

SECURITIES AND EXCHANGE COMMISSION

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38 Documents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58074 / July 1, 2008

Admin. Proc. File No. 3-12739

In the Matter of the Application of

DOUGLAS J. TOTH
c/o Robert G. Stevens, Esq.
947 State Road, Suite 202
Princeton, New Jersey 08540

For Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY
PROCEEDINGS

Violations of Rules of Fair Practice

Causing Misstatement on and Failure to Amend Form U4

Registered representative of member firm of registered securities association caused the firm to file a Form U4 on his behalf that failed to disclose a pending investment-related state civil action and to fail to amend the inaccurate Form U4 thereafter. Held, association's findings of violations and sanction imposed are sustained.

APPEARANCES:

Robert G. Stevens, for Douglas J. Toth.

Marc Menchel, Alan Lawhead, James S. Wrona, and Deborah F. McIlroy, for Financial Industry Regulatory Authority, Inc.

Appeal filed: August 28, 2007
Last brief received: December 10, 2007

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I.

Douglas J. Toth ("Toth"), a former registered representative of NASD member firm Bedminster Financial Group, Ltd. ("Bedminster"), seeks review of NASD disciplinary action. 1/ NASD found that Toth, by failing to disclose to Bedminster a pending state civil action against him for securities fraud, willfully caused Bedminster to file on his behalf an inaccurate Uniform Application for Securities Industry Registration ("Form U4") and to fail to amend the Form U4, in violation of NASD Membership Rule IM-1000-1 and Conduct Rule 2110. 2/ NASD suspended Toth in all capacities for one year. We base our findings on an independent review of the record.

II.

Toth's Association with Somerset and the New Jersey Civil Action

Toth has worked as a registered representative with various NASD member firms since 1993. Prior to joining Bedminster, Toth served as president and chief executive officer of and was registered with Somerset Financial Group, Inc. ("Somerset"), a former NASD member firm. Nicholas Thompson ("Thompson") acted as Somerset's secretary and managing director. 3/ By July 2002, Somerset was experiencing financial difficulties and ceased its broker-dealer operations. Shortly thereafter in October 2002, Somerset's NASD membership lapsed, Toth terminated his registration, and by December 2002, Somerset was effectively out of

1/ On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Because the disciplinary action here was taken before that date, we continue to use the designation NASD.

2/ Membership Rule IM-1000-1 prohibits the filing of incomplete or misleading information in connection with registration as a registered representative, and requires that such filing be corrected upon notice thereof. NASD Manual at 3111 (2001 ed.). NASD Rule 2110 requires members and associated persons to "observe high standards of commercial honor and just and equitable principles of trade." NASD Manual at 4111 (2001 ed.).

3/ We take official notice of basic information regarding Toth, Thompson, and Somerset contained in the Central Registration Depository ("CRD") available on FINRA's Web site. 17 C.F.R. § 201.323.

business. Having personally guaranteed several Somerset loans, Toth owed a substantial amount of debt to several former Somerset investors and to other creditors. 4/

On July 3, 2003, the New Jersey Attorney General and the New Jersey Bureau of Securities filed a civil action against Toth, Thompson, Somerset, and others for securities fraud (the "New Jersey Action"). 5/ The complaint (the "New Jersey Complaint") alleged that Toth and others made materially false and misleading statements to investors and omitted material facts with respect to the degree of risk, intended aims, and suitability of an investment. The New Jersey Complaint sought permanent injunctions, restitution, disgorgement, and civil penalties against Toth and others. In July 2005, the New Jersey Action was dismissed without prejudice.

Toth Meets with Bedminster

Robert Van Pelt ("Van Pelt") owns seventy-four percent of Bedminster and is its president. James Solakian ("Solakian") is a passive, twenty-four-percent owner of Bedminster. Solakian invested \$150,000 in Somerset in November 2001, which Toth had personally guaranteed. During the spring of 2003, Solakian threatened to sue Toth to recover his Somerset investment. Toth offered to bring broker-dealer business to Bedminster to offset his debt to Solakian and to avoid litigation.

Solakian arranged an initial meeting ("Initial Meeting") in May 2003 with Toth and Van Pelt. At the time of the Initial Meeting, Van Pelt was aware of Toth's financial difficulties, but he believed that Toth was a "rainmaker, essentially, somebody who could promote business." The three discussed Toth's business proposals in a general manner and the possibility of Toth joining Bedminster.

Additional Meetings Leading to Toth's Association with Bedminster

Sometime between May 2003 and August 13, 2003, Van Pelt, Toth, and Thompson met again to discuss Toth's business proposals and whether Toth and Thompson should become registered with Bedminster. The parties met at Thompson's office at vFinance Investments, Inc. ("vFinance"), in Flemington, New Jersey. 6/

4/ Toth filed a petition for bankruptcy on February 4, 2005, in the United States Bankruptcy Court for the District of New Jersey. Due to the pendency of his bankruptcy petition, NASD declined to seek monetary sanctions from Toth.

5/ Harvey v. Schloth, Civil Action ESX 03c225 (N.J. Super. Ct. Law Div. filed July 3, 2003).

6/ After Somerset closed, Thompson became associated with vFinance, which also acquired all of Somerset's former clients.

However, the witnesses gave differing testimony before the NASD Hearing Panel as to the number and dates of their meetings as well as to the matters discussed in those meetings. Van Pelt testified about one additional meeting held around May 2003 (after the Initial Meeting but before the filing of the New Jersey Complaint). According to Van Pelt, at this meeting Toth disclosed that two arbitrations were pending against him. Toth explained that one arbitration was brought by "a group of wealthy people" and the other arbitration involved a "question of suitability."

≡ Toth was not asked about and did not testify to attending a second meeting in May 2003. Toth testified that he and Thompson met with Van Pelt twice at the end of July or beginning of August 2003 (and thus after the filing of the New Jersey Complaint), which he described as "just before [his] hire date." According to Toth, at one of the two meetings, he and Thompson "sat across" from Van Pelt and reviewed with him a "folder" full of documents that contained "all the documents that relate[d] to the arbitration and every civil case." Toth could not recall whether the New Jersey Complaint was in the folder, stating, "It is possible that it was not, but we discussed it." Toth could not remember whether they discussed the merits of the New Jersey Action or "exactly what [Van Pelt] said" in response to Toth's disclosure of New Jersey Action. Toth, nonetheless, insisted that Van Pelt "knew about [the New Jersey Action]."

Thompson testified that he also attended the two meetings with Van Pelt and Toth in late July or early August. According to Thompson, at the second of these meetings, he made Van Pelt aware of "all the cases" against him, including the New Jersey Action, and "all the documents were there" for Van Pelt's review. Thompson recalled little or no reaction on Van Pelt's part to disclosure of the New Jersey Action. Thompson ultimately did not register with Bedminster. ^{7/}

Van Pelt testified to receiving an e-mail from Toth during the second week of August that notified him of an imminent "deal" for Bedminster, involving GMAC Guaranteed Northeastern Tax Credit Fund, LLC (the "GMAC Fund"). According to Van Pelt, he asked Toth what Van Pelt needed to do to effectuate the deal and Toth replied, "I need to get registered and you need to qualify with GMAC broker/dealer" Van Pelt stated that he also asked Toth, for purposes of registering him with NASD, whether there was "anything different" from Toth's last Form U4 filed with Somerset, "except for the arbitrations [they had] talked about in May [2003.]" Van Pelt testified that Toth replied, "[N]o, those are the only two items." At the hearing, Toth did not remember this conversation taking place.

^{7/} Thompson testified that he had vFinance timely disclose the New Jersey Action in an amended Form U4 in July 2003. Thompson's claim turned out to be false. vFinance did not amend Thompson's Form U4 until January 2004, and only after it was notified of the New Jersey Action by NASD.

Bedminster Files a Form U4 Registering Toth

On August 13, 2003, Van Pelt electronically filed a Form U4 registering Toth as a Bedminster general securities representative, general securities principal, and options principal with NASD and with the Virginia and New Jersey state regulators. ^{8/} Toth's Form U4 omitted the New Jersey Action. Van Pelt testified that he answered "no" in response to Question 14H(2) of Form U4, which asked: "Are you [i.e., Toth] named in any pending *investment-related* civil action that could result in a yes answer to any part of [Question] 14H(1)?" ^{9/} Other than one investment-related arbitration, Toth's Form U4 reported no other investment-related arbitration or civil litigation involving Toth.

Van Pelt testified that he gathered the information to file Toth's Form U4 based on Toth's past CRD filings and his conversations with Toth. Van Pelt testified that he was unaware of the New Jersey Action and therefore did not report it on Toth's Form U4. Van Pelt electronically affixed Toth's signature to the Form U4 under the heading, "Signature of *Applicant*," which represented that Toth "attest[ed] to the completeness and accuracy of the record" therein. ^{10/} Toth testified that he did not review or sign a manual copy of the Form before it was filed, although he knew Van Pelt intended to register him around that time.

On August 14, 2003, the day after Toth's Form U4 was filed, Van Pelt, on behalf of Bedminster, executed a soliciting dealer agreement with, among others, the GMAC Fund, making Bedminster an authorized dealer in GMAC Fund's securities. Van Pelt considered

^{8/} Form U4, as well as an amendment thereto, is filed electronically with CRD by a member firm on behalf of an individual. The member firm must provide a paper copy of the Form U4 to the individual for manual signature. As part of the member firm's recordkeeping requirements, the signed copy is kept on file by the member firm and must be made available upon regulatory request. See Membership Rule 1140, NASD Manual at 3411 (2001 ed.).

^{9/} Italics in original. Question 14H(1) of Form U4, in pertinent part, asks: "Has any domestic or foreign court ever: (a) *enjoined* you in connection with any *investment-related* activity? (b) *found* that you were *involved* in a violation of any *investment-related* statute(s) or regulation(s)?" NASD Manual at 485 (2003 ed.).

^{10/} Van Pelt also entered his own electronic signature under the heading "Signature of *Appropriate Signatory*," representing that Toth had "an opportunity to review the information contained [t]herein" and that he had "approved" it. Italics in original. According to the "Signature Section" of Toth's Form U4, a signature "includes a manual signature or an electronically transmitted equivalent" and is "effected by typing a name in the designated signature field," which constitutes a "legally binding signature." The language preceding the applicant's signature on the Form U4 also permits the "applicant's agent" to type the applicant's name on the form's signature line.

GMAC Fund a significant transaction for Bedminster. The GMAC Fund transaction made Bedminster a net profit of \$12,500, a portion of which Solakian received as part owner of the firm. Toth earned a net commission of \$6,000 on the transaction.

Efforts to Obtain Toth's Signature to the Form U4

Van Pelt testified that, after filing Toth's Form U4, he asked Toth "several times" to sign a copy of the Form U4. In a fax transmission dated August 13, 2003, the fax cover sheet stated that Toth's registration with Bedminster was effective and requested that Toth "review the attached Form U4 for accuracy" and "[s]ign and return the signature page for [Bedminster's] records." ^{11/} At the hearing, Toth testified that he never received this fax transmission. When asked if he recognized the fax number listed on the fax cover sheet, Toth testified initially that it "was an old fax number" for Somerset that was no longer in use. He later re-stated that he did not "recognize the number" and that the facsimile "never made it to [him]." NASD established that the fax number belonged to Thompson's vFinance office in Flemington.

On September 17, 2003, the New Jersey Bureau of Securities sent an information request to Bedminster regarding Toth's Form U4. Van Pelt testified that the September 17 letter requested "a complete explanation of any and all complaints against [Toth] in the state" of New Jersey. Van Pelt testified that he asked Toth in September 2003 to respond to the September 17 letter.

On October 3, 2003, Van Pelt and Toth met at Thompson's vFinance office in Flemington. Toth voiced concerns about continuing his association with Bedminster because Solakian had recently filed "multiple lawsuits against [him]." Van Pelt testified that he handed Toth a set of documents at this meeting for Toth to review and sign, which included a copy of the Form U4, and that Toth indicated he wanted to review the documents over the weekend. Toth testified that he did not recall the details of the October 3 meeting, but he was certain he did not receive any documents from Van Pelt at the time.

Bedminster Files a Form U5 Terminating Toth's Association

On October 6, 2003, Toth telephoned Van Pelt to tender his resignation, citing Solakian's lawsuits against him as the reason. Van Pelt testified that during this call he told Toth that Toth still needed to sign the documents Van Pelt gave him on October 3. Van Pelt further testified

^{11/} Form U4 instructions provide that "*Firms* are responsible for obtaining the individual/*applicant's* consent to the undertakings and attestations" in the Form U4. NASD Manual at 476 (2003 ed.) (italics in original).

that he advised Toth that, if Toth signed the documents, Van Pelt would report to CRD that Toth's termination of employment with Bedminster was "voluntary." 12/

On October 7, 2003, Van Pelt sent Toth a letter by overnight courier, confirming their October 3 meeting and their October 6 phone conversation. In the letter, Van Pelt instructed Toth to sign and return various documents or "the reason for termination [on his Form U5] will be 'for cause' with a suitable explanation." 13/ Van Pelt also again urged Toth to provide "a suitable explanation" to the New Jersey Bureau of Securities.

According to Toth, the only time he received any documents from Van Pelt was by overnight courier, although his testimony is unclear as to when this occurred. Toth "believe[d] that [he] signed those [documents] and returned them to [Van Pelt]," but he did not remember the date on which this took place. Toth denied that he received a copy of the Form U4.

On October 24, 2003, Van Pelt filed a Form U5 terminating Toth's registration with Bedminster. 14/ On October 27, 2003, Toth sent Van Pelt two e-mails. The first e-mail, titled "State of NJ," described "three pending Arbitrations" against Toth and requested that Van Pelt forward the information to the New Jersey Bureau of Securities. Toth's e-mail did not contain any reference to the New Jersey Action. The second e-mail notified Van Pelt that Toth was resigning, effective August 31, 2003. Van Pelt stated that he did not know why Toth designated his resignation date as of August 31 because Van Pelt first received the e-mail on October 27, 2003. Van Pelt never received a signed Form U4 or any other executed documents from Toth. Van Pelt testified that he did not become aware of the New Jersey Action until NASD contacted him six months after the filing and that he did not get a copy of the New Jersey Complaint until November 2004.

12/ A Uniform Termination Notice for Securities Industry Registration ("Form U5") requires disclosure of the nature of the termination (e.g., "discharged, other, permitted to resign, deceased, voluntary"), and where the termination is not voluntary or because of death, the circumstances giving rise to it. Rev. Form U5 (06-2003), NASD Manual at 501 (2003 ed.).

13/ The October 7 letter listed the documents as "the NASD fingerprint card, 1099 employment agreement, of firm compliance manual, and Rule 3040 documents for selling away from [Bedminster]."

14/ Van Pelt marked "other" as the reason for the termination and stated the reason as: "failure to provide NASD fingerprint card[,] failure to respond to written request from NJ Bureau of Securities for additional information[,] failure to sign 1099 firm agreement[,] failure to sign Rule 3040 Document[, and] failure to accept firm compliance manual."

NASD Questions Toth about his Form U4

On July 26, 2004, as part of a routine examination of Bedminster, NASD staff sent Toth a written request for information about Toth's association with Bedminster. Among other questions, the July 26 letter asked Toth for a description of "all information [Toth] provided the firm about matters requiring disclosure on [his] Form U4" including "a specific discussion" of what he informed Bedminster about the New Jersey Action. On August 9, 2004, Toth responded to NASD's letter, stating that he did not "recall all that was discussed [with Bedminster], but we had many meetings about Somerset and the problems arising from my association with that firm. In addition, all arbitrations and civil cases were discussed and disclosed."

On August 16, 2004, NASD staff notified Toth in a second written request that his letter response was not complete and lacked his signature. NASD staff asked what specific information Toth had provided to "the firm and its principals regarding [the New Jersey Action]." Additionally, NASD requested that Toth confirm "whether [he] provided [Bedminster] a copy of the suit and when this was done," and if he had not provided a copy of the New Jersey Complaint, "explain how [he] provided sufficient details on the suit so that the matter could be reviewed and accurately reflected on [his] Form U4 applications."

On August 31, 2004, NASD staff received a second letter from Toth, also dated August 9, 2004. The second letter was signed by Toth but, in response to NASD's request for additional information, Toth supplied an almost identical answer to the one in his first letter, inserting only that ". . . documents relating to the cases were give[n] to [] Van Pelt. I do not remember the dates they were given to Mr. Van Pelt but it was prior to my hire." Toth testified that the first time he saw the Form U4 that Bedminster filed on his behalf was in October 2004 when he met with NASD for his on-the-record testimony in this proceeding and that it was at this point he realized the Form U4 was inaccurate.

NASD Proceedings

On August 9, 2006, NASD's Hearing Panel found that Toth willfully caused a Form U4 to be filed containing a misrepresentation of material fact. The Hearing Panel found Van Pelt's testimony with respect to whether Toth disclosed the New Jersey Action credible and did not credit Toth's testimony. The Hearing Panel suspended Toth in all capacities for one year. On July 27, 2007, NASD's National Adjudicatory Council ("NAC") affirmed the Hearing Panel's finding that Toth willfully caused the filing of a Form U4 that contained a misrepresentation of material fact and found that he failed to correct the inaccurate Form U4.

III.

Membership Rule IM-1000-1 prohibits the filing, in connection with membership or registration as a registered representative, of information so incomplete or inaccurate as to be

misleading, and requires that such a filing be corrected upon notice thereof. 15/ Form U4 is used by NASD and other self-regulatory organizations to determine the fitness of applicants for registration as securities professionals. 16/ Consequently, the candor and forthrightness of applicants is critical to the effectiveness of the screening process. Misrepresentations on Form U4, in addition to violating Membership Rule IM-1000-1, violate the standard of just and equitable principles of trade to which every person associated with an NASD member is held. 17/

It is undisputed that on August 13, 2003, Bedminster filed an inaccurate Form U4 on Toth's behalf that failed to disclose the New Jersey Action. The record in this matter establishes that Toth willfully caused Bedminster to file the inaccurate Form U4 because he failed to supply Van Pelt with information regarding the New Jersey Action. 18/ Toth also failed to review and correct the inaccurate information in the Form U4 that was submitted on his behalf.

The Hearing Panel determined that Van Pelt "consistently and credibly" testified that Toth never disclosed the existence of the New Jersey Action. We have previously stated that "credibility determinations of an initial fact finder are entitled to considerable weight" because they are based on hearing the witnesses' testimony and observing their demeanor. 19/

Toth challenges the Hearing Panel's determination to credit Van Pelt's testimony over Toth's and Thompson's assertions that they disclosed the New Jersey Action to Van Pelt before he filed the Form U4. However, Toth's and Thompson's testimony concerning their purported disclosure of the New Jersey Action lacked specificity and support. Neither Toth nor Thompson

15/ NASD Manual at 3111 (2001 ed.).

