
Total Filings Delinquent	26				
Jay Jacobs, Inc.					
	10-K	01/30/99	04/30/99	Not filed	96
	10-Q	05/01/99	06/15/99	Not filed	98
	10-Q	07/31/99	09/14/99	Not filed	95
	10-Q	10/30/99	12/14/99	Not filed	92
	10-K	01/29/00	04/28/00	Not filed	88
	10-Q	04/29/00	06/13/00	Not filed	86
	10-Q	07/29/00	09/12/00	Not filed	83
	10-Q	10/28/00	12/12/00	Not filed	80
	10-K	02/03/01	05/04/01	Not filed	75
	10-Q	05/05/01	06/19/01	Not filed	74
	10-Q	08/04/01	09/18/01	Not filed	71
	10-Q	11/03/01	12/18/01	Not filed	68
	10-K	02/02/02	05/03/02	Not filed	63
	10-Q	05/04/02	06/18/02	Not filed	62
	10-Q	08/03/02	09/17/02	Not filed	59
	10-Q	11/02/02	12/17/02	Not filed	56
	10-K	02/01/03	05/02/03	Not filed	51
	10-Q	05/03/03	06/17/03	Not filed	50
	10-Q	08/02/03	09/16/03	Not filed	47
	10-Q	11/01/03	12/16/03	Not filed	44
	10-K	01/31/04	04/30/04	Not filed	40
	10-Q	05/01/04	06/15/04	Not filed	38
	10-Q	07/31/04	09/14/04	Not filed	35
	10-Q	10/30/04	12/14/04	Not filed	32
	10-K	01/29/05	04/29/05	Not filed	28
	10-Q	04/30/05	06/14/05	Not filed	26
	10-Q	07/30/05	09/13/05	Not filed	23
	10-Q	10/29/05	12/13/05	Not filed	20
	10-K	01/28/06	04/28/06	Not filed	16
	10-Q	04/29/06	06/13/06	Not filed	14
	10-Q	07/29/06	09/12/06	Not filed	11
	10-Q	10/28/06	12/12/06	Not filed	4
	10-K	01/27/07	04/27/07	Not filed	4
	10-Q	04/28/07	06/12/07	Not filed	2
Total Filings Delinquent	34				

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Northwestern Steel & Wire Co.					
	10-Q	04/30/01	06/14/01	Not filed	74
	10-K	07/31/01	10/29/01	Not filed	70
	10-Q	10/31/01	12/17/01	Not filed	68
	10-Q	01/31/02	03/18/02	Not filed	65
	10-Q	04/30/02	06/14/02	Not filed	62
	10-K	07/31/02	10/29/02	Not filed	58
	10-Q	10/31/02	12/16/02	Not filed	56
	10-Q	01/31/03	03/17/03	Not filed	53
	10-Q	04/30/03	06/16/03	Not filed	50
	10-K	07/31/03	10/31/03	Not filed	46
	10-Q	10/31/03	12/15/03	Not filed	44
	10-Q	01/31/04	03/16/04	Not filed	41
	10-Q	04/30/04	06/14/04	Not filed	38
	10-K	07/31/04	10/29/04	Not filed	34
	10-Q	10/31/04	12/15/04	Not filed	32
	10-Q	01/31/05	03/17/05	Not filed	29
	10-Q	04/30/05	06/14/05	Not filed	26
	10-K	07/31/05	10/31/05	Not filed	22
	10-Q	10/31/05	12/15/05	Not filed	20
	10-Q	01/31/06	03/17/06	Not filed	17
	10-Q	04/30/06	06/14/06	Not filed	14
	10-K	07/31/06	10/30/06	Not filed	10
	10-Q	10/31/06	12/15/06	Not filed	8
	10-Q	01/31/07	03/19/07	Not filed	2
	10-Q	04/30/07	06/14/07	Not filed	1
Total Filings Delinquent	25				
Paul Harris Stores, Inc.					
	10-K	02/03/01	05/04/01	Not filed	75
	10-Q	05/05/01	06/19/01	Not filed	74
	10-Q	08/04/01	09/18/01	Not filed	71
	10-Q	11/03/01	12/18/01	Not filed	68
	10-K	02/02/02	05/03/02	Not filed	63
	10-Q	05/04/02	06/18/02	Not filed	62
	10-Q	08/03/02	09/17/02	Not filed	59
	10-Q	11/02/02	12/17/02	Not filed	56
	10-K	02/01/03	05/02/03	Not filed	51
	10-Q	05/03/03	06/17/03	Not filed	50
	10-Q	08/02/03	09/16/03	Not filed	47
	10-Q	11/01/03	12/16/03	Not filed	44
	10-K	01/31/04	04/30/04	Not filed	40
	10-Q	05/01/04	06/15/04	Not filed	38
	10-Q	07/31/04	09/14/04	Not filed	35