16/ See, e.g., Daniel Richard Howard, 55 S.E.C. 1096, 1101 (2002), aff'd, 77 Fed. Appx. 2 (1st Cir. 2003) (unpublished); Rosario R. Ruggiero, 52 S.E.C. 725, 728 (1996); Thomas R. Alton, 52 S.E.C. 380, 382 (1995), aff'd, 105 F.3d 664 (9th Cir. 1996) (Table).

17/ Alton, 52 S.E.C. at 382 & n.5 (citing cases).

18/ One may be found to have caused a violation if he or she was responsible for an act or omission that he or she knew or should have known would contribute to the violation. See Rita J. McConville, Exchange Act Rel. No. 51950 (June 30, 2005), 85 SEC Docket 3127, 3145-46 & n.45 (citing Robert M. Fuller, 56 S.E.C. 976, 984 (2003), petition denied, 95 Fed. Appx. 361 (D.C. Cir. 2004) (unpublished)), petition denied, 465 F.3d 780 (7th Cir. 2006), reh'g denied, 2007 U.S. App. LEXIS 926 (7th Cir. 2007), cert. denied, 128 S. Ct. 48 (2007).

19/ Joseph Abbondante, Exchange Act Rel. No. 53066 (Jan. 6, 2006), 87 SEC Docket 203, 209 & n.21, petition denied, 209 Fed. Appx. 6 (2d Cir. 2006) (unpublished); Laurie Jones Canady, 54 S.E.C. 65, 78 n.23 (1999) (citing Anthony Tricarico, 51 S.E.C. 457, 460 (1993)), petition denied, 230 F.3d 362 (D.C. Cir. 2000).

could recall details regarding their discussion of the New Jersey Action and whether they specifically reviewed the New Jersey Complaint with Van Pelt. Moreover, Thompson was impeached by his failure to disclose the New Jersey Action to vFinance.

Toth also claimed to remember little from his October 3, 2003, meeting with Van Pelt, at which, Van Pelt testified, he again supplied Toth with a Form U4 for his signature. Toth's two e-mails dated October 27 represent the only documents that Toth ever sent to Van Pelt concerning his employment, and while he described three arbitrations in one of the e-mails, neither e-mail mentioned the New Jersey Action.

Toth claims that Van Pelt's testimony exhibited "memory and other problems." Toth cites to Van Pelt's testimony that Toth disclosed only two arbitrations, one involving "wealthy people." According to Toth, the proceeding involving "wealthy people" was in fact a civil suit in New Jersey federal court. ^{20/} Toth also notes that Van Pelt stated that he met with Toth at an office near an airport. Toth claims Van Pelt makes a mistaken reference to Somerset offices that had closed in the summer of 2002, a year prior to the meetings in question.

Toth's attempts to discredit Van Pelt based on these alleged inconsistencies provide no reason to reject the Hearing Panel's credibility determination. The NAC rejected Toth's assertions, stating that both Van Pelt's imprecise use of legal jargon (which, the NAC noted, was shared with Toth) and Van Pelt's reference to meetings taking place "near an airfield," when they did not, were not sufficient to overturn the Hearing Panel's finding that Van Pelt was credible. ^{21/} We have considered the totality of the record and find no reason to overturn the Hearing Panel's credibility determinations.

Documentary evidence also supports Van Pelt's testimony concerning his efforts to obtain Toth's signature on the Form U4. For example, on the same day that Van Pelt electronically filed the Form U4, he attempted to fax a copy to Toth for his review and signature. Although Toth claims that he never received this facsimile because it was sent to the vFinance office in Flemington, the facsimile supports Van Pelt's testimony about his efforts to have Toth review and sign the Form U4. Again, on October 7, 2003, Van Pelt sent Toth a letter, via overnight

^{20/} Although it appears that this civil suit involving Somerset investors was not disclosed on Toth's Form U4, we cannot determine from the record before us whether, as Toth argues, this was the type of case that needed to be disclosed in response to Form U4's disclosure questions. No other lawsuit, besides the New Jersey Action, is contained in the record.

^{21/} Cf. Tricarico, 51 S.E.C. at 461 (upholding NYSE credibility determination despite alleged inconsistencies in witness's testimony).

delivery, that specifically referenced their October 3 discussion in which Van Pelt supplied Toth with a Form U4 for his signature. 22/

Toth argues that "it makes no practical sense for him to fail to disclose the New Jersey [Action]" to Van Pelt when Toth knew that the State of New Jersey would be reviewing the Form U4, but this argument is inconsistent with other behavior of Toth. Toth did not disclose the New Jersey Action in his October 27, 2003, e-mail response to the inquiry from the New Jersey Bureau of Securities.

Moreover, Toth's vague responses to the 2004 NASD inquiries into the details of what he told Bedminster about the New Jersey Action further support NASD's conclusion that Toth never disclosed the existence of the New Jersey Action. Despite NASD's detailed request for information on the filing of his Form U4, Toth provided incomplete answers. When NASD staff found his first response inadequate, it wrote him again. However, Toth's second reply added only that: "documents relating to the cases were give[n] to [] Van Pelt. I do not remember the dates they were given to Mr. Van Pelt but it was prior to my hire." These vague and evasive responses, similar to Toth's testimony in this proceeding, further undermine his credibility.

Toth emphasizes repeatedly that he never saw the Form U4 before he met with NASD in October 2004 and has never signed it. Yet, Toth admits to knowing that Van Pelt intended to register him around the time of the GMAC Fund transaction and that a Form U4 would be filed by Bedminster on his behalf. As we have stated previously, primary responsibility for maintaining the accuracy of a Form U4 lies with the registered representative. 23/

22/ Toth asserts further that the errors in the Form U4 can be attributed to Van Pelt's motive "to get Toth registered as soon as possible" in order "to take advantage of Toth's rainmaking reputation" and that "[a]ccuracy took a second seat and gave way to opportunity. . . ." However, the record—consisting of both documentary and testimonial evidence—reflects Van Pelt's efforts to have Toth review and sign the Form U4 after its filing.

23/ Guang Lu, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket 2639, 2649 (rejecting applicant's defense that the president of his firm advised him not to disclose on the Form U4 that he was discharged from a previous job), aff'd, 179 Fed. Appx. 702 (D.C. Cir. 2006) (unpublished); Howard, 55 S.E.C. at 1102-03 (rejecting defense that firm's registration clerk independently forged a false answer on applicant's Form U4).

We find that Toth's failure to disclose the New Jersey Action violated Membership Rule IM-1000-1 and Conduct Rule 2110 by wilfully causing an inaccurate answer on his Form U4. 24/ Toth's failure to have his Form U4 amended thereafter further violated these rules.

IV.

Pursuant to Section 19(e)(2) of the Securities Exchange Act of 1934 ("Exchange Act"), we sustain NASD's sanction unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 25/ NASD determined to suspend Toth in all capacities for one year. 26/ We sustain the sanction imposed by NASD because, as explained below, we believe that it is neither excessive nor oppressive in light of Toth's violative conduct and that it will adequately serve the public interest and the protection of investors.

24/ Toth's conduct was willful. A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearheart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

25/ 15 U.S.C. § 78s(e)(2). Toth does not claim, nor does the record show, that NASD's action imposed an unnecessary or inappropriate burden on competition.

26/ NASD also found that Toth, as a result of his violations, is statutorily disqualified. A person is deemed to be subject to a "statutory disqualification," under Securities Exchange Act Section 3(a)(39), 15 U.S.C. § 78c(a)(39), if, among other things, "such person . . . has willfully made or caused to be made in any application . . . to become associated with a member of a self-regulatory organization . . . any statement which was at the time, and in light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application . . . any material fact which is required to be stated therein."

Under Article III, Section 3(b) of NASD's By-Laws, a "statutorily disqualified" person cannot become or remain associated with an NASD member unless the disqualified person's member firm applies for relief from the statutory disqualification under Article III, Section 3(d) of the By-Laws.

NASD declined to impose any monetary sanction because Toth had sought bankruptcy protection at the time.

We initially observe that NASD's determination to suspend Toth for one year in all capacities is consistent with NASD Sanction Guidelines. 27/ The Sanction Guidelines recommend that, for violations of NASD Conduct Rule 2110 involving filing false, misleading, or inaccurate Forms U4, or amendments, NASD should consider suspending an individual in any or all capacities for five to thirty business days and fining the individual \$2,500 to \$50,000. In egregious cases, the Guideline suggests a longer suspension for up to two years or a bar, and a fine ranging from \$5,000 to \$100,000. 28/ The Guideline further provides three "Principal Considerations," in addition to those listed in the Sanction Guidelines' Introductory Section, to apply when determining the appropriate sanction: (1) the nature and significance of the information at issue; (2) whether the failure to disclose information resulted in a statutorily disqualified individual becoming or remaining associated with a firm; and (3) whether respondent member firm's misconduct resulted in harm to a registered person, another member firm, or any other person or entity. 29/

We conclude, as did NASD, that Toth's failure to disclose the New Jersey Action constitutes egregious conduct. As we have stated, Form U4 is a critical tool for self-regulatory organizations to determine the fitness of applicants for registration as securities professionals. Toth's failure to disclose the New Jersey Action seriously undermined the effectiveness of that screening process. The existence of a state securities fraud action pending against Toth at the time of the Form U4 filing is without question significant information to the investing public, state regulators, and firms, such as Bedminster, considering hiring Toth. The fact that the New Jersey Complaint was subsequently dismissed two years after the events at issue does not diminish the importance of its timely disclosure. 30/ The NAC noted that the disclosure of such

27/ NASD promulgated the Sanction Guidelines in an effort to achieve greater consistency, uniformity, and fairness in the sanctions that are imposed for violations. NASD Sanction Guidelines at 1 (2006 ed.). Since 1993, NASD has published and distributed the Sanction Guidelines so that members, associated persons, and their counsel will have notice of the types of disciplinary sanctions that may be applicable to various violations. Id. The Guidelines are not NASD rules that are approved by the Commission, but NASD-created guidance for NASD Adjudicators—which the Guidelines define as Hearing Panels and the NAC. Id. Although the Commission is not bound by the Sanction Guidelines, it uses them as a benchmark in conducting its review under Exchange Act Section 19(e)(2).

28/ NASD Sanction Guidelines at 73-74 (2006 ed.).

29/ Id. at 77. NASD does not allege that Principal Considerations (2) or (3) are applicable here.

30/ Alton, 52 S.E.C. at 383 n.8 (holding that applicant's failure to disclose perjury conviction on his Form U4 was not negated by the fact that a court vacated applicant's conviction three weeks later).

information at the time "may have had a serious consequence upon Toth's employment in the securities industry," and we agree.

Toth does not assert that any factors mitigate the severity of his violative conduct, nor do we find anything in the record to support a claim of mitigation. Moreover, we concur with NASD's finding of aggravating conduct in the willful nature of Toth's failure to disclose the charges in the New Jersey Action. Toth, a former registered principal of a member firm with over ten years of industry experience, knew Van Pelt would be making his Form U4 filing on or around August 13, 2003. Despite indications that there were inaccuracies in his registration (for example, the inquiry from the New Jersey Bureau of Securities), Toth remained idle. Toth consistently has blamed Van Pelt and Bedminster for the inaccurate answers on the Form U4, taking no responsibility for his role in the filing, even though he failed to review the Form U4 in any reasonable time. Moreover, Toth's vague and evasive answers to NASD questioning during its investigation contributed to the pattern of nondisclosure evident throughout and provides additional aggravating conduct. 31/

We agree with NASD that a one-year suspension is necessary to protect the interests of the investing public and is remedial. 32/ The fact that the State of New Jersey had filed an action alleging securities fraud by Toth was material to any determination of whether Toth would observe the high standards of conduct demanded of associated persons. Toth's failure to disclose this information deprived his firm from considering all material information in its determination of whether or under what circumstances to allow Toth to become registered with the firm. Thus, Toth deprived Bedminster of the ability to protect the investing public, either by refusing to allow

31/ See Principal Consideration No. 12, NASD Sanction Guidelines at 7 (2006 ed.) (permitting consideration of applicant's level of cooperation with NASD during its investigation).

32/ We note that the NASD-imposed one-year suspension, without monetary sanction, is significantly less than the maximum associational bar and \$100,000 fine recommended by the Sanction Guidelines for similar misconduct.

Toth to associate or by putting in place adequate supervisory procedures. Suspending Toth for one year serves the public interest by impressing upon him and other applicants for registration the importance of disclosing such significant information and makes recurrence less likely. 33/

Accordingly, we find this sanction satisfies the standards of Exchange Act Section 19(e) in that it is neither excessive nor oppressive.

An appropriate order will issue. 34/

By the Commission (Chairman COX and Commissioners ATKINS and CASEY).



Florence E. Harmon
Acting Secretary

33/ Although "general deterrence is not, by itself, sufficient justification for expulsion or suspension, . . . it may be considered as part of the overall remedial inquiry." PAZ Sec., Inc., 494 F.3d 1059, 1066 (D.C. Cir. 2007) (quoting McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005)).

34/ We have considered all of the arguments advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58074 / July 1, 2008

Admin. Proc. File No. 3-12739

In the Matter of the Application of

DOUGLAS J. TOTH
c/o Robert G. Stevens, Esq.
947 State Road, Suite 202
Princeton, New Jersey 08540

For Review of Disciplinary Action Taken by

NASD

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY NASD

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

ORDERED that the disciplinary action taken by NASD against Douglas J. Toth, be, and it hereby is, sustained.

By the Commission:


Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58075 / July 1, 2008

Admin. Proc. File No. 3-12881

In the Matter of the Application of

WANDA P. SEARS
c/o Anthony Paduano, Esq.
Willard Knox, Esq.
Paduano & Weintraub LLP
1251 Avenue of the Americas
Ninth Floor
New York, New York 10020

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY
PROCEEDING

Unauthorized Transactions

Failure to Provide Written Notice of Outside Business Activity

General securities representative of member firm of registered securities association executed unauthorized transactions and conducted undisclosed outside business activities. Held, association's findings of violation sustained in part and set aside in part and sanctions imposed sustained in part and vacated and remanded in part.

APPEARANCES:

Anthony Paduano and Willard Knox, of Paduano & Weintraub LLP, for Wanda P. Sears.

Marc Menchel, Alan Lawhead, and Jante Santos, for FINRA.

Appeal filed: October 24, 2007
Last brief received: January 31, 2008

document 2 of 38

I.

Wanda P. Sears, a former general securities representative of American Express Financial Advisors, Inc. ("AMEX"), an NASD member firm, appeals from FINRA disciplinary action. 1/ FINRA found that Sears violated NASD Conduct Rule 2110 by making unauthorized trades in customer accounts and Rules 3030 and 2110 by preparing clients' tax returns for compensation without providing AMEX prompt written notice of this activity. 2/ FINRA suspended Sears for two years for the unauthorized trading and suspended Sears for six months for the undisclosed outside business activity. 3/ We base our findings on an independent review of the record.

II.

Unauthorized Transactions

A. 1. Debra McClure became Sears's client in 1999. McClure was a second grade teacher who took over her husband's business after he died in 2001. In February 2002, McClure received a confirmation for a purchase of 450 shares of AOL Time Warner stock for \$13,225.50. McClure testified, however, that she was "surprised" when she received the confirmation because she had "absolutely not" asked Sears to purchase the AOL Time Warner stock for her account. McClure testified that she never bought individual stocks, that she had not agreed to purchase the shares of AOL Time Warner stock, and that she had not had any discussions with Sears or anyone else at AMEX about buying this stock. In April 2002, McClure wrote a letter to AMEX complaining that "Sears never informed [her] of this transaction," that McClure "never purchased individual stocks," and that she "was unaware that [Sears] had the authority to make such

1/ Sears's Central Registration Depository ("CRD") report indicates that AMEX terminated Sears's association on April 5, 2002, for violating several company policies.

2/ NASD Rule 3030 provides that no associated person shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. NASD Rule 2110 provides that a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade. General Rule 115 extends the applicability of NASD rules governing members to their associated persons.

3/ FINRA's Department of Enforcement did not seek fines or costs in this case because Sears had sought bankruptcy protection.

purchases on [McClure's] behalf." 4/ AMEX subsequently reimbursed McClure for her losses associated with the AOL Time Warner transaction.

Sears testified that McClure authorized the AOL Time Warner trade after McClure complained that her mutual funds were "going nowhere" and Sears told McClure how Sears had made enough money trading individual stocks for Sears's daughter to make a down payment on a new house. Sears disputed McClure's claim that the AOL Time Warner trade was unauthorized, asserting that McClure was just "mistaken" and "confused." 5/

2. Walter Gwaltney became Sears's client in 1998. In 2002, Gwaltney discovered a purchase of 3,675 shares of XO Communications ("XO") stock in his retirement account in January of that year for \$549.08. Gwaltney testified, however, that he did not authorize Sears to purchase this stock. Mary Gwaltney, Walter Gwaltney's wife, testified that she also did not authorize Sears to make this purchase. 6/ In June 2002, Walter and Mary Gwaltney wrote a letter to AMEX complaining that Sears "purchased XO Communications stock in January 2002 without our knowledge." 7/

Although Sears states in her reply brief that Mary Gwaltney "was not a joint account holder," Sears testified that she discussed XO stock with Mary Gwaltney who authorized the trade. According to Sears, she told Mary Gwaltney that XO was "way, way down" but new management was hoping to revive it. Sears said that Mary Gwaltney agreed to invest \$549 as a "gamble" to get "something significant to put towards" a new boat her husband hoped to buy. 8/

B. NASD Rule 2110 requires that persons associated with member firms "observe high standards of commercial honor and just and equitable principles of trade." An associated person is "responsible for obtaining his [or her] customer's consent prior to purchasing a security for the

4/ In October 2003, in connection with FINRA's investigation, McClure signed a declaration stating that she "did not authorize" the purchase of the AOL Time Warner stock, that she "did not discuss this trade with Sears," and that she had "never given Sears permission to buy or sell individual stocks in [her] accounts without [her] prior consent."

5/ The record indicates that Sears did not earn a commission on this trade.

6/ In October 2003, in connection with FINRA's investigation, the Gwaltneys signed a declaration stating that Sears "did not request or receive permission from either of us to buy" XO stock and that they "did not even discuss this stock with Sears."

7/ The record does not indicate whether AMEX reimbursed the Gwaltneys for this trade.