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Paul Harris Stores, Inc.					
	10-Q	10/30/04	12/14/04	Not filed	32
	10-K	01/29/05	04/29/05	Not filed	28
	10-Q	04/30/05	06/14/05	Not filed	26
	10-Q	07/30/05	09/13/05	Not filed	23
	10-Q	10/29/05	12/13/05	Not filed	20
	10-K	01/28/06	04/28/06	Not filed	16
	10-Q	04/29/06	06/13/06	Not filed	14
	10-Q	07/29/06	09/12/06	Not filed	11
	10-Q	10/28/06	12/12/06	Not filed	8
	10-K	01/27/07	04/27/07	Not filed	4
	10-Q	04/28/07	06/12/07	Not filed	2
Total Filings Delinquent	26				
Ultra Motorcycle Co.					
	10-QSB	06/30/01	08/14/01	Not filed	72
	10-QSB	09/30/01	11/14/01	Not filed	69
	10-KSB	12/31/01	04/01/02	Not filed	64
	10-QSB	03/31/02	05/15/02	Not filed	63
	10-QSB	06/30/02	08/14/02	Not filed	60
	10-QSB	09/30/02	11/14/02	Not filed	57
	10-KSB	12/31/02	03/31/03	Not filed	53
	10-QSB	03/31/03	05/15/03	Not filed	51
	10-QSB	06/30/03	08/14/03	Not filed	48
	10-QSB	09/30/03	11/14/03	Not filed	45
	10-KSB	12/31/03	03/30/04	Not filed	41
	10-QSB	03/31/04	05/17/04	Not filed	39
	10-QSB	06/30/04	08/16/04	Not filed	36
	10-QSB	09/30/04	11/15/04	Not filed	33
	10-KSB	12/31/04	03/31/05	Not filed	29
	10-QSB	03/31/05	05/16/05	Not filed	27
	10-QSB	06/30/05	08/15/05	Not filed	24
	10-QSB	09/30/05	11/14/05	Not filed	21
	10-KSB	12/31/05	03/31/06	Not filed	17
	10-QSB	03/31/06	05/15/06	Not filed	15
	10-QSB	06/30/06	08/14/06	Not filed	12
	10-QSB	09/30/06	11/14/06	Not filed	9
	10-KSB	12/31/06	04/02/07	Not filed	4
	10-QSB	03/31/07	05/15/07	Not filed	3
	10-QSB	06/30/07	08/14/07	Not filed	0
Total Filings Delinquent	25				

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
UStel, Inc.					
	10-KSB	12/31/98	03/31/99	Not filed	101
	10-QSB	03/31/99	05/17/99	Not filed	99
	10-QSB	06/30/99	08/16/99	Not filed	96
	10-QSB	09/30/99	11/15/99	Not filed	93
	10-KSB	12/31/99	03/30/00	Not filed	89
	10-QSB	03/31/00	05/15/00	Not filed	87
	10-QSB	06/30/00	08/14/00	Not filed	84
	10-QSB	09/30/00	11/14/00	Not filed	81
	10-KSB	12/31/00	04/02/01	Not filed	76
	10-QSB	03/31/01	05/15/01	Not filed	75
	10-QSB	06/30/01	08/14/01	Not filed	72
	10-QSB	09/30/01	11/14/01	Not filed	69
	10-KSB	12/31/01	04/01/02	Not filed	64
	10-QSB	03/31/02	05/15/02	Not filed	63
	10-QSB	06/30/02	08/14/02	Not filed	60
	10-QSB	09/30/02	11/14/02	Not filed	57
	10-KSB	12/31/02	03/31/03	Not filed	53
	10-QSB	03/31/03	05/15/03	Not filed	51
	10-QSB	06/30/03	08/14/03	Not filed	48
	10-QSB	09/30/03	11/14/03	Not filed	45
	10-KSB	12/31/03	03/30/04	Not filed	41
	10-QSB	03/31/04	05/17/04	Not filed	39
	10-QSB	06/30/04	08/16/04	Not filed	36
	10-QSB	09/30/04	11/15/04	Not filed	33
	10-KSB	12/31/04	03/31/05	Not filed	29
	10-QSB	03/31/05	05/16/05	Not filed	27
	10-QSB	06/30/05	08/15/05	Not filed	24
	10-QSB	09/30/05	11/14/05	Not filed	21
	10-KSB	12/31/05	03/31/06	Not filed	17
	10-QSB	03/31/06	05/15/06	Not filed	15
	10-QSB	06/30/06	08/14/06	Not filed	12
	10-QSB	09/30/06	11/14/06	Not filed	9
	10-KSB	12/31/06	04/02/07	Not filed	4
	10-QSB	03/31/07	05/15/07	Not filed	3
	10-QSB	06/30/07	08/14/07	Not filed	0
Total Filings Delinquent	35				
Yarc Systems Corp.					
	10-QSB	04/30/00	06/14/00	Not filed	86
	10-QSB	07/31/00	09/14/00	Not filed	83
	10-QSB	10/31/00	12/15/00	Not filed	80
	10-KSB	01/31/01	05/01/01	Not filed	75
	10-QSB	04/30/01	06/14/01	Not filed	74
	10-QSB	07/31/01	09/14/01	Not filed	71

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Yarc Systems Corp.					
	10-QSB	10/31/01	12/17/01	Not filed	68
	10-KSB	01/31/02	05/01/02	Not filed	63
	10-QSB	04/30/02	06/14/02	Not filed	62
	10-QSB	07/31/02	09/16/02	Not filed	59
	10-QSB	10/31/02	12/16/02	Not filed	56
	10-KSB	01/31/03	05/01/03	Not filed	51
	10-QSB	04/30/03	06/16/03	Not filed	50
	10-QSB	07/31/03	09/15/03	Not filed	47
	10-QSB	10/31/03	12/15/03	Not filed	44
	10-KSB	01/31/04	04/30/04	Not filed	40
	10-QSB	04/30/04	06/14/04	Not filed	38
	10-QSB	07/31/04	09/14/04	Not filed	35
	10-QSB	10/31/04	12/15/04	Not filed	32
	10-KSB	01/31/05	05/02/05	Not filed	27
	10-QSB	04/30/05	06/14/05	Not filed	26
	10-QSB	07/31/05	09/14/05	Not filed	23
	10-QSB	10/31/05	12/15/05	Not filed	20
	10-KSB	01/31/06	05/01/06	Not filed	15
	10-QSB	04/30/06	06/14/06	Not filed	14
	10-QSB	07/31/06	09/14/06	Not filed	11
	10-QSB	10/31/06	12/15/06	Not filed	8
	10-KSB	01/31/07	05/01/07	Not filed	3
	10-QSB	04/30/07	06/14/07	Not filed	2

Total Filings Delinquent 29

Commissioners Atkins & Campos Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
August 24, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12738

In the Matter of **NEXT FINANCIAL GROUP, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against NEXT Financial Group, Inc. ("Respondent" or "NEXT").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. **NEXT Financial Group, Inc.,** a broker-dealer headquartered in Houston, Texas, is a wholly owned subsidiary of NEXT Financial Holdings, Inc., a privately-held company. The company is owned and controlled by its registered representatives and employees. NEXT has over 700 registered representatives nationwide. NEXT has been registered with the Commission as a broker-dealer since June 1999. NEXT's registered representatives are primarily retail salespersons and financial planners classified as independent contractors.