8/ The record does not indicate whether Sears earned a commission on this trade.

customer's account." 9/ As we have held, "[u]nauthorized trades are a serious breach of the duty to observe high standards of commercial honor and just and equitable principles of trade." 10/ Such misconduct goes "to the heart of the trustworthiness of a securities professional," 11/ and "is a fundamental betrayal of the duty owed by a sales[person] to his [or her] customers." 12/

Both Debra McClure and Walter Gwaltney testified that Sears purchased a security for their respective accounts without obtaining their authorization. Although Sears contends that McClure's and Gwaltney's testimony "was outweighed by substantial evidence that such customers authorized such trades," Sears's only evidence on this point was her own testimony, and the Hearing Panel did not credit that testimony. The Hearing Panel stated that the "customers who testified were adamant that they did not give Sears permission to purchase the stocks in question for their accounts." It concluded that, "having heard all of the witnesses testify and having observed their demeanor, [it] did not find Sears' testimony to be credible."

It is well established that "the credibility determination of the initial decisionmaker is entitled to considerable weight and deference, since it is based on hearing the witnesses' testimony and observing their demeanor." 13/ We have also held that, "without substantial evidence in the record to the contrary, we cannot depart from the fact finder's determination of credibility." 14/ We find no basis to disturb the Hearing Panel's credibility finding here. As the Hearing Panel noted, McClure and Gwaltney testified adamantly that they did not authorize the transactions. Neither was discredited in any way nor was their testimony called into question as a result of cross-examination during the hearing. Their testimony was also consistent with other documentary evidence in the record. Accordingly, we find that Sears made unauthorized trades in the accounts of McClure and Gwaltney and, therefore, violated Rule 2110 as alleged. 15/

9/ Carlton Wade Fleming, Jr., 52 S.E.C. 409, 412 (1995).

10/ Bradley Kanode, 49 S.E.C. 1155, 1156 (1989).

11/ Adam Stuart Levine, 51 S.E.C. 395, 397 (1993).

12/ Keith L. DeSanto, 52 S.E.C. 316, 323 (1995), aff'd, 101 F.3d 108 (2d Cir. 1996) (Table); accord Michael G. Keselica, 52 S.E.C. 33, 37 (1994).

13/ Jon R. Butzen, 52 S.E.C. 512, 514 n.7 (1995).

14/ Fu-Sung Peter Wu, 55 S.E.C. 737, 746-47 n.22 (2002).

15/ Robert E. Gibbs, 51 S.E.C. 482, 483-84 (1993) (finding unauthorized transaction where no basis existed for disagreeing with credibility of customer's testimony that trade was unauthorized where such testimony "was comprehensive and was not discredited or called into question as the result of extensive cross-examination during the hearing" and "was consistent on the relevant facts with an affidavit that [customer] and his wife had previously submitted to the NASD"), aff'd, 25 F.3d 1056 (10th Cir. 1994) (Table).

III.

FINRA also made findings that Sears executed an additional eighteen unauthorized trades in the accounts of four other clients. As discussed below, we have determined to set aside these additional findings of violation.

In addition to McClure and Gwaltney, the two customers who testified at the hearing, FINRA's Department of Enforcement ("Enforcement") included in its exhibits declarations (the "Declarations") from four of Sears's other clients in which those clients stated that Sears made unauthorized trades in their accounts. A FINRA examiner prepared the Declarations, and Sears's clients signed them. In the Declarations, Laura Rossie stated that Sears made twelve unauthorized trades in her account, Charles Hoskins stated that Sears made four unauthorized trades in his account, and Paul DiMarco and Diane Rinehard each stated that Sears made one unauthorized trade in their accounts. None of these additional four customers testified, and Enforcement did not introduce any documentation underlying these trades. Its counsel stated in closing argument merely that the Declarations "corroborated" the assertions of the testifying customers. Sears testified that she never made any unauthorized trades in any of the accounts identified in the Declarations.

Sears argues that it was unfair for FINRA to find unauthorized trades based on the declarations because the "unauthorized trades referenced in the Declarations were neither identified nor the subject of any cause of action in the Complaint." ^{16/} The complaint alleged unauthorized trades only in the accounts of McClure, Gwaltney, and a third customer, Jean Thomas. ^{17/} The complaint did not mention customers Rossie, Hoskins, DiMarco, or Rinehard.

We have held that a complaint need not specify all details regarding a case against a respondent. ^{18/} Rather, we have found it "sufficient if the respondent 'understood the issue' and

^{16/} Sears also contends that the Declarations "constituted impermissible hearsay." However, "it is well established that hearsay evidence is admissible in administrative proceedings, if it is deemed relevant and material." *Otto v. SEC*, 253 F.3d 960, 966 (7th Cir. 2001). The Declarations were relevant and material, and FINRA therefore admitted them properly.

^{17/} Although Enforcement initially planned to call Thomas, it never did so, and the Hearing Panel made no findings with respect to her account. Enforcement stated that it ultimately chose not to call Thomas because her testimony would be "cumulative and redundant." Thomas was 85 years old at the time of the hearing and had been hospitalized recently.

^{18/} See, e.g., *Fox & Co. Inv.*, Securities Exchange Act Rel. No. 52697 (Oct. 28, 2005), 86 SEC Docket 1895, 1908 n.34 (sustaining NASD's finding of recordkeeping violations even though "NASD's complaint did not specifically allege Applicants' failure to book the arbitration award as a liability in FOX's January 31, 2002 books and records as one of the inaccuracies supporting the alleged recordkeeping violations").

'was afforded full opportunity' to justify its conduct during the course of the litigation." ^{19/} Thus, in considering this kind of procedural question, we have focused less on "the adequacy of the . . . pleading" and more on "the fairness of the whole procedure." ^{20/}

Here, the record does not indicate that Sears had adequate notice that the claims made by the four other customers in the Declarations were intended to provide a basis for additional findings of violation. There is no reference to any of these four additional customers in the complaint. Enforcement's pre-hearing brief discussed only the trades that the complaint alleged were unauthorized. Although Enforcement introduced the Declarations at the hearing, it adduced no underlying documentation related to the trades, and it did not indicate that it sought to hold Sears liable for those trades. In closing arguments, Enforcement counsel asserted only that the evidence of unauthorized trading in the accounts of McClure and Gwaltney was "corroborated by the other [D]eclarations." Enforcement's proposed findings of fact did not seek a finding that Sears engaged in unauthorized trading in the accounts of Rossie, Hoskins, DiMarco, or Rinehard, and its post-hearing brief urged only that the Hearing Panel find that "Sears violated NASD Conduct Rule 2110 by effecting [the] unauthorized transactions as alleged in the Complaint."

FINRA, however, found that Sears violated Rule 2110 by executing unauthorized trades in the accounts of not only McClure and Gwaltney but also in the accounts of Rossie, Hoskins, DiMarco, and Rinehard. Under the circumstances, we conclude that it is not appropriate to hold Sears liable for additional Rule 2110 violations based on the Declarations because it appears Sears lacked adequate notice that the Declarations were an additional basis for FINRA's allegations. ^{21/} We therefore set aside the additional findings of unauthorized trading based on the Declarations. ^{22/}

^{19/} Aloha Airlines, Inc. v. CAB, 598 F.2d 250, 262 (D.C. Cir. 1979) (quoting NLRB v. McKay Radio & Tel. Co., 304 U.S. 333, 350 (1938)).

^{20/} Id. (quoting 2 K. Davis, Administrative Law Treatise, § 8.04 at 525 (1958)).

^{21/} See 15 U.S.C. § 78o-3(b)(8) (requiring that FINRA "provide a fair procedure for the disciplining of members and persons associated with members").

^{22/} See James L. Owsley, 51 S.E.C. 524, 528 (1993) (setting aside findings of antifraud violations based on misrepresentations not alleged in NASD's complaint where the record did not indicate that the respondent "understood the issue and was afforded a sufficient opportunity to justify his conduct with respect thereto"); Paulson Inv. Co., 47 S.E.C. 886, 890 (1983) (setting aside violations not charged in NASD's complaint where the record indicated that Applicants were not "given adequate notice of these additional allegations, or a proper opportunity to defend themselves against them").

Outside Business Activities

A. Sears admitted that, at her office, she helped her clients prepare tax returns. She testified that, while associated with AMEX, she "worked with approximately forty people on their tax returns each year." Sears also testified that she never disclosed to AMEX that she provided these tax preparation services. The record contains "Outside Activities Disclosure Forms" that Sears submitted to AMEX for the years 1998-2002 that corroborate Sears's admission. Sears did not disclose her tax preparation activities on any of the forms. Sears also admitted that, between 1998-2002, she received total compensation for these services of approximately \$3,515. 23/

B. NASD Rule 3030 provides that no "person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member." The record establishes, and Sears does not dispute, that Sears prepared tax returns for her clients for compensation. Although Sears does not deny that she never gave express written notice of her tax preparation services to AMEX, she argues that AMEX had constructive notice of her activities. Sears contends that she "disclosed her assistance" to AMEX and that AMEX "was on notice of such assistance" because she kept copies of the tax returns in her client files which her supervisors reviewed and because she prepared the returns on AMEX computers. Neither action, however, constitutes the requisite written notice Rule 3030 demands. 24/

Although Sears does not deny providing the tax services as FINRA found, she argues that those services cannot form the basis for findings of violation because, she asserts, no precedent "constru[es] the preparation of customer tax returns as an outside business activity." We do not consider this argument to be a valid defense because no precedent suggests that tax preparation

23/ As part of FINRA's investigation, Sears sent FINRA a letter recounting her non-securities income received from 1998-2002. In this letter, Sears acknowledged preparing tax returns for her clients. She attached spreadsheets detailing each client's name, the type of tax return prepared, and the compensation received.

24/ See Herbert J. Burns, 52 S.E.C. 823, 825 (1996) (finding that applicant violated NYSE rule prohibiting engaging in outside business activities without making a written request and receiving the prior written consent of member firm where applicant claimed that firm approved his activities in minutes of board meetings that applicant wrote on a yellow legal pad because "the informal jottings of an interested person cannot constitute the requisite written permission to engage in outside business activities").

services do not constitute an outside business activity, 25/ and because NASD has stressed in its publications that associated persons are required "to report any kind of business activity engaged in away from their firm." 26/ AMEX's own outside activities disclosure form, moreover, required that associated persons disclose any "source of compensation outside the company."

Sears also challenges FINRA's finding that she engaged in undisclosed outside business activities on the ground that, according to Sears, FINRA relied improperly on the testimony of Richard Zue, Sears's former supervisor. According to Sears, Zue's testimony "was inherently biased and unreliable" because Zue, in addition to supervising Sears, "was a rival financial advisor." FINRA, however, "credit[ed]" Zue's testimony that "he had no knowledge that Sears prepared tax returns for customers," and Sears presented no evidence that contradicted Zue on this point. 27/ Although Sears argues further that the Commission should give no weight to Zue's testimony because she "presented substantial evidence that [AMEX] knew of her assistance to some of her customers with the preparation of their tax returns," the sole basis of that assertion of knowledge is that she kept the returns in her files and prepared the returns on AMEX computers -- a proposition we already rejected as sufficient notification. She did not establish that AMEX or Zue, in fact, knew about her outside business activities.

Although FINRA credited Zue's testimony, his testimony was not the basis for FINRA's findings. Its opinion stated that it found the Rule 3030 violation "based on Sears's own admissions." As noted, Sears admitted she prepared tax returns for clients for compensation and did not provide AMEX written notice of these activities. We agree with FINRA that Sears's own

25/ It is obvious that a violation can be found even though the rule or concept at issue has never been litigated. See, e.g., Inv. Planning, Inc., 51 S.E.C. 592, 598 (1993) (finding that applicants charged unfair prices by charging at least 4% markups despite applicants' claim "that disciplinary action for charging a 5% markup [was] unprecedented").

26/ NASD Notice to Members 01-79 (emphasis in original), available at www.finra.org.

27/ After Enforcement introduced a memorandum Zue wrote describing conversations with some of Sears's clients which led Zue to conclude that Sears had made unauthorized trades in the accounts of at least three other clients, Sears introduced affidavits signed by those three clients disclaiming that Sears made unauthorized trades in their accounts. FINRA, therefore, did "not rely on the Zue memorandum" because the "affidavits [came] directly from Sears's customers, and [were] not a secondhand account of conversations with customers." Nonetheless, although FINRA did not rely on the Zue memorandum to support the allegations of unauthorized trading, it found Zue's testimony with respect to his lack of knowledge of Sears's outside business activities to be credible. We also do not rely on the Zue memorandum to sustain findings of unauthorized trading. As noted, Sears introduced no evidence to refute Zue's testimony with respect to her tax services.

admissions establish that she violated Rules 3030 and 2110, and we see no basis to set aside this finding. 28/

V.

Section 19(e)(2) of the Securities Exchange Act of 1934 requires that we sustain FINRA's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 29/ We begin our analysis with a consideration of whether the imposed sanctions are allowable under FINRA's Sanction Guidelines. Although we are not bound by the guidelines, we use them as a benchmark in conducting our review under Section 19(e)(2).

A. We turn first to the two-year suspension FINRA imposed for Sears's unauthorized trading. FINRA's Sanction Guidelines recommend a suspension of ten business days to one year or, in egregious cases, a suspension of up to two years or a bar. 30/ The guidelines identify three categories of egregious unauthorized trading: (1) "quantitatively" egregious unauthorized trading, i.e., unauthorized trading that is egregious because of the sheer number of unauthorized trades executed; (2) unauthorized trading accompanied by aggravating factors, such as efforts to conceal the unauthorized trading, attempts to evade regulatory investigative efforts, customer loss, or a history of similar misconduct; and (3) "qualitatively" egregious trading measured by the strength of the evidence and the respondent's motives in effecting the trades. 31/ Although FINRA found that Sears's unauthorized trades were not qualitatively egregious and did not involve aggravating conduct, it nonetheless found those trades quantitatively egregious.

We emphasize that, as we have noted previously, "[u]nauthorized trading is very serious misconduct." 32/ Here, however, we have set aside findings of violation with respect to eighteen of the twenty trades FINRA deemed unauthorized. Under the circumstances, it is appropriate to

28/ FINRA's finding that Sears also violated Rule 2110 is in accord with "the judicially-recognized policy that a violation of another NASD rule constitutes a violation of just and equitable principles of trade." Anthony H. Barkate, 57 S.E.C. 488, 489 n.1 (2004) (citing Sirianni v. SEC, 677 F.2d 1284, 1288 (9th Cir. 1982)), petition denied, 125 Fed. Appx. 892 (9th Cir. 2005) (unpublished).

29/ 15 U.S.C. § 78s(e)(2). Applicant does not claim, and the record does not show, that FINRA's sanctions impose an unnecessary or inappropriate burden on competition.

30/ FINRA Sanction Guidelines 103 (2006 ed.). The guidelines also recommend a fine, but FINRA did not impose a fine because Sears had filed for bankruptcy. See supra note 3.

31/ Id. at 103 n.2.

32/ Howard Alweil, 51 S.E.C. 14, 18 (1992).

remand the proceeding to FINRA so that it may have the opportunity to assess appropriate sanctions on the basis of the unauthorized trading violations that we have sustained. 33/

B. We now turn to the six-month suspension that FINRA imposed for the undisclosed outside business activities. 34/ FINRA's Sanction Guidelines recommend a suspension of up to thirty days when the outside business activities do not involve aggravating conduct. When the outside business activities do involve aggravating conduct, the Guidelines recommend a suspension of up to one year or, in egregious cases, a longer suspension or bar. 35/

FINRA found that Sears's outside business activities involved aggravating conduct "because Sears's tax preparation services involved American Express customers, Sears gave the impression that the services were approved by American Express, and Sears attempted to conceal her activities from American Express by annually certifying that she had no undisclosed outside business activities." Despite these aggravating factors, however, FINRA imposed only a six-month suspension in light of the minimal compensation Sears received for the tax services. 36/

33/ Although we have set aside the findings of unauthorized trading violations based on the Declarations and thus find only two unauthorized trades for purposes of evaluating the egregiousness of Sears's misconduct, FINRA admitted the Declarations properly, see supra note 16, and they may be considered in gauging aggravating factors when assessing appropriate sanctions for the two unauthorized trading violations that we have sustained. Cf. Gateway Int'l Holdings, Inc., Exchange Act Rel. No. 53907 (May 31, 2006), 88 SEC Docket 430, 440 n.30 (noting that "[a]lthough we are not finding violations based on [other] failures [to file timely reports], we may consider them, and other matters that fall outside the [Order Instituting Proceedings], in assessing appropriate sanctions"); Peter J. Kisch, 47 S.E.C. 802, 810 n.23 (1982) (setting aside finding of antifraud violation because "deception practiced on regulatory authorities does not in itself constitute a violation of antifraud provisions" but noting that "it is clearly an aggravating factor to be considered in assessing appropriate sanctions").

34/ FINRA ordered that this six-month suspension was to be served concurrently with the two-year suspension for unauthorized trading.

35/ FINRA Sanction Guidelines at 14.

36/ See id. (stating that the principal considerations in determination sanctions for violations of Rule 3030 include: (1) whether the outside activity involved customers of the firm, (2) whether the outside activity resulted directly or indirectly in injury to customers of the firm and, if so, the nature and extent of the injury, (3) the duration of the outside activity and the number of customers involved, (4) whether the respondent created the impression that the employer (member firm) had approved the activity, and (5) whether the respondent misled his or her employer member firm about the existence of the outside activity or otherwise concealed the activity from the firm).

Sears argues that the record does not support a finding of aggravating conduct. Although she does not dispute that her tax preparation services involved AMEX customers, she contends that her failure to advertise her tax services to her clients and her receipt of only minimal compensation "flatly contradicts" the finding that she gave the impression that her tax preparation services were approved by AMEX. We disagree. Clients whom Sears assisted with their tax returns in Sears's office could have easily received the impression that AMEX approved her activities regardless of whether Sears advertised those services or charged minimal fees. Sears also argues, as she argued with respect to the underlying violation, that, rather than concealing her activities from AMEX, AMEX was "well aware" of her assistance to her clients because she maintained copies of the tax returns in her files. Notwithstanding Sears's retention of the tax returns in her client files, Sears failed to disclose her activities on AMEX's outside business activities form. In our view, Sears has not refuted the facts establishing aggravating conduct.

We also find that the six-month suspension is not excessive or oppressive. Rule 3030 ensures that member firms "receive prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities could be raised at a meaningful time and so that appropriate supervision could be exercised as necessary under applicable law." ^{37/} As we stated in an analogous context, it is a "prophylactic rule designed to assure that an employee engages in conduct consistent with his duties to his employer and its clients." ^{38/} Sears's misconduct, however, deprived customers of the oversight and supervision provided by Sears's employer firm. ^{39/} The nature of a Rule 3030 violation indicates, as reflected in the sanction guidelines, that a suspension provides an appropriate remedy for such misconduct. Such suspensions are appropriate to "secure compliance with the rules, regulations, and policies of both [FINRA] and [the Commission]." ^{40/} A suspension in this case will impress upon Sears the importance of complying with this requirement in the future.