B. FACTS

1. NEXT recruits new registered representatives ("recruits"), encouraging them to leave their current broker-dealer and bring their current customers to NEXT, before customers had consented to the disclosure of their nonpublic personal information, or to the transfer of their account. To facilitate this process, NEXT devotes a team of employees to assist incoming

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had consented to the disclosure of their nonpublic personal information, or to the transfer of their account. To facilitate this process, NEXT devotes a team of employees to assist incoming registered representatives with the account transfer process. This team of employees is known as NEXT's "transition team."

2. The transition team assists recruits by pre-populating account transfer documents such as customer notification letters, Automated Customer Account Transfer forms, NEXT new account information forms, change of broker-dealer letters, and mailing labels.

3. The transition team provides every recruit with a "transition tools e-mail" that contains a sample Excel spreadsheet many recruits used to supply NEXT with his or her current customer information, including nonpublic personal information.

4. Until February 2007, the customer information called for in the Excel spreadsheet included for each customer account: (1) name of the primary account owner, trustee, or custodian and the secondary account owner; (2) brokerage account numbers; (3) "direct" account numbers such as mutual fund account numbers and variable annuity account numbers; (4) whether or not each brokerage account is "managed;" (5) social security or tax identification numbers of primary and secondary account owners; (6) account type; (7) net worth; (8) annual income; (9) years of investment experience; (10) mailing address and, if that is a post office box, the actual residential, physical address; (11) home telephone number; (12) date of birth of the primary account owner; (13) bank name, city, state and zip code; (14) passport number; (15) driver's license number; (16) occupations of the primary and secondary account owners; and (17) the primary and secondary account owners' employers, with work addresses and work telephone numbers and fax numbers. Recruits provided this nonpublic personal information to NEXT prior to joining NEXT.

5. As of February 2007, NEXT stopped asking recruits to provide social security numbers, dates of birth and driver's license number for their customers. The information NEXT currently collects from recruits still includes other nonpublic personal information listed in paragraph II.B.4. above.

6. The transition team encouraged recruits to e-mail the completed Excel spreadsheet, which included nonpublic customer information, to NEXT to begin pre-populating the transition documents. Often, NEXT e-mails the database back to the recruit to be reformatted or to have the recruit add information. NEXT does not encrypt e-mail.

7. The transition team provides instructions to recruits on how to export data into spreadsheet format for use with other software programs that NEXT can use to create account transfer forms prior to the recruit joining NEXT.

8. The transition team explains to recruits the features of recruits' current broker-dealer computer system, including how these systems can be utilized to extract customer information, including nonpublic personal information, and export the information into NEXT's Excel spreadsheet.

9. Until on or about May 2006, in some instances, the NEXT transition team used recruits' user ID and password, provided by recruits, to access recruits' current broker-dealer's computer system. Once NEXT gained access to the other broker-dealer's system, the transition team extracted nonpublic personal information and downloaded the information to NEXT's home office computer network for the purpose of pre-populating transfer documents. The NEXT transition team also used recruits' user IDs and Passwords to access various mutual fund and annuity company websites to extract nonpublic personal information.

10. Recruits provide the customer information, including non-public personal information, two weeks prior to a recruit's employment with NEXT.

11. The printed transfer documents are sent to the recruit, who, upon his official start date with NEXT, immediately sends his customers notification of change letters and the pre-populated forms for the customers' review and signature.

12. On limited occasions NEXT used recruits' customer data to pre-populate NEXT's own internal back office client database system, and to facilitate opening new accounts. This allowed NEXT to create a customer profile containing nonpublic personal information before the individual actually became a customer of NEXT.

13. Until in or about May 2006, the NEXT database in which customer information was stored could be accessed by anyone at the NEXT home office. Nonpublic personal customer information was stored indefinitely on NEXT's common server. Even if a customer did not transfer his account to NEXT, the non-public personal information was maintained in the NEXT database.

14. On a limited number of occasions, NEXT also forwarded nonpublic information to its clearing firm in anticipation of a recruit transferring a large number of brokerage accounts to NEXT.

15. NEXT has received nonpublic personal customer information from a recruit, only to have the recruit decide not to join NEXT. The customer information was retained on the NEXT computer system.

16. Recruits' customers are not informed that their nonpublic personal customer information is being provided to NEXT before the information is provided to NEXT.

17. NEXT takes no steps to determine whether the privacy policies of the recruits' current firms disclose that a registered representative may transfer nonpublic personal customer information to NEXT or other nonaffiliated broker-dealers.

18. Generally, the Privacy Policies of the recruits' current broker-dealers do not disclose that their registered representatives may provide nonpublic personal customer information to nonaffiliated broker-dealers, such as NEXT.

19. Generally, the Privacy Policies of the recruits' current broker-dealers do not provide the customers an opt out notice or a reasonable opportunity to opt out of the disclosure to NEXT of nonpublic personal customer information by the recruit.

20. When a registered representative leaves NEXT he is permitted to take copies of all his customer files and documents which include nonpublic personal information.