The individual facts of this case suggest that a suspension of six months is appropriately remedial and not punitive. The aggravating conduct noted above -- the involvement of Sears's clients in her outside business activities, the impression Sears gave that her member firm approved her activities, and the repeated failure by Sears to disclose her activities on AMEX's outside activities disclosure form -- warrants a suspension over thirty days and up to one year. As FINRA noted, the minimal compensation Sears received -- approximately \$3,000 -- indicates

^{37/} Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons, Exchange Act Rel. No. 26063 (Sept. 6, 1988), 41 SEC Docket 1254, 1254.

^{38/} Burns, 52 S.E.C. at 829 (discussing equivalent NYSE rule).

^{39/} Micah C. Douglas, 52 S.E.C. 1055, 1060 (1996) (finding that applicant's failure to inform his employer firm of his outside business activities "deprived potential customers of the oversight and supervision provided by [applicant's] employer firm").

^{40/} See Boruksi v. SEC, 289 F.2d 738, 740 (2d Cir. 1961).

that a suspension of less than a year is appropriate. Sears raises no other facts, however, that mitigate her misconduct. 41/ We conclude, based on all the facts, that a six-month suspension is neither excessive or oppressive and therefore satisfies the standard set forth in the Exchange Act.

An appropriate order will issue. 42/

By the Commission (Chairman COX and Commissioners ATKINS and CASEY).



Florence E. Harmon
Acting Secretary

41/ Although Sears argues that lesser sanctions are warranted due to FINRA's reliance on Zue's testimony, we noted above that FINRA based its findings on Sears's own testimony.

42/ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58075 / July 1, 2008

Admin. Proc. File No. 3-12881

In the Matter of the Application of

WANDA P. SEARS
c/o Anthony Paduano, Esq.
Willard Knox, Esq.
Paduano & Weintraub LLP
1251 Avenue of the Americas
Ninth Floor
New York, New York 10020

For Review of Disciplinary Action Taken by

FINRA

ORDER MODIFYING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES
ASSOCIATION

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

ORDERED that the sanction imposed by FINRA on Wanda P. Sears for engaging in unauthorized transactions in violation of FINRA Rule 2110 be, and it hereby is, vacated and remanded to FINRA for further proceedings in accordance with this opinion; and it is further

ORDERED that the sanction imposed on Sears for failing to disclose an outside business activity in violation of FINRA Rules 3030 and 2110 be, and it hereby is, sustained.

By the Commission.



Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 270 and 275

[Release Nos. IC-28327; IA-2751 File No. S7-19-08]

RIN 3235-AK19

REFERENCES TO RATINGS OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of three releases that the Securities and Exchange Commission (“Commission”) is publishing simultaneously relating to the use in its rules and forms of credit ratings issued by nationally recognized statistical rating organizations (“NRSROs”). In this release, the Commission proposes to amend five rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that rely on NRSRO ratings. The proposed amendments are designed to address concerns that the reference to NRSRO ratings in Commission rules may have contributed to an undue reliance on NRSRO ratings by market participants.

DATES: Comments should be received on or before September 5, 2008.

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

Electronic comments:

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-19-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the

instructions for submitting comments.

Paper comments:

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

All submissions should refer to File Number S7-19-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm.

All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Penelope Saltzman, Acting Assistant Director, or Vincent Meehan, Senior Counsel, (202) 551-6792, Office of Regulatory Policy, or Smeeta Ramarathnam, Senior Counsel, (202) 551-6792, Office of Special Projects, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment amendments to rules 2a-7 [17 CFR 270.2a-7], 3a-7 [17 CFR 270.3a-7], 5b-3 [17 CFR 270.5b-3], and 10f-3 [17 CFR 270.10f-3] under the Investment Company Act of 1940 ("Investment

Company Act”),¹ and amendments to rule 206(3)-3T [17 CFR 275.206(3)-3T] under the Investment Advisers Act of 1940 (“Investment Advisers Act” or “Advisers Act”).²

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¹ 15 U.S.C. 80a. Unless otherwise noted, all references to rules under the Investment Company Act will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270], and all references to statutory sections are to the Investment Company Act.

² 15 U.S.C. 80b. Unless otherwise noted, all references to rules under the Investment Advisers Act will be to Title 17, Part 275 of the Code of Federal Regulations [17 CFR 275], and all references to statutory sections are to the Investment Advisers Act.

I. INTRODUCTION

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,³ the Commission published for notice and comment two rulemaking initiatives.⁴ The first proposes additional requirements for NRSROs⁵ that were directed at reducing conflicts of interest in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating process.⁶ The second is designed to improve investor understanding of the risk characteristics of structured finance products. Those proposals address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in light of the role they played in determining the credit ratings for securities that were the subject of the recent turmoil in the credit markets.

Today's proposals comprise the third of these three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on credit ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial Markets ("PWG"), the Financial Stability Forum ("FSF") and the Technical Committee of the International

³ Pub. L. No. 109-291, 120 Stat. 1327 (2006).

⁴ Proposed Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967 (June 16, 2008) [73 FR 36212 (June 25, 2008)] ("NRSRO June 16, 2008 Proposing Release").

⁵ As described in more detail below, an NRSRO is an organization that issues ratings that assess the creditworthiness of an obligor itself or with regard to specific securities or money market instruments, has been existence as a credit rating agency for at least three years, and meets certain other criteria. The term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 ("Exchange Act"). A credit rating agency must apply with the Commission to register as an NRSRO, and currently there are ten registered NRSROs.

⁶ See Press Release No. 2008-110 (June 11, 2008).

Organization of Securities Commissions (“IOSCO”).⁷ Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an “official seal of approval” on ratings that could adversely affect the quality of due diligence and investment analysis. The Commission believes that today’s proposals could reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions.

II. BACKGROUND

The Commission first used the term “NRSRO” in our rules in 1975 in the net capital rule for broker-dealers, Rule 15c3-1 (“Net Capital Rule”)⁸ under the Securities Exchange Act of 1934 (the “Exchange Act”)⁹ as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, we have used the designation in a number of regulations under the federal securities laws. Although we originated the use of the term NRSRO for a narrow purpose in our own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, rules issued by other financial regulators, in the United States and abroad, and private financial contracts.

Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear disadvantages of using the term in many of our regulations. Foremost, there is a risk that investors interpret the

⁷ See President’s Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 2008), available at www.ustreas.gov (“PWG Statement”); *The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008), available at www.fsforum.org (“FSF Report”); Technical Committee of the International Organization of Securities Commissions, *Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets* (March 2008), p. 9, available at www.iosco.org.

⁸ 17 CFR 240.15c3-1.

⁹ 15 U.S.C. 78a.

use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events,¹⁰ there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process. In light of this, the Commission proposes to amend regulations under the Investment Company Act and the Investment Advisers Act that use the term NRSRO or refer to NRSRO ratings.¹¹

III. DISCUSSION

The credit ratings issued by NRSROs are used in four of the Commission's rules under the Investment Company Act – rules 2a-7, 3a-7, 5b-3, and 10f-3 – and one rule under the Investment Advisers Act – rule 206(3)-3T. These rules use the credit ratings issued by the NRSROs in different contexts, and for different purposes, to distinguish among various grades of debt and other rated securities. We propose to amend each rule to omit references to NRSRO ratings and, except with respect to one of the rules, substitute alternative provisions that are designed to appropriately achieve the same purpose as the ratings. Below we discuss these proposals in greater detail in the context of each rule we propose to amend.

A. Rule 2a-7

Rule 2a-7 under the Investment Company Act governs the operation of money market funds. Unlike other investment companies (“funds”), money market funds seek to maintain a stable share price, typically at \$1.00 per share. To do so, most money market funds use the

¹⁰ See NRSRO June 16, 2008 Proposing Release, *supra* note 4, at Section I.C.

¹¹ These regulations include rules 2a-7, 3a-7, 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-3T under the Investment Advisers Act.

amortized cost method of valuation (“amortized cost method”) or the penny-rounding method of pricing (“penny-rounding method”) permitted by rule 2a-7.¹² The Investment Company Act and applicable rules generally require funds to calculate current net asset value per share by valuing their portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by the board of directors.¹³ These valuation requirements are designed to prevent unfair share pricing from diluting or otherwise adversely affecting the interests of investors.¹⁴

Rule 2a-7 exempts money market funds from these provisions but contains maturity, quality, and diversification conditions designed to minimize the deviation between a money market fund’s stabilized share price and the market value of its portfolio.¹⁵ Among these conditions, rule 2a-7 limits a money market fund’s portfolio investments to securities that have received credit ratings from the “Requisite NRSROs” in one of the two highest short-term rating categories or comparable unrated securities (*i.e.*, “Eligible Securities”).¹⁶ Rule 2a-7 further restricts money market funds to securities that the fund’s board of directors (which typically rely

¹² Under the amortized cost method, portfolio instruments are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. *See* rule 2a-7(a)(2). Share price is determined under the penny-rounding method by valuing securities at market value, fair value or amortized cost and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent. *See* rule 2a-7(a)(18).

¹³ *See* section 2(a)(41) of the Investment Company Act (defining value) and rules 2a-4 (defining current net asset value) and 2a-7(c) thereunder (money market fund share price calculations).

¹⁴ If shares are sold or redeemed based on a net asset value which turns out to have been either understated or overstated to the amount at which portfolio instruments could have been sold, then the interests of either existing shareholders or new investors will have been diluted. *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 136-138, 288 (1940).*

¹⁵ Rule 2a-7 contains conditions that apply to each investment a money market fund proposes to make, as well as conditions that apply to a money market fund’s entire portfolio.

¹⁶ The term “Eligible Security” is defined in rule 2a-7(a)(10). “Requisite NRSROs” is defined in rule 2a-7(a)(21).

on the fund's adviser¹⁷) determines present minimal credit risks, and specifically requires that determination "be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO."¹⁸

We propose to eliminate references to ratings by amending rule 2a-7 in four principal ways.¹⁹ In combination, these proposed amendments are designed to offer similar protections to the current rule's reliance on NRSRO ratings.²⁰

1. *Minimal Credit Risk Determination*

Under the proposed amendments, we would rely on money market fund boards of directors to determine that each portfolio instrument presents minimal credit risks,²¹ and whether the security is a "First Tier Security" or a "Second Tier Security" for purposes of the rule.²² We believe that money market fund boards of directors would still be able to use quality determinations prepared by outside sources, including NRSRO ratings that they conclude are credible, in making credit risk determinations. We expect that the boards of directors (or their

¹⁷ See rule 2a-7(e).

¹⁸ Rule 2a-7(c)(3)(i). Thus, under the current rule, where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security presents minimal credit risks. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)], at text preceding n.18.

¹⁹ The proposed amendments would also make conforming amendments to rule 2a-7's record keeping and reporting requirements. See proposed rule 2a-7(c)(11).

²⁰ In 2003, the Commission published a concept release in which we sought comment on the use of NRSRO ratings in our rules. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Investment Company Act Release No. 26066 (June 4, 2003) [68 FR 35258 (June 12, 2003)]. Comments on the concept release are available at: <http://www.sec.gov/rules/concept/s71203.shtml>. As discussed above, recent events have highlighted the need to revisit our reliance on NRSRO ratings in the context of these developments. See also the extensive discussion of market developments in the NRSRO June 16, 2008 Proposing Release, *supra* note 4.

²¹ See proposed rule 2a-7(a)(10).

²² Rule 2a-7(c)(4) addresses portfolio diversification requirements for money market funds, including diversification requirements relating to First and Second Tier Securities.

delegates) would understand the basis for the rating and make an independent judgment of credit risks.

Under the proposed amendments, a security would be an Eligible Security if the board of directors determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.²³ A security would be a First Tier Security if the fund's board had determined that the issuer has the "highest capacity to meet its short-term financial obligations."²⁴ A security would be a Second Tier Security if it is an Eligible Security but is not a First Tier Security.²⁵ We have designed these proposed definitions to retain a degree of risk limitations similar to what is in the current rule.

We request comment on the proposed amendments. What are the advantages and disadvantages of eliminating the requirement to use NRSRO ratings from rule 2a-7? Would eliminating the rating requirements from rule 2a-7 affect the amount or nature of risks money market funds would be willing or able to take? What are the advantages and disadvantages of relying on minimum credit risk determinations? What are the advantages and disadvantages of having fund directors and investment advisers exclusively make credit quality determinations? Are we correct that the current rule's reliance on credit ratings discourages fund directors and

²³ Proposed rule 2a-7(a)(10).

²⁴ Proposed rule 2a-7(a)(12).

²⁵ See rule 2a-7(a)(22). The specific language of this provision would not change, but the definitions of "Eligible Security" and "First Tier Security" would change under the proposal. Consistent with the current rule, under proposed rule 2a-7, a money market fund that is not a tax exempt fund generally must limit its investments in Second Tier Securities to no more than five percent of fund assets, with investment in the Second Tier Securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars. Proposed rule 2a-7(c)(3)(ii)(A) and (c)(4)(i)(C)(1). Tax exempt money market funds are subject to different limitations on investments in Second Tier Conduit Securities. Rule 2a-7(c)(3)(ii)(B) and (c)(4)(i)(C)(2).

investment advisers from performing independent credit risk assessments? What other alternatives could we adopt to encourage more independent credit risk analysis and meet the regulatory objectives of rule 2a-7's requirement of NRSRO ratings? Are the distinctions our proposed amendments would draw between First Tier and Second Tier Securities workable? Is there a better way to describe the characteristics of a First Tier Security without reference to ratings? Are we correct in our expectation that the proposed standards would not impose additional burdens on boards or investment advisers, or require new recordkeeping requirements?

2. *Portfolio Liquidity*

Under the proposed amendments, a money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under section 22(e) of the Investment Company Act and any commitments the fund has made to its shareholders.²⁶ In addition, the proposed amendments would expressly limit a money market fund's investment in illiquid securities to not more than 10 percent of its total assets.²⁷ The proposed amendments would define a Liquid Security as a security that can be sold or disposed

²⁶ See proposed rule 2a-7(c)(5). Section 22(e) of the Investment Company Act prohibits registered investment companies from suspending the right of redemption or postponing the date of payment upon redemption of any redeemable security for more than seven days except for certain periods specified in the provision. While the Investment Company Act requires only that an investment company make payment of the proceeds of redemption within seven days, most money market funds promise investors that they will receive proceeds much sooner, often on the same day that the request for redemption is received by the fund.

²⁷ The proposed standard codifies the current standard regarding portfolio liquidity. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] ("Rule 2a-7 1996 Amending Release"), at text accompanying n.108 ("The limit on money fund holdings of illiquid securities is ten percent of fund assets."); Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] ("1986 Valuation Release"). Although credit ratings do not directly incorporate liquidity risks, they have been used as a proxy for liquidity because a security may lose liquidity if its credit rating falls.

of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.²⁸ These proposed provisions should be familiar to managers of money market funds. Past releases proposing, adopting and amending rule 2a-7 repeatedly emphasized the special duty of the board of directors of a money market fund to monitor purchases of illiquid instruments.²⁹ Money market funds often have a greater and perhaps less predictable volume of redemptions than other open-end investment companies. Further, the portfolio management of a money market fund may be impaired if a fund were forced to meet redemption requests by selling marketable securities that it would otherwise wish to retain in order to avoid attempting to dispose of illiquid portfolio instruments.³⁰ In light of these potential problems, the proposal would prohibit money market funds from acquiring illiquid securities representing more than 10 percent of their total assets.³¹ In the event that changes in the money market fund's portfolio or other external events cause the fund's investments in illiquid instruments to exceed 10 percent of the fund's assets, the money market fund would have to take steps to bring the aggregate amount of illiquid securities back within the proposed limitations as

²⁸ See proposed rule 2a-7(a)(17). See also 1986 Valuation Release, *supra* note 27 at text following n.21.

²⁹ See, e.g., Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (proposing rule 2a-7); Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] ("Rule 2a-7 Adopting Release"); 1986 Valuation Release, *supra* note 27.

³⁰ Rule 2a-7 Adopting Release, *supra* note 29, at text preceding, accompanying and following nn.37-39.

³¹ Proposed rule 2a-7(c)(5). Money market funds must limit their investments in illiquid assets to not more than 10 percent of their net assets. See rule 2a-7 1996 Amending Release, *supra* note 27, at n.108 and accompanying text. An investment company's portfolio security is illiquid if it cannot be disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the investment company. See *id.* at n.107 and accompanying text.

soon as reasonably practicable. However, consistent with the current rule, this requirement generally would not force the money market fund to liquidate any portfolio security where the fund would suffer a loss on the sale of that instrument.³²

We request comment on the proposed amendments. Should we include in rule 2a-7 an express requirement that money market funds limit their exposure to illiquid securities? Do the proposed requirements provide money market funds sufficient flexibility to retain securities that may be illiquid if the disposal of those securities would not be in the best interests of the fund? Are there alternative or additional provisions that we should consider to address the way in which money market funds should evaluate liquidity risk and determine whether to dispose of securities that present an increasing liquidity risk?

3. *Monitoring Minimal Credit Risks*

The proposed amendments would also amend rule 2a-7's downgrade and default provisions. We propose that in the event the money market fund's investment adviser becomes aware of any information about a portfolio security or an issuer of a portfolio security that suggests that the security may not continue to present minimal credit risks, the money market fund's board of directors would have to reassess promptly whether the portfolio security continues to present minimal credit risks.³³ This proposed requirement would replace the provisions in the current rule that generally require a money market fund board to promptly

³² See Rule 2a-7 Adopting Release, *supra* note 29, at n.38.

³³ Proposed rule 2a-7(c)(7) ("In the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any information about a portfolio security or an issuer of a portfolio security that may suggest that the security may not continue to present minimal credit risks, the board of directors shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.").

reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as the board determines is in the best interests of the fund and its shareholders.³⁴ We do not believe that the proposed amendments would require investment advisers to subscribe to every rating service publication in order to comply with this proposal. However, we would expect an investment adviser to exercise reasonable diligence in keeping abreast of new information about a portfolio security that is reported in the national financial press or in publications to which the investment adviser subscribes.

We request comment on the proposed amendments. Would the requirement that the board of directors reassess the credit risk of a security when investment advisers become aware of information that may suggest the security no longer presents minimal credit risks provide adequate investor protections? Would investment advisers be able to stay abreast of new information about their portfolio securities?

4. *Commission Notice of Rule 17a-9 Transactions*

Finally, the proposed amendments would require that money market funds provide the Commission with prompt notice when an affiliate of the money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to rule 17a-9 under the Investment Company Act.³⁵ We believe that the current notice

³⁴ Rule 2a-7(c)(6)(i)(A). This current assessment is not required, however, if the downgraded security is disposed of or matures within five business days of the specified event and in the case of events specified in rule 2a-7(c)(6)(i)(A)(2), the board is subsequently notified of the adviser's actions. Rule 2a-7(c)(6)(i)(B).

³⁵ Proposed rule 2a-7(c)(7)(iii)(B) (requiring notice to the Commission of any "purchase of a security from the fund by an affiliated person or promoter of or principal underwriter for the fund or an affiliated person of such a person in reliance on rule 17a-9"). See rule 17a-9 (exempting from section 17(a) of the Act the purchase of a security "that is no longer an Eligible Security (as defined in [rule 2a-7(a)(10)]) under certain conditions." Notification under this proposed provision would also be amended to require electronic mail, instead of the other means currently listed in rule 2a-7(c)(6)(iii). We believe this change is appropriate in light of recent changes in

provisions, which are triggered when a security held by a fund defaults, provide us with incomplete information about money market funds holding distressed securities, particularly those that have engaged in an affiliated transaction with an affiliated person. The additional notice, which we believe would impose little burden on money market funds or their managers, would enhance our oversight of money market funds especially during times of economic stress.

We request comment on the proposed amendments.

B. Rule 3a-7

Rule 3a-7 under the Investment Company Act excludes structured finance vehicles from the Act's definition of "investment company" subject to certain conditions.³⁶ In a typical financing, a sponsor transfers a pool of assets (such as residential mortgages) to a limited purpose entity, which in turn issues fixed income securities that are rated investment grade or higher by at least one NRSRO. Payment on the securities depends primarily on the cash flows generated by the pooled assets. As a result, these are often referred to as "asset-backed" securities.

Rule 3a-7 contains a number of conditions that differentiate investment companies from structured financings. The conditions include the requirement that structured financings offered to the general public are rated by at least one NRSRO in one of the four highest ratings

telecommunications technology, and because most of the notices of default that we have received in the past year have been transmitted electronically.

³⁶ Structured financings meet the definition of investment company under section 3(a) of the Act because they issue securities and invest in, own, hold, or trade securities. Almost none of the structured financings, however, are able to operate under the Act's requirements. *See* Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] ("Rule 3a-7 Adopting Release").

categories.³⁷ The rule contains an exception under which asset-backed securities sold to accredited investors³⁸ and qualified institutional buyers³⁹ may be unrated, or may be rated less than investment grade, if the issuer and its underwriters use reasonable care to ensure that all excepted sales are to such persons.⁴⁰ We concluded that these persons are in a position to evaluate the structured financing vehicle and to take steps to protect themselves from the types of abusive practices against which the Investment Company Act was designed to protect.⁴¹

We understand that today most asset-backed securities are issued by special purpose vehicles that do not rely on rule 3a-7 to exclude them from the application of the Investment Company Act. Instead, they rely on section 3(c)(7), which was added to the Act in 1996, after the Commission adopted rule 3a-7, and provides an exception from the Act for companies whose securities are limited to any issuer, the outstanding securities of which are owned exclusively by persons who are qualified purchasers, and that is not making and does not at that time propose to make a public offering of such securities. Moreover, asset-backed securities issued by financing vehicles that rely on rule 3a-7, even when highly rated, generally are not marketed to retail

³⁷ Rule 3a-7(a)(2).

³⁸ The exception permits the sale of asset backed fixed-income securities to “accredited investors” as defined in paragraphs (1), (2), (3) and (7) of rule 501(a) under the Securities Act [17 CFR 230.501(a)], and includes any entity in which of all of the equity owners come within such paragraphs. Rule 3a-7(a)(2)(i).

³⁹ The exception permits the sale of any asset backed securities to “qualified institutional buyers” as defined in rule 144A under the Securities Act [17 CFR 230.144A] and certain other persons involved in the organization or operation of the issuer or an affiliate, as defined in rule 405 under the Securities Act [17 CFR 230.405]. Rule 3a-7(a)(2)(ii).

⁴⁰ Rule 3a-7(a)(2).

⁴¹ See Exclusion from the Definition of Investment Company for Certain Structured Financings, Investment Company Act Release No. 18736 (May 29, 1992) [57 FR 23980 (June 5, 1992)] (proposing rule 3a-7).

investors.⁴² Accordingly, we propose to eliminate the rule's reliance on ratings by amending the rule to eliminate the exclusion for structured financings offered to the general public.

In addition, we are proposing to amend the part of the rule that addresses substitution of eligible assets to remove the reference to ratings downgrades. The rule permits the issuer to acquire additional eligible assets or dispose of assets only if, among other conditions, the acquisition or disposition of the assets does not result in a downgrading in the rating of the issuer's outstanding fixed-income securities.⁴³ We propose to require instead that the issuer have procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed income securities.⁴⁴

Finally, we propose to amend the portion of the rule that deals with the safekeeping of assets.⁴⁵ Among other requirements, the rule provides that cash flows from the asset pool periodically be deposited in a segregated account, consistent with the rating of the outstanding fixed income securities.⁴⁶ This provision was intended to ensure that the segregated account in which the cash flows are deposited and the length of time that the servicer holds the cash flows before depositing them in the segregated account would pose a minimal risk of loss to the fixed income security holders. We propose to change this provision to require that the cash flows be deposited in a segregated account consistent with the full and timely payment of the outstanding fixed income securities.⁴⁷ The proposed amendment is designed to minimize the risk of loss of

⁴² See *Credit & Finance Risk Analysis Asset Backed Securities and Structural Finance*, at <http://www.credfinrisk.com/assetsecure.html>.

⁴³ Rule 3a-7(a)(3)(ii).

⁴⁴ Proposed rule 3a-7(a)(3)(ii).

⁴⁵ Rule 3a-7(a)(4).

⁴⁶ Rule 3a-7(a)(4)(iii).

⁴⁷ Proposed rule 3a-7(a)(4)(iii). The proposed amendment would require the issuer to take "actions

cash flows pending payment to the fixed income securities holders.

We request comment on our proposed amendments to rule 3a-7. What are the advantages and disadvantages of eliminating the NRSRO rating requirement from the rule? Is our understanding that structured financings are generally not marketed to retail investors correct? If not, should we retain an exclusion for structured finance offerings to the general public? If so, what standards should we impose that could distinguish structured finance vehicles from investment companies for those investors? For example, should we permit offerings to the general public if a sponsor or trustee conducts an independent statistical analysis of the anticipated cash flows? Are we correct in our assumption that dropping the rating requirement from the rule will not blur the current distinction between structured finance vehicles and investment companies? If not, should the rule incorporate alternatives to the rule's rating requirement that would clarify the distinction? For example, should the rule contain specific requirements regarding abuses that the Act is designed to address, such as self-dealing and overreaching by the issuer? Does our proposal regarding the deposit of cash flows into a segregated account provide sufficient protection against the possibility of loss while the servicer is handling cash flows pending payment to the fixed income security holders? Would an alternative standard provide better protection?

C. Rule 5b-3

Rule 5b-3 under the Investment Company Act permits a fund, subject to certain conditions, to treat a repurchase agreement as an acquisition of the securities collateralizing the

necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the full and timely payment of the outstanding fixed income securities.”

repurchase agreement in determining whether the fund is in compliance with two provisions of the Act that may affect a fund's ability to invest in repurchase agreements.⁴⁸ Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties. Section 5(b)(1) of the Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements a diversified fund may enter into with any one counterparty.

Rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully."⁴⁹ A repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government

⁴⁸ In a typical investment company repurchase agreement, a fund enters into a contract with a broker, dealer, or bank (the "counterparty" to the transaction) for the purchase of securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing the return on the fund's investment. Repurchase agreements provide funds with a convenient means to invest excess cash on a secured basis, generally for short periods of time. Economically, a repurchase agreement functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement. See *Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities*, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] ("Rule 5b-3 Adopting Release").

⁴⁹ Rule 5b-3(a). The term "Collateralized Fully" is defined in rule 5b-3(c)(1). An investment company investing in a repurchase agreement primarily looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the credit quality of the counterparty for satisfaction of the repurchase agreement.

securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the “Requisite NRSROs” or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund’s board of directors or its delegate.⁵⁰

In proposing rule 5b-3, the Commission explained that the highest rating category requirement in the definition of collateralized fully was designed to ensure that the market value of the collateral would remain fairly stable and that the fund could more readily liquidate the collateral quickly in the event of a default.⁵¹

We propose to eliminate the requirement that collateral other than cash or government securities be rated by an NRSRO. As an alternative, we propose to require that if the collateral is not cash or government securities, the fund’s board of directors (or its delegate) determines that the collateral securities present minimum credit risks and are highly liquid. Specifically, the proposal would require collateral other than cash or government securities to consist of securities that the fund’s board of directors (or its delegate) determines at the time the repurchase agreement is entered into (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time, (ii) are subject to no greater than minimal credit risk, and (iii) are issued by a person that has the highest capacity to meet its financial

⁵⁰ Rule 5b-3(c)(1)(iv). The term “Requisite NRSROs” means any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer or, if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO. Rule 5b-3(c)(6). The term “unrated securities” means securities that have not received a rating from the Requisite NRSROs. Rule 5b-3(c)(8).

⁵¹ See Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] (“Rule 5b-3 Proposing Release”), at n.43 and accompanying text.

obligations.⁵² Although the rule would no longer require the collateral to be rated by an NRSRO, we anticipate that evaluating credit risk and liquidity of the collateral could incorporate ratings, reports, analyses, and other assessments issued by NRSROs and other persons.⁵³

NRSRO ratings are also used in a provision of rule 5b-3 that permits a fund to deem the acquisition of a “refunded security” as the acquisition of the escrowed government securities for purposes of section 5(b)(1)’s diversification requirements.⁵⁴ Under this provision, a debt security must satisfy certain conditions to be considered a refunded security under the rule. One of these conditions is that an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities.⁵⁵ This condition is not required, however, if the refunded security has received a debt rating in the highest rating category from an NRSRO.⁵⁶

We are proposing to eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO. Rule 5b-3 requires the certification by an independent certified public accountant (together with the other conditions) to ensure that the bankruptcy of the issuer of the pre-refunded securities would not affect payments on the

⁵² Proposed rule 5b-3(c)(1)(iv)(C). Under the proposal, the board would make credit quality determinations for all non-government collateral securities, rather than just unrated securities. As in the current rule, the proposed rule would permit the board to delegate this credit quality and liquidity determination.

⁵³ A fund that acquires repurchase agreements would have to adopt and implement a written policy reasonably designed to comply with this requirement under rule 38a-1 under the Investment Company Act. *See* rule 38a-1(a) (requiring registered funds to adopt and implement written policies and procedures reasonably designed to prevent the fund’s violation of federal securities laws).

⁵⁴ Rule 5b-3(b). Under the rule, a refunded security means a debt security the principal and interest payments of which are to be paid by U.S. government securities that have been irrevocably placed in an escrow account and are pledged only to the payment of the debt security. Rule 5b-3(c)(4).

⁵⁵ Rule 5b-3(c)(4)(iii).

⁵⁶ *Id.*

securities from the escrow account.⁵⁷ The Commission included this exception because in rating refunded securities, NRSROs typically require that an independent third party make the same determination.⁵⁸

We request comment on the proposed amendments. How would the proposed elimination of the rating requirement from the definition of “collateralized fully” affect funds? Would the proposed board determinations sufficiently address our concerns that collateral securities be of high quality in order to limit a fund’s exposure to counterparties’ credit risks? If not, are there additional or alternative standards that would better address our concerns? How would the proposal to eliminate the exception for rated securities from the condition that refunded securities obtain a certification from an independent auditor affect funds? We expect that with respect to rated refunded securities, funds may be able to satisfy the certification requirement by determining that an NRSRO required an independent certified public accountant to make the same determination.⁵⁹ Would funds incur any costs in determining that a refunded security has received an accountant certification rather than relying on an NRSRO rating? Is there an alternative standard that would provide an equivalent evaluation? For example, should we permit the board to rely on another independent third party to provide the certification?

D. Rule 10f-3

Section 10(f) of the Investment Company Act prohibits a registered investment company from purchasing any security for which an affiliated underwriter is acting as a principal

⁵⁷ See Rule 5b-3 Adopting Release, *supra* note 48, at text accompanying n.25 (explaining that the conditions required in the definition of refunded security correspond to those in the definition of the term in rule 2a-7); Rule 2a-7 19986 Amending Release, *supra* note 31, at section II.D.2.

⁵⁸ See Technical Revisions to the Rules and Forms Regulating Money Market Funds, Investment Company Act Release No. 22921 (Dec. 2, 1997) [62 FR 64968 (Dec. 9, 1997)], at section I.B.2.c.

⁵⁹ See, e.g., STANDARD & POOR’S, PUBLIC FINANCE CRITERIA: DEFEASANCE: LEGAL DEFEASANCE CRITERIA, CASH FLOW VERIFICATION (Sept. 8, 2006).

underwriter⁶⁰ during the existence of an underwriting or selling syndicate for that security.⁶¹ The prohibition was intended to address Congress's concern that underwriters were "dumping" otherwise unmarketable securities on affiliated funds, either by forcing the fund to purchase unmarketable securities from the underwriting affiliate itself, or by forcing or encouraging the fund to purchase the securities from another member of the syndicate.⁶² Congress also expressed concern regarding the amount of underwriting fees earned by the sponsors and affiliated persons who placed the securities with the fund.⁶³

The Commission adopted rule 10f-3 in 1958 to permit a fund that is affiliated with members of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met.⁶⁴ We amended rule 10f-3 in 1979 to add municipal securities to the class of

⁶⁰ The term "principal underwriter" means (in relevant part) an underwriter who, in connection with a primary distribution for securities: (i) is in privity of contract with the issuer or an affiliated person of the issuer; (ii) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or (iii) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution. 15 U.S.C. 80a-2a(a)(29).

⁶¹ Section 10(f) prohibits a fund from purchasing a security during the existence of an underwriting or selling syndicate if a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund or is a person of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person. An affiliated person of a fund includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such other person. 15 U.S.C. 80a-2(a)(3)(A), (B) and (C).

⁶² See REPORT OF THE SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 279, 76th Cong., 2d Sess., pt. 3, at 2581, 2589 (1939). The sales were also used to alleviate certain of an affiliated underwriter's financial difficulties. For example, an underwriter could benefit by rapidly turning over its securities inventory to produce working capital and to reduce the related expenses of carrying the inventory.

⁶³ See HEARINGS ON S.3580 BEFORE A SUBCOMMITTEE OF THE COMMISSION ON BANKING AND CURRENCY, 76th Cong., 3d Sess. 209, 212-23 (1940).

⁶⁴ Adoption of Rule N-10-F-3 Permitting Acquisition of Securities of Underwriting Syndicate Pursuant to Section 10(f) of the Investment Company Act of 1940, Release No. 2797 (Dec. 2,

securities that funds could purchase under the rule.⁶⁵ The rule defines municipal securities that may be purchased during an underwriting in reliance on the rule (“eligible municipal securities”) to include securities that have an investment grade rating from at least one NRSRO or, if the issuer or the entity supplying the revenues or other payments from which the issue is to be paid has been in continuous operation for less than three years (*i.e.*, a less seasoned security), one of the three highest ratings from an NRSRO.⁶⁶ The Commission explained that the rationale behind the rating requirement was to prevent the purchase of less seasoned securities and reduce the risk of unloading unmarketable securities on the fund.⁶⁷

We propose to eliminate the references to ratings in rule 10f-3, and amend the rule’s definition of “eligible municipal security” to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time. In addition, the securities would have to be either: (i) subject to no greater than moderate credit risk; or (ii) if they are less seasoned securities, subject to a minimal or low amount of credit risk.⁶⁸

1958) [23 FR 9548 (Dec. 10, 1958)]. The rule codified the conditions of orders that the Commission had granted prior to 1958 exempting certain funds from section 10(f) to permit them to purchase specific securities.

⁶⁵ Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10736 (June 14, 1979) [44 FR 36152 (June 20, 1979)] (“Rule 10f-3 1979 Adopting Release”). Rule 10f-3(c)(1)(iii).

⁶⁶ Rule 10f-3(a)(3).

⁶⁷ Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10592 (Feb. 13, 1979) [44 FR 10580 (Feb. 21, 1979)] (“1979 10f-3 Amendments Proposing Release”).

⁶⁸ Proposed rule 10f-3(a)(3). The proposed rule would define “eligible municipal securities” to mean “municipal securities” as defined in section 3(a)(29) of the Securities Exchange Act of 1934, that have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time and either (i) are subject to no greater than moderate credit risk or (ii) if the issuer of the municipal securities, or the entity supplying the revenues or other payments from which the issue is to be paid, has been in continuous operation for less than three years, including the operation of any predecessors, the securities are subject to a minimal or low amount of credit risk.”

Unlike our proposals to amend other rules, we are not proposing to add a requirement that the board of directors make the determination regarding credit risk and liquidity. Rule 10f-3 already requires a fund's directors, including a majority of disinterested directors, to approve procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.⁶⁹ Accordingly, the board, including a majority of disinterested directors, already is required to review purchases of municipal securities made in reliance on the rule, and would continue to do so under our proposal. In addition, pursuant to its oversight role, the board would be required to approve procedures for ensuring that municipal securities meet the proposed conditions for credit quality and liquidity. Although the rule would no longer require municipal securities to be rated by an NRSRO, fund boards of directors would still be able to incorporate quality determinations prepared by outside sources, including ratings, reports, analyses, and other assessments issued by NRSROs and other persons, in their approval of procedures and in their review of transactions under the rule.

We request comment on the proposed amendment to rule 10f-3. What would be the effect of eliminating the rating requirement in the definition of "eligible municipal securities"? Is the proposed standard that municipal securities purchased in reliance on rule 10f-3 present no more than moderate credit risks and are highly liquid sufficient to limit the possibility underwriters may sell unmarketable securities to the fund? Is there an alternative that would

⁶⁹ Rule 10f-3(c)(10). The Commission added the requirement that disinterested directors adopt procedures made in reliance on the rule and periodically review the fund's compliance with these procedures in 1979. See Rule 10f-3 1979 Adopting Release, *supra* note 65. At the time, we stressed that in determining specific procedures to be included in the guidelines for transactions in reliance on the rule, the board should be aware generally of the nature of any affiliation that the investment company (or any of its officers, directors, employees or adviser) may have with underwriters and any role the affiliate person would play in mounting the underwriting of a particular issue. See 1979 10f-3 Amendments Proposing Release, *supra* note 67, at text preceding n.23. Our proposal would not affect this existing requirement with respect to the purchase of municipal securities.

better address our regulatory concerns?