21. Registered representatives departing NEXT are also allowed to download, and take with them, their customer information from any electronic database to which they have access. This includes all their customer information from mutual fund and annuity companies, the NEXT internal database system, and the clearing broker-dealer host computer system.

22. Until June 2006, the NEXT privacy policy did not clearly and conspicuously inform the customer that NEXT would allow the registered representative leaving NEXT to provide the customers' nonpublic personal information to a new firm without the customers' consent. Customers also had not been given a reasonable opportunity to opt out of NEXT's practice of allowing a customer's nonpublic personal information to be provided to the registered representative's new firm.

C. VIOLATIONS

1. As a result of the conduct described above, Respondent willfully violated Regulation S-P Rule 10, which prohibits the disclosure of nonpublic personal information about consumers to nonaffiliated third parties without proper opt out notice and reasonable opportunity to opt out.

2. As a result of the conduct described above, Respondent willfully violated Regulation S-P Rule 30, which requires every broker-dealer to adopt policies and procedures to safeguard customer records and information. By allowing registered representatives to take customer nonpublic personal information with them, NEXT failed to ensure the security of customer records and information, and failed to protect against unauthorized access to customer records.

3. As a result of the conduct described above, Respondent willfully violated Regulation S-P Rule 4, which requires a broker-dealer to provide customers with a clear and conspicuous notice that accurately reflects the broker-dealer's privacy policies and practices.

4. As a result of the conduct described above, Respondent willfully violated Regulation S-P Rule 6, which requires privacy notices to include the categories of nonpublic personal information that will be disclosed, and the categories of affiliates and nonaffiliated third parties to which nonpublic personal information may be disclosed.

5. As a result of the conduct described above, Respondent willfully aided and abetted and caused other broker-dealers' violations of Regulation S-P Rule 10, which prohibits the disclosure of nonpublic personal information about consumers to nonaffiliated third parties without proper notice and reasonable opportunity to opt out.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, civil penalties pursuant to Section 21B of the Exchange Act;

C. Whether, pursuant to Section 21C of the Exchange Act, Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Regulation S-P Rules 6, 10, 30, or 4.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him 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 mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey Not Participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56334 / August 29, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2670 / August 29, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12740

In the Matter of **ILONA KAY COLLINS,** **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 Ilona Kay Collins ("Respondent" or "Collins") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the 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

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[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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these proceedings, and the findings contained in paragraph III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Collins, age 44, was a certified public accountant licensed to practice in the State of Iowa from February 1986 to June 2004 and licensed to practice in the State of Colorado from June 1991 to May 2004. She was the Controller at Quovadx, Inc. ("Quovadx" or the "Company") from approximately November 2000 until April 2004.

2. Quovadx, a Delaware corporation headquartered in Englewood, Colorado, is a software company that licenses software and sells related services to the healthcare industry. At all relevant times, Quovadx's common stock was registered with the Commission under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the NASDAQ.

3. On August 14, 2007, a final judgment was entered against Collins, permanently enjoining her from violating, directly or indirectly, 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 any violation of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13, thereunder, in the civil action entitled Securities and Exchange Commission v. Ilona Kay Collins, Civil Action Number 07-cv-01506-WDM-MEH, in the United States District Court for the District of Colorado.

4. The Commission's Complaint alleged, among other things, that, in the third quarter of 2003, Quovadx fraudulently recognized approximately $380,000 in software licensing revenue from three purported sales to one of its customers. The Complaint also alleged that Collins approved the recognition of the revenue from these transactions when she knew or was reckless in not knowing that this customer was merely holding the software licenses until they were resold to other customers the next quarter and there was no likelihood that Quovadx would otherwise collect the revenues from those transactions. The Complaint also alleged that in February 2004, Collins participated in a plan to channel payment from another Quovadx customer to the customer holding the software licenses, which created the false appearance that Quovadx had collected part of the revenue from these three transactions. The Complaint also alleged that Collins also signed a management representation letter for 2003 sent to Quovadx's outside auditor that failed to disclose the true facts and circumstances of these three transactions.

IV.

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

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

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

B. After five years from the date of this order, Collins may request that the Commission consider her reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in her practice before the Commission will be reviewed either by the independent audit committee of the public company for which she works or in some other acceptable manner, as long as she practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which she is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which she is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges her responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that her state CPA license is current and she has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Nancy M. Morris
Secretary

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

Commissioners Atkins & Nazareth Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56341 / August 30, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2672 / August 30, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12741

In the Matter of **DAVID A. MILLER, CPA** **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 David A. Miller ("Miller" 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, 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[1] that:

1. Miller, age 36, is a resident of Houston, Texas. During the relevant time period, Miller was the Chief Accounting Officer of Integrated Electrical Services, Inc. ("IES"). Among his duties, Miller was responsible for ensuring proper disclosure in IES's financial statements. Miller is currently self employed. From January 2005 to April 2007, Miller was the Chief Financial Officer of IES. Miller is a licensed CPA in the State of Texas.

2. IES is a Delaware corporation headquartered in Houston, Texas. During the relevant time period, IES was a leading provider of electrical contracting services in the United States, whose shares were traded on the New York Stock Exchange and registered with the Commission under Section 12(b) of the Exchange Act.

3. For the quarter ended June 30, 2003, the fiscal year ended September 30, 2003, the quarter ended December 31, 2003, and the quarter ended March 31, 2004, IES failed to properly disclose material loss contingencies related to its accounts receivable.[2] The loss contingencies surrounding IES's accounts receivable comprised approximately $3 million in revenues recorded on unsigned, disputed change orders from two electrical construction contracts at an IES subsidiary, Pan American Electric, Inc. ("Pan Am").

4. In February 2000, Pan Am contracted with Centex Rodgers, Inc. ("Centex") for work on construction of the Vanderbilt University Medical Center. By the end of 2002, IES had recorded revenue of approximately $1.7 million based on work performed pursuant to unsigned change orders. Centex later disputed payment on those change orders. After negotiations, in June 2004 IES accepted $35,000 as payment in full and wrote-off the remaining balance associated with the disputed account receivable, approximately $1.7 million, with the agreement that Centex would continue to work with IES and its subsidiaries.

5. In June 2000, Pan Am contracted with Beers Skanska for work on construction of the Bay Medical Center Surgery/ER unit in Panama City, Florida. By the end of 2002, IES had recorded revenue of approximately $1.3 million based on work performed pursuant to unsigned change orders. Beers Skanska later disputed payment on those change orders. IES wrote down the value of the change orders by 50% in September 2004. After negotiations and litigation, IES recovered $810,000 on the project in January 2005.

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[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.

[2] On August 29, 2007, the Commission filed a Complaint in the Southern District of Texas, Houston Division, entitled SEC v. IES, et al. ("Complaint"), alleging that IES and certain individuals violated the federal securities laws. Simultaneous with the filing of the Complaint, without admitting or denying the allegations therein, IES agreed to the entry of a permanent injunction for violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-13, and 12b-20 thereunder. Miller is not a party to, or named as a defendant in, the Complaint.

6. Prior to writing down the value on the Vanderbilt and Bay Medical account receivables, IES failed to properly disclose the material loss contingencies that existed on the two projects. Moreover, Miller failed to ensure IES's proper disclosure of these material loss contingencies.

7. IES maintained an allowance for doubtful accounts, which IES disclosed in its filings with the Commission. Among other things, IES's disclosure states that the allowance maintained is subject to "judgments and estimates," and the specific amount of the allowance was reflected quarterly and annually in IES's financial statements. However, IES failed to properly disclose material changes in estimates for its allowance for doubtful accounts reserve when it lowered such reserve by nearly $2 million over the course of three consecutive quarters.

8. During the quarters ended September 30, 2003, December 31, 2003, and March 31, 2004, IES changed the percentage basis for estimating the general portion of its uncollectible accounts receivable from approximately 1% down to 0.25%. This resulted in IES reducing its allowance account and thereby increasing its pre-tax income by $550,000 for the quarter and fiscal year ended September 30, 2003, by $1.1 million for the quarter-ended December 31, 2003, and by $200,000 for the quarter-ended March 31, 2004. These reductions were material to IES's pre-tax income in each period. However, IES failed to properly disclose that it had changed the percentage basis for its doubtful accounts. Moreover, Miller failed to ensure IES's proper disclosure of the changes of the percentage basis for its doubtful accounts.

9. As a result of the conduct described above, Miller caused violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder.

IV.

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

Accordingly, it is hereby ORDERED that Miller cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.

By the Commission.

Nancy M. Morris
Nancy M. Morris
Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56340 / August 30, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2671 / August 30, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-11091

In the Matter of David R. Decker, CPA	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT RESPONSIBLE FOR THE PREPARATION OR REVIEW OF FINANCIAL STATEMENTS REQUIRED TO BE FILED WITH THE COMMISSION

On April 24, 2003, David R. Decker ("Decker") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Decker pursuant to Rule 102(e) of the Commission's Rules of Practice.[1] Decker consented to the entry of the April 24, 2003 order without admitting or denying the findings therein. This order is issued in response to Decker's application for reinstatement to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

Decker was alleged to have engaged in improper professional conduct in connection with his work on BKR Metcalf Davis' ("Metcalf Davis") audit of Chancellor Corporation's ("Chancellor") 1998 financial statements. Decker was responsible for conducting a review of the audit workpapers as part of the Metcalf Davis' quality control function. In addition, he also performed audit steps to determine the appropriate date of consolidation of Chancellor's results with that of a subsidiary it acquired during 1998. In performing his work on the Chancellor audit, Decker failed to exercise due professional care, maintain professional skepticism and obtain sufficient evidential matter. In addition, Decker failed to design appropriate audit procedures to determine whether or not Chancellor's senior management had fraudulently fabricated documents to support their accounting positions. Finally, Decker's actions on the audit caused Chancellor to file a materially false and misleading Form 10-KSB for 1998.

[1] *See* Accounting and Auditing Enforcement Release No. 1762 dated April 24, 2003. Decker was permitted, pursuant to the order, to apply for reinstatement after three years upon making certain showings.

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F. ?

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 56344 / August 31, 2007

INVESTMENT COMPANY ACT OF 1940
Rel. No. 27961 / August 31, 2007

Admin. Proc. File No. 3-9615

In the Matter of

THE ROCKIES FUND, INC.

ORDER DENYING REQUEST FOR RECONSIDERATION

On October 2, 2003, we issued an opinion (the "Commission Opinion") finding, among other things, that The Rockies Fund, Inc. (the "Fund"), a closed-end investment company, and its directors Stephen Calandrella, Charles Powell, and Clifford Thygesen (collectively "Respondents") violated antifraud provisions of the Securities Exchange Act of 1934 by filing quarterly and annual reports containing material misrepresentations as to the classification, valuation, and ownership of certain shares of stock of Premier Concepts, Inc. ("Premier") between June 30, 1994 and December 31, 1995. 1/

We prohibited Calandrella, who was the president of the Fund as well as one of its directors, 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. We prohibited Powell and Thygesen, independent directors of the Fund, from such service or action with a right to reapply after three years. We issued cease-and-desist orders as to all Respondents. Finally, we ordered Calandrella to pay a civil money penalty of $500,000 and Powell and Thygesen each to pay a civil money penalty of $160,000. 2/

1/ The Rockies Fund, 56 S.E.C. 1198, reconsideration denied, Securities Exchange Act Rel. No. 49788 (June 1, 2004), 82 SEC Docket 3764, aff'd in part, vacated in part, and remanded, 428 F.3d 1088 (D.C. Cir. 2005), on remand, Exchange Act Rel. No. 54892 (Dec. 7, 2006), 89 SEC Docket 1517.