E. Rule 206(3)-3T

Rule 206(3)-3T under the Investment Advisers Act of 1940 establishes a temporary alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients.⁷⁰ That section makes it unlawful for any investment adviser, directly or indirectly “acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . , without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”⁷¹ Rule 206(3)-3T contains several conditions that are designed to prevent overreaching by advisers by requiring an adviser to disclose to its client the conflicts of interest involved in principal transactions, inform the client of the circumstances in which the adviser may effect a trade on a principal basis, and provide the client with meaningful opportunities to refuse to consent to a particular transaction or revoke the prospective general consent to these transactions.⁷²

An adviser generally may not rely on the rule for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser (“control person”) is the issuer or is an underwriter of the security.⁷³ As we stated when we adopted the rule, the incentives associated with underwriting securities may bias the

⁷⁰ Rule 206(3)-3T [17 CFR 275.206(3)-3T]. *See also* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (Sept. 24, 2007) [72 FR 55022 (Sept. 28, 2007)] (“Principal Trade Rule Release”).

⁷¹ 15 U.S.C. 80b-6(3).

⁷² *See* Principal Trade Rule Release, *supra* note 70, at text accompanying n.28.

⁷³ Rule 206(3)-3T(a)(2).

advice being provided or lead the adviser to exert undue influence on its client's decision to invest in the offering or the terms of that investment.⁷⁴ The rule contains an exception to this "underwritten securities" exclusion for trades in which the adviser or a control person is an underwriter of non-convertible *investment-grade* debt securities.⁷⁵ We provided this exception because non-convertible investment grade debt securities may be less risky and therefore less likely to be "dumped" on clients.⁷⁶ The rule defines an "investment grade debt security" as a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two NRSROs.⁷⁷

We propose to amend rule 206(3)-3(T), to eliminate an adviser's ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of the rule. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.⁷⁸

Finally, as we stated when we adopted rule 206(3)-3T, an adviser subject to rule 206(4)-7 of the Advisers Act must adopt and implement written policies and procedures reasonably

⁷⁴ Principal Trade Rule Release, *supra* note 70, at n.35 and accompanying and following text.

⁷⁵ *Id.* at text accompanying n.36. There is no exception if the adviser or a control person is the issuer of the securities.

⁷⁶ *Id.* at text following n.36. We also noted in the Principal Trade Rule Release that it may be easier for clients to identify whether the price they are being quoted for a non-convertible investment grade debt security is fair given the relative comparability, and the significant size, of the non-convertible investment grade debt markets. *Id.*

⁷⁷ Rule 206(3)-3T(c).

⁷⁸ Proposed rule 206(3)-3T(c). Although the proposed amendment would no longer require a security underwritten by an adviser or its control person to be rated by NRSROs to be eligible under the rule, investment advisers could refer to ratings, reports, analyses, and other assessments issued by NRSROs and other persons, for the purpose of evaluating credit risk and liquidity.

designed to prevent violations of the Advisers Act (and the rules thereunder) by the adviser or any of its supervised persons.⁷⁹ An adviser seeking to rely on rule 206(3)-3T, therefore, would have to adopt and implement policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality.

We request comment on our proposed revised definition of "investment grade debt security." Is it appropriate for us to allow advisers seeking to rely upon the rule to determine whether a security is investment grade based on the criteria in the rule? Is there another definition of "investment grade" elsewhere in the federal securities laws that we should incorporate by reference into the rule? Are there alternative methods to ensure that advisers seeking to rely on the exception to the underwriting exclusion do so only with respect to investment grade debt? Are there alternative or additional factors we should require an adviser to consider in making its determination? In addition, we expect that advisers, in order to establish their eligibility to rely on the rule, would document their determination that a security is investment grade quality, as well as the process for making such a determination. Are we correct? Should we make such documentation an explicit requirement of the rule, or amend rule 204-2 under the Advisers Act⁸⁰ (the books and records rule) to require such documentation?

IV. REQUEST FOR COMMENT

We request comment on the rule amendments proposed in this release. We also request suggestions for additional changes to existing rules, and comments on other matters that might

⁷⁹ Principal Trade Rule Release, *supra* note 70, at nn.56-58 and accompanying text. In that connection, an adviser seeking to rely on rule 206(3)-3T, as proposed to be amended, would need to adopt and implement policies and procedures reasonably designed to ensure that the adviser's methodology for determining investment grade quality is consistent with the adviser's legal obligations.

⁸⁰ 17 CFR 275.204-2.

have an effect on the proposals contained in this release. Commenters are requested to provide empirical data to support their views.

V. PAPERWORK REDUCTION ACT

Certain provisions of the proposed amendments to rules 2a-7, 3a-7, 5b-3, and 10f-3 under the Investment Company Act, and rule 206(3)-(3)T under the Investment Advisers Act, contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).⁸¹ The Commission is submitting this proposal to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: “Rule 2a-7 under the Investment Company Act of 1940, Money market funds” (OMB Control No. 3235-0268); “Rule 10f-3 under the Investment Company Act of 1940, Exemption for the Acquisition of Securities During the Existence of an Underwriting and Selling Syndicate” (OMB Control No. 3235-0226); and “Temporary rule for principal trades with certain advisory clients, rule 206(3)-3T” (OMB Control No. 3235-0630). There are currently no approved collections for rules 3a-7 and 5b-3, and the proposed amendments would not create any new collections. We adopted the rules pursuant to the Investment Company Act and the Investment Advisers Act.

Our proposed amendments are designed to address the risk that the reference to and required use of NRSRO ratings in our rules:

- is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs; and
- encourages investors to place undue reliance on NRSRO ratings.

An agency may not conduct or sponsor, and a person is not required to respond to, a

⁸¹ 44 U.S.C. 3501-3520.

collection of information unless it displays a currently valid control number.

A. Rule 2a-7

Rule 2a-7 under the Investment Company Act exempts money market funds from the Act's valuation requirements, permitting money market funds to maintain stable share pricing, subject to certain risk-limiting conditions. We propose to amend rule 2a-7 in four principal ways to: (i) rely on money market fund boards of directors (who usually rely on the funds' advisers) to determine that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security;" (ii) add a portfolio liquidity requirement to the rule that would require that money market funds hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions, and expressly limit their investment in illiquid securities to not more than 10% of their total assets; (iii) in the event the money market fund's investment adviser becomes aware of any new information about a portfolio security (or an issuer of a portfolio security) that may suggest that the security may not continue to present minimal credit risks, the proposal would amend rule 2a-7's downgrade and default provisions to require a money market fund's board of directors to reassess promptly whether the portfolio security continues to present minimal credit risks; and (iv) require a money market fund to notify the Commission of the purchase of a money market fund's portfolio security by an affiliated person in reliance on rule 17a-9 under the Investment Company Act.⁸² The proposed amendments also would make conforming amendments to rule 2a-7's record keeping and reporting requirements.⁸³

The proposed amendments to rule 2a-7 would impose a new reporting obligation on

⁸² See rule 17a-9.

⁸³ See proposed rule 2a-7(c)(11).

money market funds. The proposed reporting requirement to notify the Commission of the purchase of a money market fund's portfolio securities by an affiliated person in reliance on rule 17a-9 under the Investment Company Act is designed to assist Commission staff in overseeing money market funds' affiliated transactions that are otherwise prohibited. If adopted, the new collection of information would be mandatory for money market funds. Information submitted to the Commission related to a rule 17a-9 transaction would be accorded confidential treatment to the extent permitted by law.⁸⁴

Commission staff estimates that there are 808 money market funds, all of whom are subject to rule 2a-7.⁸⁵ Of these money market funds, Commission staff estimates that an average of 10 funds per year would be required to provide notice to the Commission of a rule 17a-9 transaction, with the total annual responses per fund, on average, requiring .5 hours of an attorney's time at a cost of \$147.50.⁸⁶ Given these estimates, we estimate that the total annual burden of the proposed amendments to rule 2a-7 for all money market funds would be approximately 5 hours and \$1,475.⁸⁷

⁸⁴ See, e.g., 17 CFR 200.83.

⁸⁵ These include registered money market funds and series of registered money market funds. See Investment Company Institute, *Trends in Mutual Fund Investing April 2008*, May 29, 2008, available at http://www.ici.org/stats/latest/trends_04_08.html.

⁸⁶ Based on information provided by money market fund representatives, Commission staff estimates the cost would equal 0.5 hours of an attorney's time at \$295 per hour (0.5 hours x \$295 per hour = \$147.50). The estimated hourly wages used in this PRA analysis were derived from reports prepared by the Securities Industry and Financial Markets Association. See Securities Industry and Financial Markets Association, *Report on Management and Professional Earnings in the Securities Industry – 2007* (2007), modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead; and Securities Industry and Financial Markets Association, *Office Salaries in the Securities Industry – 2007* (2007), modified to account for an 1800-hour work year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

⁸⁷ These estimates are based on the following calculations: (10 money market funds x .5 hours) = 5 hours; (10 money market funds x 147.50) = \$1,475.

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

B. Rule 3a-7

Rule 3a-7 under the Investment Company Act excludes structured finance vehicles from the Act's definition of "investment company" subject to certain conditions. The conditions include the requirement that structured financings offered to the general public are rated by at least one NRSRO in one of the four highest rating categories. The proposed amendments would: (i) eliminate rule 3a-7's reliance on ratings by eliminating the exclusion for structured financings offered to the general public; (ii) remove the reference to ratings downgrades in the section of the rule that addresses substitution of eligible assets; and (iii) amend the portion of the rule that deals with safekeeping of assets. Commission staff estimates that the proposal may result in a new collection of information but any collection of information would not have an associated burden. Although in the condition in rule 3a-7 dealing with the substitution of assets, the proposed amendments would require the issuer to have procedures to ensure that the acquisition or disposition of assets does not adversely affect the full and timely payment of the outstanding fixed income securities, Commission staff believes that almost all issuers currently have these procedures in place.

We request comment on whether issuers currently have these procedures in place.

C. Rule 5b-3

Rule 5b-3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act under certain conditions. We propose to amend rule 5b-3 by requiring a fund's board of directors, or its

delegate, to determine that the securities collateralizing a repurchase agreement present minimum credit risks and are highly liquid.⁸⁸ To that end, the fund's board of directors, pursuant to rule 38a-1 under the Investment Company Act, would have to develop procedures to ensure that at the time the repurchase agreement is entered into the securities meet the requirements for collateral outlined in the amendments to the proposed rule. These procedures are necessary to make sure that the market value of the collateral remains fairly stable and that the fund would be able to liquidate the collateral quickly in the event of a default.⁸⁹ This collection of information would be mandatory for funds that rely on rule 5b-3. Records of information made in connection with this requirement would be required to be maintained for inspection by Commission staff, but the collection would not otherwise be submitted to the Commission.

The existing rule provides that unrated securities are collateral if the fund's board, or its delegate, makes the determination that the unrated securities are comparable to securities that are rated in the highest rating category by the Requisite NRSROs.⁹⁰ Thus, fund boards may have existing procedures regarding credit quality determinations for unrated securities. In addition, as a matter of good business practice, we believe that some funds currently evaluate the credit risk and liquidity of rated securities. Thus, we believe that most funds already have procedures to evaluate collateral securities. As of March 31, 2008, 4,714 investment companies were registered with the Commission. Commission staff estimates that 90% of all registered investment companies, or 4,243 funds, currently have procedures for evaluating collateral securities. Commission staff therefore estimates that 471 funds would need to develop

⁸⁸ Proposed rule 5b-3(c)(1)(iv)(C).

⁸⁹ See Rule 5b-3 Proposing Release, *supra* note 51, at text accompanying n.43.

⁹⁰ Rule 5b-3(c)(1)(iv)(D).

procedures and evaluate collateral securities, and the staff estimates this would involve a one-time burden of 942 hours and an ongoing burden of 5,652 hours, at a cost of approximately \$1,294,308.⁹¹

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

D. Rule 10f-3

Rule 10f-3, permits funds that are affiliated with members of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met. We are proposing to amend the rule's definition of "eligible municipal securities" to include credit quality and liquidity requirements.

Under the current rule, fund boards are required to approve procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.⁹² Accordingly, the board currently reviews purchases of municipal securities made in reliance on the rule, and would continue to do so under our proposal. Pursuant to the amendments to the proposed rule, fund boards would need to approve additional procedures for ensuring that municipal securities meet the standards for credit quality and liquidity. These procedures are necessary to eliminate any possibility that an affiliated underwriter may "unload" otherwise unmarketable securities on a fund. This collection of

⁹¹ Commission staff estimates that each fund board would incur a one-time burden of 2 hours to develop procedures for evaluating credit and liquidity risks (471 boards x 2 hours = 942 hours). Commission staff believes that any incidental costs incurred by boards of directors would be incorporated into funds' overall board costs and would not add any particular costs. In addition, staff estimates that a board delegate would spend an average of 1 hour to evaluate the credit risks for the collateral for each of an average of 12 repurchase agreements each year (471 funds x 12 hours = 5,652 hours). Assuming the evaluation would be performed by a senior business analyst (at \$229 per hour), the total cost estimate would be \$1,294,308.

⁹² Rule 10f-3(c)(10).

information would be mandatory for funds that rely on rule 10f-3. Records of information made in connection with this requirement would be required to be maintained for inspection by Commission staff, but the collection would not otherwise be submitted to the Commission.

In our most recent PRA submission, we estimated that approximately 350 funds engage in rule 10f-3 transactions each year. We further estimated that each fund would, on average, take two hours to review and revise, as needed, written procedures for rule 10f-3 transactions. We believe that any revisions funds would have to make to comply with the proposed amendments would be incorporated in the two hours of review. Accordingly, we do not believe that the proposed amendments to rule 10f-3 would change the burdens currently approved for rule 10f-3.

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

E. Rule 206(3)-3T

Rule 206(3)-3T under the Advisers Act establishes a temporary alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. So long as each condition of the rule is met, an eligible adviser may provide the transaction-by-transaction disclosure required under section 206(3) of the Advisers Act either orally or in writing. One condition of the rule is that an adviser generally may not rely on rule 206(3)-3T for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser (“control person”) is the issuer or is an underwriter of the security. The rule contains an exception to this “underwritten securities” exclusion for trades in which the adviser or a control person is an underwriter of non-convertible *investment-grade* debt securities. The proposed

amendment to rule 206(3)-3T would modify the definition of “investment grade debt security” to mean a non-convertible debt security that, at the time of sale, the investment adviser has determined to be subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

Under the proposed amendment to rule 206(3)-3T, there is a single new collection burden. Pursuant to its obligations under rule 206(4)-7 under the Advisers Act, an adviser seeking to rely on rule 206(3)-3T must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act that address the adviser’s methodology for determining whether a security is investment grade quality pursuant to the definition. This collection of information is designed to minimize the incentives associated with underwriting securities that may bias the advice being provided or may lead the adviser to exert undue influence on its client’s decision to invest in the offering or the terms of that investment. Although the rule does not call for any of the information collected to be provided to us, to the extent advisers include any of the information in a filing, such as Form ADV, the information would not be kept confidential.

We anticipate that the burden associated with this collection would mostly be borne upfront as advisers develop their policies and procedures for how to identify non-convertible investment grade debt securities in connection with the credit risk and liquidity elements specified under the rule. This would require drafting the policies and procedures, potentially subjecting them to review of outside counsel, implementing them, and explaining their contours in the adviser’s Form ADV.

We estimate that the average burden for drafting the required policies and procedures for each eligible adviser that chooses to rely on the rule in connection with underwritten securities in

particular, would be approximately 10 hours on average. Further, we expect the drafting burden would be uniform with respect to each eligible adviser regardless of how many individual non-discretionary advisory accounts that adviser administers or seeks to engage with in principal trading. As of June 1, 2008, there were 639 advisers that were eligible to rely on the temporary rule (*i.e.*, also registered as broker-dealers), 409 of which indicate that they have non-discretionary advisory accounts.⁹³ We estimate that 90% of those 409 advisers, or a total of 368 of those advisers, rely on the rule.⁹⁴ Of those, we estimate that only 50% would seek to engage in principal trades with clients of securities they or a control person underwrote. Thus, we estimate that the total number of advisers who would rely on the non-convertible investment grade debt exception to the “underwritten securities” exclusion under the rule would be approximately 185.

Accordingly, we estimate that the total burden for creating initial policies and procedures under the proposal for the estimated 185 advisers that would rely on the rule would be 1,850 hours.⁹⁵ We also estimate an average one-time cost for the preparation of the policies and procedures for approximately three hours of outside legal counsel time of \$1,200 per eligible adviser on average,⁹⁶ for a total of \$222,000.⁹⁷

⁹³ IARD data as of June 1, 2008, for Items 6.A(1) and 5.F(2)(e) of Part 1A of Form ADV.

⁹⁴ We anticipate that most investment advisers that are dually registered as broker-dealers will make use of the rule to engage in, at a minimum, riskless principal transactions to limit the need for these advisers to process trades for their advisory clients with other broker-dealers. We estimate that 10% of these advisers will determine that the costs involved to comply with the rule are too significant in relation to the benefits that the adviser, and their clients, will enjoy.

⁹⁵ This estimate is based on the following calculation: 10 hours per adviser x 185 eligible advisers that will rely on the rule = 1,850 total hours.

⁹⁶ Outside legal fees are in addition to the projected 10 hours per adviser burden discussed in note 95 and accompanying text.

⁹⁷ This estimate is based on the following calculation: (\$400 per hour x 3 hours x 185 advisers = \$222,000).

F. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments 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, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-19-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-19-08, and be submitted to the Securities and Exchange Commission, Public Records Management Office Room, 100 F Street, NE, Washington, DC 20549-1110.

VI. COST-BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings. The proposed amendments to rules 2a-7, 3a-7, 5b-3, and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act would eliminate the reference to and requirement for the use of NRSRO ratings in these rules.

A. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to investors of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in our rules. An over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information. The purpose of the proposed rule amendments is to encourage investors to examine more than a single source of information in

making an investment decision. Eliminating reliance on ratings in the Commission's rules could also result in greater investor due diligence and investment analysis. In addition, the Commission believes that eliminating the reliance on ratings in its rules would remove any appearance that the Commission has placed its imprimatur on certain ratings.

More specifically, the principal benefit of the proposed amendments to rule 2a-7 would be to emphasize the importance of money market funds making independent assessments of credit risks. The benefit of the proposed amendments to rule 3a-7 would be to emphasize that ratings are not necessary for accredited investors and qualified institutional buyers to protect themselves in evaluating structured finance vehicles issued under the rule. Similarly, the benefit of the proposed amendments to rules 5b-3 and 10f-3 would be to emphasize the importance to funds that acquire repurchase agreements or securities in an affiliated underwriting of making an independent evaluation of the credit risks associated with the collateral or the underwritten security, respectively. In addition, by moving away from a required reliance on credit ratings in our rules, funds may benefit by acquiring a wider range of securities that present attractive investment opportunities and the requisite level of credit risks, although they do not meet the current rules' ratings requirements. The principal benefit of the proposed amendment to rule 206(3)-3T would be to allow advisers to consider factors other than only a rating by NRSROs of the credit quality of a debt security for purposes of eligibility of the rule. Advisers would determine, based upon established criteria of whether the security presents no more than moderate credit risk and has sufficient liquidity, whether a security is investment grade for purposes of the rule. Investment advisers could, in addition to considering NRSRO ratings, weigh various factors and consider a security's credit quality based on those qualitative and quantitative elements it deems most relevant. An additional benefit of the proposed amendment

would be that non-discretionary advisory clients of advisers also registered with us as broker-dealers may have easier access to a wider range of securities. This, in turn, would increase liquidity in the markets for these securities and promote capital formation in these areas. These benefits are difficult to measure quantitatively, but qualitatively we believe the potential benefits are significant.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are also requested to identify sources of empirical data that could be used for the metrics they propose.

B. Costs

We anticipate that funds and investment advisers could incur certain costs if the proposed amendments are adopted. Funds and investment advisers may incur additional costs if they perform a more detailed and comprehensive analysis before making an investment decision. Such costs are difficult to measure, but we believe that they would be justified by the benefits related to a more informed investment decision as discussed in the previous section. In addition, the purpose of the proposal is to emphasize that it is not the Commission's intent to encourage investors to place undue reliance on NRSRO ratings in making investment decisions. In many cases, investors may still choose to rely solely on NRSRO ratings without incurring additional costs.

Additionally, in proposing to remove the ratings requirements from our rules, we would broaden the set of potential investments available to funds and investment advisers. For example, under the proposed amendments to rule 2a-7, money market funds would be able to invest in securities that have received credit ratings outside of the two highest short-term rating categories. It is possible that some investors, funds, or investment advisers may incur additional costs if funds and investment advisers use this expanded discretion to purchase (or sell in the

case of principal transactions under rule 206(3)-3T) risky or illiquid securities. We believe that these potential costs would be mitigated, however, by market forces, including, in the case of money market funds, investors' desire to maintain the principal value of their investments.

We request comment on these costs. Would eliminating the rating requirements from our rules affect the amount or nature of risks that investment companies and investment advisers would be willing or able to take? We request comment on available metrics to quantify these costs and any other costs the commenter may identify. Commenters are also requested to identify sources of empirical data that could be used for the metrics they propose.

Rule 2a-7. We anticipate that the proposed amendments to rule 2a-7 would impose minimal new costs on a portion of money market funds. In general, we expect that money market fund boards of directors (or their delegates) would incur no additional costs in making credit and liquidity risk determinations regarding portfolio securities because the proposed rules would codify the determinations regarding credit risk and liquidity that we believe boards (or their delegates) make under the current rule. Some money market funds, however, would incur costs to notify the Commission regarding rule 17a-9 transactions. For purposes of the PRA analysis, Commission staff estimates that on average 10 money market funds each year are likely to provide notices regarding rule 17a-9 transactions, at a cost of approximately \$1,475.⁹⁸ We request comment on these cost estimates. Do commenters foresee additional or alternative costs if the proposed amendments to rule 2a-7 are adopted? Have we accurately estimated the number of money market funds that would have to report rule 17a-9 transactions annually? Have we accurately estimated money market funds' potential costs in reporting rule 17a-9 transactions?

Rule 3a-7. Our proposed amendments to rule 3a-7 under the Investment Company Act

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See supra note 87 and accompanying text.

may impose minor costs. Specifically, retail investors who are able, because of the rule, to buy structured finance products would no longer be able to participate in the market. We understand that these products generally are not marketed to retail investors, however, and the number of retail investors affected, if there are any, may be quite low. The proposed amendments also may result in more limited access to capital for issuers of structured financings to the extent there is a retail market that is eliminated under the proposed amendments. All investors who hold structured finance products bought under the existing rule may bear some costs of reduced liquidity to the extent a retail market no longer exists because the pool of potential buyers in the secondary market may be reduced. These costs are difficult to assess given that any existing market may be very small.

Commission staff estimates the following potential costs associated with the proposed amendments to rule 3a-7:

- *Costs to retail investors* – Retail investors may incur certain opportunity costs under the proposal because they would not be able to purchase the securities of structured finance vehicles that rely on rule 3a-7. These potential costs may be mitigated, however, because we understand, based on staff experience that this market, if it exists, represents a very small amount of all structured finance products (perhaps less than 1% of the \$306.7 billion in asset-backed securities issued in 2007).⁹⁹
- *Procedures for the acquisition or disposition of assets* – Although we are proposing to remove rule 3a-7's rating requirement, we anticipate that structured

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See Worldwide ABS Issuance, Asset-Backed Alert: The Weekly Update on Worldwide Securitization (June 13, 2008), p.11.

financing vehicles would be rated by the NRSROs. We expect that market participants generally will continue to require that issuers obtain ratings.

Accordingly, as a matter of good business practice, Commission staff estimates that almost all issuers will continue to have procedures in place to ensure that the acquisition or disposition of assets does not adversely affect the full and timely payments to outstanding security holders. Thus, Commission staff believes that the proposed amendments would not impose any new cost burdens on issuers.

- *Deposits in segregated accounts* –We believe that almost all issuers have already taken the actions necessary for cash flows to be deposited in segregated accounts consistent with the full and timely payment of outstanding fixed income securities in meeting the current rule’s ratings requirement. Commission staff does not anticipate any new costs associated with this provision of the proposal.

We request comment on these cost estimates. Are structured financings offered to the retail market under rule 3a-7? If so, how large is the retail market for these products? What costs would retail investors incur if the proposed amendments are adopted? How would retail investors sell or dispose of their current structured finance vehicle holdings if the proposed amendments were adopted? How should any opportunity costs investors may face if the proposed amendments are adopted be quantified? Would there be any new costs associated with developing procedures for the acquisition or disposition of assets and deposits in segregated accounts?

Rule 5b-3. Our proposed amendments to rule 5b-3 under the Investment Company Act may impose costs on funds that rely on the rule. Specifically, a fund’s board of directors, or its delegate, pursuant to rule 38a-1 under the Investment Company Act, would be required to

develop written policies and procedures to ensure that at the time the repurchase agreement is entered into the collateral meets the requirements outlined in the amendments to the proposed rule.¹⁰⁰ The proposal would require collateral other than cash or government securities to consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into: (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time; (ii) are subject to no greater than minimal credit risk, and (iii) the issuer of which has the highest capacity to meet its financial obligations. The existing rule provides that collateral may consist of unrated securities if the fund's board, or its delegate, makes the determination that the unrated securities are comparable to securities that are rated in the highest rating category by the Requisite NRSROs. Consistent with the requirements of rule 38a-1 under the Investment Company Act, we expect that fund boards would have existing procedures regarding credit quality determinations for unrated securities. In addition, as a matter of good business practice, we believe that most funds currently evaluate the credit risk and liquidity of rated securities. Thus, we believe that most funds already have procedures to evaluate collateral securities. For purposes of the PRA analysis, Commission staff estimates that 90% of all investment companies, or 4,243 funds, currently have procedures for evaluating collateral securities.¹⁰¹ Commission staff therefore estimates that 471 funds would need to develop procedures and evaluate collateral securities, at an annual cost of approximately \$1,294,308.¹⁰²

Our proposed amendments to rule 5b-3 may result in another cost to affected funds.

¹⁰⁰ Rule 38a-1(a).

¹⁰¹ See *supra* text preceding note 90.

¹⁰² See *supra* note 91.

Currently, NRSRO ratings are used in a provision of rule 5b-3 that permits a fund to deem the acquisition of a “refunded security” as the acquisition of the escrowed government securities for purposes of section 5(b)(1)’s diversification requirements.¹⁰³ Under this provision, a debt security must satisfy certain conditions to be considered a refunded security under the rule. One of these conditions is that an independent certified public accountant must have certified to the escrow agent that the escrowed securities would satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities.¹⁰⁴ This condition is not required, however, if the refunded security has received a debt rating in the highest rating from an NRSRO.¹⁰⁵

We propose to eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO. As previously discussed, the Commission included this exception because in rating refunded securities, NRSROs typically require that an independent third party make the same determination.¹⁰⁶ As previously noted, Commission staff believes that market pressures currently require almost all issuers to have refunded securities certified by an independent accountant. To the extent that refunded securities are rated, and the rating agency requires certification by an independent certified public accountant, funds would not incur additional costs in determining whether a security had been certified in accordance with the rule. Accordingly, we do not expect there would be a change in current costs to issuers as a

¹⁰³ Under the rule, a refunded security is defined as a debt security the principal and interest payments of which are to be paid by U.S. government securities that have been irrevocably placed in an escrow account and are pledged only to the payment of the debt security. Rule 5b-3(c)(4).

¹⁰⁴ Rule 5b-3(c)(4)(iii).

¹⁰⁵ *Id.*

¹⁰⁶ See rule 5b-3 Proposing Release, *supra* note 51.

result of this proposal.

We request comment on these cost estimates. Do commenters foresee additional or alternative costs if the proposed amendments to rule 5b-3 are adopted? Have we accurately estimated current and future costs for collateral procedures? Are we correct in estimating that funds are unlikely to incur any additional costs in determining that a refunded security has received an accountant certification?

Rule 10f-3. We do not believe that our proposed amendments to rule 10f-3 would impose costs on funds that rely on rule 10f-3 to purchase municipal securities. Under the current rule, fund boards are required to adopt procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.¹⁰⁷ Commission staff estimates that these costs would not change. As noted above in our analysis of the PRA, we currently estimate that boards spend, on average, two hours each year to review and revise their procedures for acquiring securities in compliance with the conditions in rule 10f-3. We believe that any changes funds would make to their procedures in order to comply with the proposed amendments to the rule would be included in this annual review and revision.

We request comment on these cost estimates. Have we accurately estimated the costs associated with the proposal's required additional procedures for purchases of municipal securities? Do commenters foresee additional or alternative costs if the proposed amendments to rule 10f-3 are adopted?

Rule 206(3)-3T. In lieu of relying exclusively on credit ratings to determine eligibility for principal trading of underwritten securities under the rule, advisers would need to make a determination of a security's credit risk and liquidity. This determination would impose some

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Rule 10f-3(c)(10).

costs on advisers. Advisers seeking to rely on the exception would need to develop and implement procedures regarding their eligibility determinations in accordance with their responsibilities under Advisers Act rule 206(4)-7. And, in making their determinations, many advisers would expend resources beyond merely obtaining credit ratings from NRSROs, as is required under the current rule.

Commission staff estimates that the costs of preparing the procedures for making the determinations of credit quality and liquidity under the rule would be borne upfront. Once generated, reviewed, and implemented by eligible advisers, advisers would be able to follow them for purposes of making further determinations of eligibility for underwritten securities under the requirements of the rule. For purposes of the PRA analysis, our staff has estimated the number of hours and costs the average adviser would spend in the initial preparation of its policies and procedures.¹⁰⁸ Based on those estimates, our staff estimates that advisers would incur costs of approximately \$1,820 on average per adviser, including legal consultation.¹⁰⁹ Assuming there are 185 eligible advisers (*i.e.*, advisers that also are registered broker-dealers) that would prepare relevant policies and procedures, our staff estimates that the total costs would be \$336,700.¹¹⁰

We request comment on these cost estimates. Are the cost estimates accurate regarding

¹⁰⁸ See *supra* note 97 and accompanying text. We estimate the following burdens and/or costs: (i) for drafting the policies and procedures, approximately 10 hours on average per eligible adviser, of which we estimate there are 185, for a total of 1,850 hours; and (ii) for utilizing outside legal professionals in the preparation of the policies and procedures, approximately \$1,200 on average per eligible adviser, for a total of \$222,000.

¹⁰⁹ We estimate that the internal preparation function will most likely be performed by a compliance clerk at \$62 per hour. $\$62 \text{ per hour} \times 10 \text{ hours} = \620 on average per adviser of internal costs for preparation of the policies and procedures. $\$620$ on average per adviser of internal costs + $\$1,200$ on average per adviser of costs for outside legal counsel = $\$1,820$ on average per adviser.

¹¹⁰ This estimate is based on the following calculation: $\$1,820$ on average per adviser \times 185 advisers = $\$336,700$ in total costs for preparation of the policies and procedures.

the proposed procedures for making credit quality determinations? Do commenters foresee additional or alternative costs if the proposed amendments to rule 206(3)-3T are adopted?

C. Request for Comment

We request comment on all aspects of this cost-benefit analysis, including comment as to whether the estimates we have used in our analysis are reasonable. We welcome comment on any aspect of our analysis, including the estimates and the assumptions we have described. In particular, we request comment as to any costs or benefits we may not have considered here that could result from the adoption of the proposed amendments. We also request comment on the numerical estimates discussed above, and request comment on specific costs and benefits from covered institutions that have experienced any of the situations analyzed above.

VII. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Investment Company Act section 2(c) and Investment Advisers Act section 202(c) 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.¹¹¹ If adopted, the Commission believes that these amendments would reduce the potential for over-reliance on ratings, and thereby promote investor protection. The Commission anticipates that these proposed amendments would improve investors' ability to make informed investment decisions, which would therefore lead to increased efficiency and competitiveness of the U.S. capital markets. The Commission expects that this increased market efficiency and investor confidence also may encourage more efficient capital formation.

¹¹¹ 15 U.S.C. 80a-2(c) and 15 U.S.C. 80b-2(c).

Efficiency. As discussed above, the proposed amendments could result in additional costs for investment companies and registered investment advisers, which could affect the efficiency of these institutions. The proposed amendments to rule 2a-7 may slightly decrease the efficiency of certain money market funds, to the extent that any funds may be relying exclusively on credit ratings to make current minimal credit risk determinations. We believe that independently generated assessments of credit risks are important, however, and a slight decrease in efficiency may be warranted. Our proposed amendments to rule 3a-7 may reduce market efficiency by limiting the ability of retail investors who invest in structured financing vehicles. However, the proposal to eliminate sales of structured finance vehicles to the retail market would clearly delineate investors who are eligible to buy these products, which may increase market efficiency.

Ratings provide a standard for retail investors, funds, and advisers alike. By eliminating reliance on ratings, the proposed amendments may have a negative impact on efficiency by eliminating an objective standard in credit quality determinations. The proposed amendments also could decrease efficiency to the extent that funds acquired securities that do not meet the particular ratings requirement and that result in the concerns that the rating requirements were designed to address. On the other hand, the proposed amendments may result in some increased market efficiency by affording funds access to securities that do not meet the rating requirements in the current rules, but that would satisfy the credit risk and liquidity standards in the proposed amendments. We do not anticipate that the proposed amendments to rules 2a-7, 5b-3, and 10f-3 would have other impacts on the efficiency of funds that rely on those rules. The proposed amendments to rule 206(3)-3T may increase efficiency by affording clients access to certain investment grade debt securities underwritten by the adviser or its affiliate that they might not have had access to under the standard requiring NRSRO ratings.

Competition. If investors believe the proposed amendments to rule 2a-7 would make the rule less rigorous in part because of the loss of an independent third party check on money market fund investments, they may turn to other cash investment vehicles they perceive as offering greater protections. In addition, investors in money market funds may unduly rely on ratings of the money market funds themselves as a proxy for the quality and safety of these funds' portfolio securities. This may potentially increase costs to money market funds that would not otherwise seek ratings. The proposed amendments to rule 3a-7, may impact certain issuers of structured finance vehicles that, for example, may specialize in the retail market if they had some competitive advantage, such as a distribution channel. Eliminating the exclusion for structured finance vehicles offered to retail investors may make these issuers less competitive in this market. The proposed amendments to rule 206(3)-3T may promote competition because, by providing a more subjective standard for the underwritten securities exception, they may increase the alternative sources of the security for the client without diminishing the adviser's best execution obligations, thereby potentially improving price. We do not believe the proposed amendments to rules 5b-3 or 10f-3 would significantly affect competition because these amendments would apply to all money market funds and other funds.

Capital formation. We do not believe the proposed amendments to the rules would have a significant effect on capital formation. To the extent potential money market fund investors may react positively to money market funds' independent credit risk assessments and management of risks, we believe any effect the proposed amendments to rule 2a-7 may have on capital formation would be positive. Our proposed amendments to rule 3a-7 would limit capital formation for issuers that offer structured finance products to retail investors in reliance on rule 3a-7. The proposed amendments would have no effect on the ability of issuers who rely on rule

3a-7 to offer structured financings to accredited investors and qualified institutional buyers to raise capital. We do not expect that the proposed amendments to rules 5b-3 or 10f-3 would have an adverse effect on capital formation. If the proposed amendments to rule 206(3)-3T have any effect on capital formation, it is likely to be positive, although indirect. Providing a means for advisers, consistent with their fiduciary obligations, to offer their clients underwritten investment grade securities sold as principal, might serve to broaden the potential universe of purchasers of securities, opening the door to greater investor participation in the securities markets with a potential positive effect on capital formation.

We request comment on all aspects of this analysis, and specifically request comment on any effect the proposed amendments might have on the promotion of efficiency, competition, and capital formation that we have not considered. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. REGULATORY FLEXIBILITY ACT CERTIFICATION

Section 3(a) of the Regulatory Flexibility Act of 1980¹¹² (“RFA”) requires the Commission to undertake an initial regulatory flexibility analysis (“IRFA”) of the proposed rule amendments on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.¹¹³ Pursuant to Section 605(b) of the RFA, the Commission hereby certifies that the proposed amendments to rules 2a-7 and 3a-7 under the Investment Company Act, would not, if adopted, have a significant economic impact on a substantial number of small entities. The proposal would:

- (a) Amend rule 2a-7 under the Investment Company Act to: (i) rely on money

¹¹² 5 U.S.C. 603(a).

¹¹³ 5 U.S.C. 605(b).

market fund boards of directors (who usually rely on the funds' advisers) to determine that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security;" (ii) add a portfolio liquidity requirement to the rule that would require that money market funds hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions, and expressly limit their investment in illiquid securities to not more than 10% of the their total assets; (iii) in the event the money market fund's portfolio manager becomes aware of any new information about a portfolio security (or an issuer of a portfolio security) that may suggest that the security may not continue to present minimal credit risks, the proposal would amend rule 2a-7's downgrade and default provisions to require a money market fund's board of directors to reassess promptly whether the portfolio security continues to present minimal credit risks; and (iv) require a money market fund to notify the Commission of the purchase of a money market fund's portfolio securities by an affiliated person in reliance on rule 17a-9 under the Investment Company Act. The proposed amendments also would make conforming amendments to rule 2a-7's record keeping and reporting requirements; and

- (b) Amend rule 3a-7 under the Investment Company Act to: (i) eliminate the rule's reliance on ratings by eliminating the exclusion for structured financings offered to the general public; (ii) remove the reference to ratings downgrades in the section of the rule that addresses substitution of eligible assets; and (iii) amend the portion of the rule that deals with safekeeping of assets.