2/ This assessment was based on the findings of the law judge that a penalty should be imposed on Calandrella in an amount equal to $50,000 for each misstated filing and (continued...)

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On review, the U.S. Court of Appeals for the D.C. Circuit affirmed our findings of antifraud violations based on the filing of periodic reports containing material misrepresentations and related reporting violations, vacated our findings as to manipulation and the acceptance of improper compensation, and remanded this matter for reconsideration of the sanctions we had imposed. 3/ On December 7, 2006, on remand, we issued an opinion (the "Commission Remand Opinion") finding that it was in the public interest to impose cease-and-desist orders on all Respondents, to prohibit Calandrella, Powell, and Thygesen from associating with or acting as an affiliated person of an investment company, with a right to reapply (after five years in the case of Calandrella and after three years in the case of Powell and Thygesen), and to order Calandrella to pay a civil money penalty of $50,000 and Powell and Thygesen to pay a civil money penalty of $20,000 each.

On December 19, 2006, Respondents submitted a motion seeking reconsideration of the Commission Remand Opinion. Respondents base their motion on three grounds. First, Respondents argue that what they characterize as our "conclusion that there is 'no record evidence' showing reliance on counsel or auditors in the development of the valuations" ignores the record evidence cited by Respondents. 4/ Respondents contend that the evidence of reliance is sufficient to mitigate the sanctions imposed and that we should therefore reduce the sanctions imposed in the Commission Remand Opinion. Second, Respondents argue that we "did not address [their] contention that the valuation errors would have been avoided had the process deficiencies been noted" during a March 1994 examination by Commission staff. 5/ Respondents contend that the "course of dealing" between Respondents and Commission staff "illustrates one of the reasons why . . . [Respondents] did not believe at the time that their valuations were improper" and that "as a matter of fairness and equity, this course of dealing should mitigate the sanctions." Third, Respondents argue that their request for an explanation of the alleged inconsistency between the sanctions imposed here and those imposed in certain cited cases "does not 'attempt[] to downplay the seriousness' of the issues and should not impact the Commission's analysis of 'the likelihood of future violations.'" Respondents contend that one case in particular, Parnassus Investments, 6/ supports their request to alleviate the sanctions imposed.

2/ (...continued)
$100,000 for the manipulation, and on Thygesen and Powell in the amount of $20,000 each for each misstated filing.

3/ The Rockies Fund, Inc. v. SEC, 428 F.3d 1088 (D.C. Cir. 2005).

4/ Respondents' arguments pertain only to alleged reliance with respect to the valuation of Premier stock, not the classification or ownership thereof.

5/ Respondents make no such argument regarding "errors" as to classification or ownership.

6/ Initial Decision Rel. No. 131 (Sept. 3, 1998), 67 SEC Docket 2760.

In any event, Respondents assert, they "acknowledged the seriousness of the issues and, from the beginning, engaged in conduct that should have mitigated the sanctions."

We consider Respondents' motion under Rule of Practice 470. 7/ Reconsideration is an extraordinary remedy designed to correct manifest errors of law or fact or permit the introduction of newly discovered evidence. 8/ Motions for reconsideration are not to be used to reiterate arguments previously made or to cite authorities previously available. 9/ Respondents' motion does not meet the rigorous standard applied. Rather, it is based on a reworking of arguments and facts previously considered and rejected by the Commission and the Court of Appeals. As such, it is an inappropriate attempt to avoid the finality of the Commission's administrative process. The motion affords no basis for reconsideration of the Commission Remand Opinion.

A. Assertion of Reliance on Advice of Counsel and Auditor

The Commission Remand Opinion fully considered Respondents' contention that reliance on counsel and the Fund's auditors should mitigate sanctions and rejected it, stating that "Respondents point to no record evidence showing that they received contemporary advice from attorneys or auditors that the valuations of Premier contained in the periodic reports in question were reasonable." Nothing in Respondents' motion causes us to reconsider this conclusion, which is fatal to their reliance argument.

Respondents' present argument is based on their mischaracterization of the Commission Remand Opinion as concluding that there is "'no record evidence' showing reliance on counsel or auditors in the development of the valuations," together with citation to evidence showing that counsel was consulted concerning the development of the valuation procedures adopted by the Fund. The Court of Appeals has already considered and rejected this argument, finding that "even if true, much of the testimony showed that the Fund used no set procedure – whether developed by counsel or not – for valuing its holdings, instead generally relying on Calandrella's recommendation to the board." 10/ The Court found that this "haphazard process for valuing the largest holding of the Fund" constituted recklessness, not a basis for mitigation of damages.

7/ 17 C.F.R. § 201.470.

8/ See Philip A. Lehman, Exchange Act Rel. No. 54991 (Dec. 21, 2006), 89 SEC Docket 2006 (Order Denying Request for Reconsideration).

9/ See Feeley & Willcox Asset Mgmt. Corp., Order Denying Motion for Reconsideration, 56 S.E.C. 1264, 1267 & n.8 (2003).

10/ Rockies Fund, 428 F.3d at 1097; see also id. (finding that the Fund "rejected its publicly stated valuation procedures," noting without criticism Commission characterization of valuation method as "inconsistent and slipshod," and characterizing valuation process for Premier shares as "haphazard").

Respondents' further citation to evidence that the Fund's counsel attended certain unspecified meetings during which he "observed the valuation process" and discussed what the minutes of the meetings should reflect has been considered by the Commission and rejected because it does not show that counsel gave Respondents any advice at all about the reasonableness of the valuations. Respondents' reliance on Blinder, Robinson & Co. v. SEC 11/ is inapt. In Blinder, Robinson, the court held, among other things, that a district court decision holding that petitioners did not establish reliance on counsel as a defense to liability did not preclude petitioners' offering, in a subsequent administrative proceeding, evidence as to the circumstances surrounding the lawyer-client relationship insofar as relevant to a determination as to whether sanctions should be imposed in the public interest (and if so, what sanctions). 12/ Petitioners here introduced evidence as to their attorney-client relationship, which, as discussed above, we considered.

With respect to the asserted reliance on the Fund's auditor, Respondents cite testimony by the auditor purporting to show that he "discussed various factors . . . that formed the basis of the 1994 valuation of Premier with Calandrella 'at some length,' and was satisfied that the valuation was reasonable." We have already considered this testimony and concluded in the Commission Remand Opinion that "[s]ubsequent testimony that the valuations were, in the auditor's view, not unreasonable, cannot establish reliance." Respondents point to no evidence showing that the auditor's purported conclusion as to the reasonableness of the valuation was communicated to Calandrella (or any other Respondent) prior to the violative conduct, a critical requirement for reliance. 13/ Respondents also argue that in one instance, in 1995, the Fund lowered a valuation figure to one the outside auditor proposed after discussions with Calandrella. This evidence does not establish whether Calandrella disclosed all the facts relevant to the valuation of the Premier shares to the auditor so that the auditor could make an informed judgment as to valuation before proposing the use of the lower figure and thus does not adequately establish reliance. 14/

11/ 837 F.2d 1099, 1109 (D.C. Cir. 1988).

12/ Id. at 1109-11.

13/ See The Rockies Fund, 56 S.E.C. at 1240 n.82 (setting forth elements required to establish reliance). Respondents similarly contend that their counsel testified that he thought Respondents acted reasonably – not that he told Respondents that the valuations were reasonable.

14/ Respondents adduced no evidence showing full disclosure of relevant facts to the auditor and communication of the auditor's opinion to those asserting reliance on it. See, e.g., supra note 11.

B. Assertion that Commission Staff Had Uncommunicated Concerns about Valuation Process

Respondents argue that the Commission Remand Opinion failed to address their argument that, before any of the misconduct at issue here, "Commission staff apparently already had concluded that the Fund's processes were deficient but did not communicate that deficiency to the Fund as part of a March 1994 [examination]. After conversations with Calandrella in 1994, the staff allegedly developed concerns about the Fund's valuations procedures," but, Respondents contend, these alleged concerns were never communicated to Respondents.

Respondents made a similar assertion in the introduction to their brief before us on remand, followed by the observation that "the setting for the failings here should not be ignored." Their brief, however, did not return to this argument to explain in what way the "setting" they alleged should be considered. We originally considered and rejected Respondents' argument that any alleged failure of Commission staff to identify any problems with the Funds' valuations of Premier should act as an estoppel of our action against them. 15/

Respondents expand somewhat on this argument in the motion before us now. They claim that Commission staff "contribut[ed] to [Respondents'] belief that their valuation process had passed inspection by the Commission before a single faulty valuation was developed." This claim suffers from the same flaw as their argument concerning their purported reliance on counsel, i.e., whatever Commission staff may have thought of the Fund's valuation procedures in March, 1994, the Court found that, commencing with the periodic reports in June, 1994, the Fund did not use the valuation procedures the Fund had previously established, but rather engaged in a "haphazard process" that rose to the level of recklessness.

Respondents also argue that, because of their contention that Commission staff failed to communicate its conclusions "that the Fund's processes were deficient," "as a matter of fairness and equity, this course of dealing should mitigate the sanctions." Respondents' allegation that "[Commission] staff allegedly developed concerns about the Fund's valuations procedures" is followed by a citation to two pages of the testimony of a Commission examiner involved in the 1994 examination of the firm. 16/ Nothing in this testimony suggests in any way that staff "developed concerns" about the valuation procedure. The examiner stated that Calandrella "basically indicated to [the examiner] that the board of directors – he presented them with the valuations, they signed off on them; that there was very little discussions [sic] or any questions

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15/ The Rockies Fund, 56 S.E.C. 1198 at 1239.

16/ In their brief before us on remand, Respondents also cite cryptically to the Court's opinion, 428 F. 3d at 1097, in support of the allegation that "staff had concluded as early as March 1994 that the Fund's valuation practices . . . were fundamentally flawed." There is nothing in the Court's opinion at this or any other page that discusses any Commission staff conclusions in March 1994.

asked." Neither this language, nor anything in the examiner's ten pages of testimony, explains what, if anything, the examiner knew or asked about the valuations to which he was referring, such as the method by which the valuations had been calculated, or the extent of any written explanation of the valuations that might have accompanied them. The testimony does not indicate any conclusions he may have drawn about the propriety of the valuation procedures or the valuations themselves. 17/

C. Assertion Regarding Alleged Adjudicative Inconsistency

Respondents renew their argument that "adjudicative consistency" with the result in Parnassus Investments 18/ supports their request to alleviate the sanctions imposed. A comparison of the sanctions imposed here with those imposed in Parnassus does not implicate the issue of adjudicative consistency. 19/ As we said in the Commission Remand Opinion:

> [I]n Parnassus the law judge found that the conduct in question "did not involve fraud, but rather violations of technical provisions of the securities laws." Parnassus Investments, 67 SEC Docket at 2789. In this case, in contrast, we found, as did the Court of Appeals, that respondents acted at least recklessly in violating antifraud provisions of the securities laws.

Respondents contend that our "attempt[s] to distinguish" Parnassus fail because the conduct in Parnassus, as in this proceeding, was found to be reckless. The Commission Remand Opinion did not distinguish Parnassus on the basis of Respondents' mental state, but on the basis of the nature of the violations found. As noted above, the Commission Remand Opinion contrasted the "violations of technical provisions" found by the law judge in Parnassus with Respondents' conduct here, which both we and the Court of Appeals found to be fraudulent. Considering the egregiousness of Respondents' misconduct as found by the Court of Appeals,

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17/ Respondents argue that the law judge "improperly barred" them from offering certain evidence apparently pertaining to this general issue. Respondents raised this argument in their original appeal to the Commission, and it was considered and rejected in the Commission Opinion. Respondents may not challenge this determination in a request to reconsider the Commission Remand Opinion.

18/ 67 SEC Docket 2760.

19/ Moreover, as we stated in the Commission Remand Opinion, "We have consistently held that the appropriate sanction depends on the facts and circumstances of each case and cannot be precisely determined by comparison with action taken in other proceedings. See, e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973); see also, e.g., Anthony A. Adonnino, Exchange Act Rel. No. 48618 (Oct. 9, 2003), 81 SEC Docket 981, 999; Jonathan Feins, 54 S.E.C. 366, 380 (1999)."

together with other relevant factors discussed in the Commission Remand Opinion, 20/ we found the sanctions we imposed to be in the public interest. Nothing in Respondents' motion persuades us that we should revisit that determination. 21/

Respondents contend that, by refusing to find that the likelihood of future violations is low, the Commission Remand Opinion "elevate[d] one issue, [Respondents'] interpretation of the legal significance of prior precedent, over all of [Respondents'] positive responses to this matter." As positive responses, they assert that they "cooperated with the staff at every turn . . . , resolved all issues raised by the staff in March 1994 [during the examination] . . . , admitted their mistakes . . . , and exited the line of business in which the violations occurred." They further assert that they took these actions "notwithstanding the fact that the Fund's shareholders voiced their satisfaction with [the individual Respondents] in the face of the allegations of wrongdoing." They contend that "[i]t is unreasonable to discount all of [Respondents'] actions that reflect an understanding of the seriousness of the issues because of a request to be treated no worse than those whose conduct was worse."

The Commission Remand Opinion explicitly addressed many of the "positive responses to this matter" on which Respondents rely. It "[took] into consideration Respondents'

20/ Our discussion of factors relevant to sanctions encompassed both the factors set forth in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981), and a variety of other factors unique to this case.

21/ Although Respondents on remand identified Parnassus as "[t]he only case that [Respondents] have been able to identify as similar to the current context," they now argue that Robert F. Lynch, Administrative Proceeding File No. 3-3115 (S.E.C. June 29, 1973), 1973 SEC LEXIS 3480 (Initial Decision), aff'd, 46 S.E.C. 5 (1975), involves "similar or more egregious conduct but lighter sanctions" than we imposed on remand. Having failed to cite this authority at an earlier time, Respondents may not rely on it on now. See supra note 9.

We note, however, that although Respondents characterize the sanction imposed in Lynch as a "one-year bar and no fine," the sanction was in fact a permanent bar with the right to reapply after one year. Lynch, 46 S.E.C. at 11 & n.19. Moreover, the Commission noted in Lynch that because the propriety of the right to reapply had neither been appealed by the Division nor called for review by the Commission, the option of altering that aspect of the sanctions was not open to the Commission. Lynch, 46 S.E.C. at 11 n.19. We also note that when Lynch was decided, the Commission did not have the authority to impose civil money penalties in administrative proceedings except in insider trading cases. See generally Arthur W. Laby & W. Hardy Caldecott, Patterns of Enforcement Under the 1990 Remedies Act: Civil Money Penalties, 58 Albany L. Rev. 5, 5-13 (1994) (discussing history of availability of civil penalties).

cooperation with the Commission [examination]." 22/ It noted Respondents' assertion that they "'voluntarily exited the line of business that involved the violations at issue here,'" but also noted that "there is nothing to preclude their entering the securities industry again at some point." 23/ The Commission Remand Opinion's conclusion that Respondents' "attempts to downplay the seriousness of actions found by the Court of Appeals to constitute fraud fall far short of a recognition that the conduct in question was wrongful" is a rejection of their assertion that they have admitted their mistakes. The sanctions we imposed in the Commission Remand Opinion were considerably lighter than those imposed in the Commission Opinion. As noted in the Commission Remand Opinion, they were lighter than those that could have been imposed for misconduct of the type engaged in by Respondents.

Respondents requested that we hear oral argument on their motion for reconsideration. Rule of Practice 451 provides that we will consider motions on the basis of the papers filed by the parties without oral argument unless we determine that the presentation of facts and legal arguments in the briefs and record and the decisional process would be significantly aided by oral argument. 24/ We believe that Respondents have presented their contentions in a manner that has permitted us to fully evaluate and determine the matters at issue and that oral argument would not significantly aid the decisional process.

Accordingly, IT IS ORDERED THAT Respondents' motion for reconsideration and motion for oral argument in this matter be, and they hereby are, denied. 25/

By the Commission.

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

Nancy M. Morris
Secretary

22/ We note that the examination occurred before the filings at issue were made, so cooperation during the examination is in any event of limited relevance.

23/ See Schield Mgmt. Co., Exchange Act Rel. No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862-67 (barring president of investment adviser where measures taken to limit president's future role at firm were "largely reversible, at [firm's] option" and where such measures would have no effect on president's assumption of similar role at another firm).

24/ 17 C.F.R. § 201.451.

25/ We have considered all of the contentions advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed in this opinion.