Based on information in filings submitted to the Commission, we believe that there are

no money market funds that are small entities.¹¹⁴ In addition, we are not aware of any issuers that currently rely on rule 3a-7 that are small entities. For these reasons, the Commission believes the proposed amendments to rules 2a-7 and 3a-7 under the Investment Company Act would not, if adopted, have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to rules 2a-7 and 3a-7 could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

IX. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This IRFA has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments to rules 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act. The proposed amendments would remove references to and the required use of NRSRO ratings from these rules.

A. Reasons for the Proposed Action

As discussed above, the proposed rule amendments are designed to address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings.

B. Objectives of the Proposed Action

Our proposed amendments are designed to address the risk that reference to and use of

¹¹⁴ Under the Investment Company Act, an investment company is considered a small entity if it, together with other investment companies in the same group of related investment companies, have net assets of \$50 million or less as of the end of its most recent fiscal year. See 17 CFR 270.0-10.

NRSRO ratings in our rules:

- is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs; and
- encourages investors to place undue reliance on the NRSRO ratings.

C. Legal Basis

The Commission is proposing amendments to rule 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c) and 80a-37(a)]. The Commission is proposing amendments to rule 10f-3 under the authority set forth in sections 10(f), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a-10(f), 80a-30(a) and 80a-37(a)]. The Commission is proposing amendments to rule 206(3)-(3)T under the authority set forth in sections 206A and 211(a) of the Investment Advisers Act [15 U.S.C. 80b-6A, 80b-11(a)].

D. Small Entities Subject to the Proposed Rule Amendments

The proposed amendments to rules 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act would affect funds and registered investment advisers, including entities that are considered to be a small business or small organization (collectively, “small entity”) for purposes of the RFA. Under the Investment Company Act, a fund is considered a small entity if it, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.¹¹⁵ Under the Investment Advisers Act, a small entity is an investment adviser that: (i) manages less than \$25 million in assets; (ii) has total assets of less than \$5 million on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under

¹¹⁵

17 CFR 270.0-10.

common control with another investment adviser that manages \$25 million or more in assets, or any person (other than a natural person) that has had total assets of \$5 million or more on the last day of the most recent fiscal year.¹¹⁶ Based on Commission filings, we estimate that 122 investment companies may be considered small entities. We also estimate that as of June 1, 2008, 572 investment advisers were small entities.¹¹⁷ The Commission assumes for purposes of this IRFA that 19 of these small entities (those that are both investment advisers and broker-dealers) could rely on rule 206(3)-3T,¹¹⁸ and that 50% of these, or 10 advisers, will seek to engage in principal trades with clients of securities they or a control person underwrote.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments to rule 5b-3 would require collateral for repurchase agreements other than cash or government securities to have minimal credit risk and be highly liquid. Specifically, the proposal would require collateral other than cash or government securities to consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into: (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time; (ii) are subject to no greater than minimal credit risk, and (iii) the issuer of which has the highest capacity to meet its financial obligations.¹¹⁹ The proposed amendments to rule 10f-3 would amend the rule's definition of "eligible municipal security" to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time. In addition, the securities would have to be either: (i) subject to no greater than moderate credit risk; or (ii) if

¹¹⁶ 17 CFR 275.0-7.

¹¹⁷ IARD data as of June 1, 2008, for Item 12 of Part 1A of Form ADV.

¹¹⁸ IARD data as of June 1, 2008, for Items 6.A(1) and 12 of Part 1A of Form ADV.

¹¹⁹ Proposed rule 5b-3(c)(1)(iv)(C).

they are less seasoned securities, subject to a minimal or low amount of credit risk.¹²⁰ The proposed amendments to rule 206(3)-3T would impose a new compliance requirement in connection with advisers' obligations relating to written policies and procedures under rule 206(4)-7 under the Advisers Act.

Small entities registered with the Commission as investment companies or investment advisers seeking to rely on each of the rules as it is proposed to be amended would be subject to the same requirements as larger entities. With respect to rule 206(3)-3T, in each case, however, an investment adviser, whether large or small, would only be able to rely on the rule as it is proposed to be amended if it also is registered with us as a broker-dealer. As noted above, we estimate that 19 small entities are advisers that are also registered as broker-dealers and therefore only those small entities are eligible to rely on the rule. In developing the requirements of the proposed amendments to each of rules 5b-3 and 10f-3 under the Investment Company Act, and rule 206(3)-3T under the Investment Advisers Act, we considered the extent to which the proposed amendments would have a significant impact on a substantial number of small entities.

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed amendments could have any effect that we have not considered. We also request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

F. Duplicative, Overlapping, or Conflicting Federal Rules

Rule 31a-1 under the Act requires the retention of ledger accounts for each portfolio security and each person through which a portfolio transaction is effected. Although some of the procedures under the proposed amendments to rules 5b-3 and 10f-3 may overlap with

¹²⁰ Proposed rule 10f-3(a)(3).

information in the ledgers, the rule 5b-3 and 10f-3 procedures would contain additional information specifically related to the concerns underlying these rules.

The Commission believes that there are no rules that duplicate or conflict with the proposed amendments to rule 206(3)-3T.

G. Significant Alternatives

The RFA directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) establishing different compliance or reporting standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

With respect to rules 5b-3 and 10f-3, the Commission preliminarily believes that special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those entities could acquire repurchase agreements with collateral that may not retain its market value or liquidity in the event of a counterparty default. We do not expect that the requirement that refunded securities be certified by a certified public accountant would result in any costs or burdens for either small or large entities. With respect to rule 10f-3, we preliminarily believe that special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may put those entities at greater risk for purchasing unmarketable municipal securities in an affiliated underwriting. We preliminarily believe, therefore, that it is important for the credit quality and liquidity considerations required by the proposed amendments to rules 5b-3 and 10f-3 to apply to all funds relying on the rules,

not just those that are not considered small entities. Further consolidation or simplification of the proposals for funds that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

With respect to rule 206(3)-3T, the Commission preliminarily believes that special compliance or reporting requirements or timetables for small entities, or an exemption from coverage for small entities may create the risk that the investors who are advised by and effect securities transactions in underwritten securities through such small entities may not receive adequate protection combined with access to securities. We believe, therefore, that it is important for the investment quality consideration required by the proposed amendments to apply to all advisers, not just those that are not considered small entities. Further consolidation or simplification of the proposals for investment advisers that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

We have endeavored through the proposed amendments to rules 5b-3, 10f-3 and 206(3)-3T to minimize the regulatory burden on all entities eligible to rely on the respective rules, including small entities, while meeting our regulatory objectives. It was our goal to ensure that eligible small entities may benefit from the Commission's approach to the proposed amendments to the same degree as other funds or eligible advisers, as appropriate.

We request comment on whether it is feasible or necessary for small entities to have special requirements or timetables for, or exemptions from, compliance with the proposed amendments to each of the rules. In particular, could any of the proposed amendments be altered in order to ease the regulatory burden on small entities, without sacrificing the effectiveness of the proposed amendments?

H. Request for Comments

We encourage the submission of comments with respect to any aspect of this IRFA. In particular, we request comments regarding: (i) the number of small entities that may be affected by the proposed amendments; (ii) the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and (iii) how to quantify the impact of the proposed amendments. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. Comments should be submitted to the Commission at the addresses previously indicated.

X. STATUTORY AUTHORITY

The Commission is proposing amendments to rules 2a-7, 3a-7, and 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)]. The Commission is proposing amendments to rule 10f-3 under the authority set forth in sections 10(f), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a-10(f), 80a-30(a), 80a-37(a)]. The Commission is proposing amendments to rule 206(3)-(3)T under the authority set forth in sections 206A and 211(a) of the Investment Advisers Act [15 U.S.C. 80b-6A, 80b-11(a)].

List of Subjects

17 CFR Parts 270

Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULE AMENDMENTS

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

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

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

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

* * * * *

2. Section 270.2a-7 is amended by:
 - a. Revising paragraphs (a)(10), (a)(12), and (a)(17);
 - b. Removing paragraph (a)(19);
 - c. Redesignating paragraph (a)(20) as paragraph (a)(19);
 - d. Removing paragraph (a)(21);
 - e. Redesignating paragraphs (a)(22) through (a)(27) as paragraphs (a)(20) through (a)(25);
 - f. Removing paragraph (a)(28);
 - g. Redesignating paragraph (a)(29) as paragraph (a)(26);
 - h. In paragraphs (b)(1) and (b)(2), revising the phrase “(c)(2), (c)(3), and (c)(4)” to read “(c)(2), (c)(3), (c)(4), and (c)(5)”;
 - i. Revising paragraphs (c)(3)(i), (c)(3)(iii), and (c)(3)(iv)(C);
 - j. Adding paragraph (c)(3)(iv)(D);
 - k. In paragraph (c)(4)(v), revising the phrase “requirements of paragraphs (c)(4) and (c)(5)” to read “requirements of paragraphs (c)(4) and (c)(6)”;
 - l. Redesignating paragraphs (c)(5) through (c)(10) as paragraphs (c)(6) through

(c)(11);

- m. Adding new paragraph (c)(5);
- n. In newly redesignated paragraph (c)(6), revising the phrase “(pursuant to paragraphs (c)(9)(ii) and (c)(10)(vi) of this section)” to read “(pursuant to paragraphs (c)(10)(ii) and (c)(11)(vi) of this section)”;
- o. In newly redesignated paragraph (c)(7):
 - i. revising the paragraph heading;
 - ii. revising paragraph (i);
 - iii. in the introductory text of paragraph (ii), revising the phrase “paragraphs (c)(6)(ii)(A) through (D)” to read “paragraphs (c)(7)(ii)(A) through (C)”;
 - iv. adding “or” at the end of paragraph (ii)(B);
 - v. removing paragraph (ii)(C) and redesignating paragraph (ii)(D) as paragraph (ii)(C);
 - vi. revising paragraph (iii);
 - vii. revising the heading to paragraph (iv); and
 - viii. in paragraph (iv), revising the phrase “For purposes of paragraphs (c)(6)(ii) and (iii)” to read “For purposes of paragraphs (c)(7)(ii) and (iii)”;
- p. Revising newly designated paragraph (c)(10)(ii);
- q. In newly redesignated paragraph (c)(11):
 - i. in paragraph (i), revising the phrase “paragraphs (c)(6) through (c)(9)” to read “paragraphs (c)(7) through (c)(10)”;
 - ii. revising paragraph (iii);
 - iii. in paragraph (iv), revising the phrase “paragraph (c)(9)(iii) of this

section” to read “paragraph (c)(10)(iii) of this section”;

iv. in the introductory text of paragraph (v), in the first sentence, revising “paragraph (c)(9)(iv) of this section” to read “paragraph (c)(10)(iv) of this section”;

v. in paragraph (vi), revising the phrase “paragraph (c)(9)(ii)” to read “paragraph (c)(10)(ii)”;

vi. in paragraph (vii), in the first sentence, revising the phrase “this paragraph (c)(10)” to read “this paragraph (c)(11)”;

vii. in paragraph (vii), in the second sentence, revising the phrase “paragraphs (c)(6)(ii) (with respect to defaulted securities and events of insolvency) or (c)(7)(ii)” to read “paragraphs (c)(7)(ii) (with respect to defaulted securities and events of insolvency) or (c)(8)(ii)”;

r. Revising the introductory text of paragraph (e) and in paragraph (e)(2) revising the phrase “paragraph (c)(6)(iii) of this section” to read “paragraph (c)(7)(iii) of this section”.

These additions and revisions read as follows:

§ 270.2a-7 Money market funds.

(a) * * *

(10) *Eligible Security* means a security with a remaining maturity of 397 calendar days or less that the fund’s board of directors determines presents minimal credit risks (which determination must be based on factors pertaining to credit quality and the issuer’s ability to meet its short-term financial obligations).

* * * * *

(12) *First Tier Security* means a security the issuer of which the fund’s board of directors has determined has the highest capacity to meet its short-term financial obligations.

* * * * *

(17) *Liquid Security* means a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.

* * * * *

(c) * * *

(3) * * *

(i) *General.* The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that are at the time of Acquisition Eligible Securities.

* * * * *

(iii) *Securities Subject to Guarantees.* A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be; *Provided, however,* that the issuer of the Guarantee, or another institution, has undertaken to promptly notify the holder of the security in the event the Guarantee is substituted with another Guarantee (if such substitution is permissible under the terms of the Guarantee).

(iv) * * *

(C) The issuer of the Demand Feature, or another institution, has undertaken to promptly notify the holder of the security in the event the Demand Feature is substituted with another Demand Feature (if such substitution is permissible under the terms of the Demand Feature); and

(D) The fund's board of directors determines that the Underlying Security or any

Guarantee of such security presents minimal credit risks (which determination must be based on factors pertaining to credit quality in addition).

* * * * *

(5) *Portfolio Liquidity.* The money market fund shall hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the Act (15 U.S.C. 80a-22(e)) and any commitments it has made to shareholders; *Provided, however,* immediately after the Acquisition of any security, a money market fund shall not have invested more than ten percent of its Total Assets in securities that are not Liquid Securities.

* * * * *

(7) *Monitoring, Defaults and Other Events.*

(i) *Monitoring.* In the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any information about a portfolio security or an issuer of a portfolio security that may suggest that the security may not continue to present minimal credit risks, the board of directors shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.

* * * * *

(iii) *Notice to the Commission.* The money market fund shall promptly notify the Commission by electronic mail directed to the Director of the Division of Investment Management of any:

(A) Default with respect to one or more portfolio securities (other than an immaterial

default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for 1/2 of 1 percent or more of a money market fund's Total Assets, of such fact and the actions the money market fund intends to take in response to such situation; or

(B) Purchase of a security from the fund by an affiliated person or promoter of or principal underwriter for the fund or an affiliated person of such a person in reliance on §270.17a-9.

* * * * *

(iv) *Defaults for Purposes of Paragraphs (c)(7) (ii) and (iii).* * * *

* * * * *

(10) * * *

(ii) *Securities Subject to Demand Features or Guarantees.* In the case of a security subject to one or more Demand Features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity (pursuant to paragraph (c)(5) of this section) of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

* * * * *

(11) * * *

(iii) *Credit Risk Analysis.* For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks used to determine the status

of the security as an Eligible Security shall be maintained and preserved in an easily accessible place.

* * * * *

(e) *Delegation.* The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1) (board findings); (c)(7)(ii) (defaults and other events); (c)(8)(i) (general required procedures: Amortized Cost Method); (c)(8)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(9) (required procedures: Penny Rounding Method) of this section) provided:

* * * * *

3. Section 270.3a-7 is amended by:
 - a. Revising paragraph (a)(2) introductory text;
 - b. In paragraph (a)(2)(i) revising the phrase "Any fixed-income securities may be sold" to read "Any fixed-income securities sold";
 - c. In paragraph (a)(2)(ii), revising the phrase "Any securities may be sold" to read "Any securities sold";
 - d. In paragraph (a)(2), concluding paragraph, revising the phrase "persons specified in paragraphs (a)(2)(i) and (ii) of this section" to read "persons specified in this section";
 - e. Revising paragraph (a)(3)(ii); and
 - f. Revising paragraph (a)(4)(iii).

The revisions read as follows:

§ 270.3a-7 Issuers of asset-backed securities.

(a) * * *

(2) Securities sold by the issuer or any underwriter thereof are:

* * * * *

(3) * * *

(ii) The issuer has procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed-income securities; and

* * * * *

(4) * * *

(iii) Takes actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account consistent with the full and timely payment of the outstanding fixed-income securities.

* * * * *

4. Section 270.5b-3 is amended by:

- a. Adding "or" at the end of paragraph (c)(1)(iv)(B);
- b. Revising paragraph (c)(1)(iv)(C);
- c. Removing paragraph (c)(1)(iv)(D);
- d. Revising paragraph (c)(4)(iii);
- e. Removing paragraphs (c)(5), (c)(6), and (c)(8); and
- f. Redesignating paragraph (c)(7) as paragraph (c)(5).

The revisions read as follows:

§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.

* * * * *

(c) * * *

(1) * * *

(iv) * * *

(C) Securities that the investment company's board of directors, or its delegate,

determines at the time the repurchase agreement is entered into:

(1) Are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time;

(2) Are subject to no greater than minimal credit risk; and

(3) The issuer of which has the highest capacity to meet its financial obligations; and

* * *

(4) * * *

(iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant has certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities.

* * *

5. Section 270.10f-3 is amended by:

a. Revising paragraph (a)(3);

b. Removing paragraph (a)(5); and

c. Redesignating paragraphs (a)(6), (a)(7), and (a)(8) as paragraphs (a)(5), (a)(6), and (a)(7).

The revision reads as follows:

§ 270.10f-3 Exemption for the acquisition of securities during the existence of an

underwriting or selling syndicate.

(a) * * *

(3) *Eligible Municipal Securities* means “municipal securities,” as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)), that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time and either:

(i) Are subject to no greater than moderate credit risk; or

(ii) If the issuer of the municipal securities, or the entity supplying the revenues or other payments from which the issue is to be paid, has been in continuous operation for less than three years, including the operation of any predecessors, the securities are subject to a minimal or low amount of credit risk.

* * * * *

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

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

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

* * * * *

7. Section 275.206(3)-3T is amended by revising paragraph (c) to read as follows:

§ 275.206(3)-3T Temporary rule for principal trades with certain advisory clients.

* * * * *

(c) For purposes of paragraph (a)(2) of this section, an *investment grade debt security* means a non-convertible debt security that, at the time of sale, the investment adviser has determined to be subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

* * * * *

By the Commission.



Florence E. Harmon
Acting Secretary

Dated July 1, 2008]

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229, 230, 239, and 240

[Release No. 33-8940; 34-58071; File No. S7-18-08]

RIN 3235-AK18

SECURITY RATINGS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of three releases that the Commission is publishing simultaneously relating to the use of security ratings by nationally recognized statistical rating organizations in its rules and forms. In this release, the Commission proposes to replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings (for example, Forms S-3 and F-3 eligibility criteria) with alternative requirements. In addition, the Commission requests comment on its rules relating to the disclosure of security ratings.

DATES: Comments should be received on or before September 5, 2008.

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an E-mail to rule-comments@sec.gov. Please include File Number S7-18-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

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Paper comments:

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

All submissions should refer to File Number S7-18-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's 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, 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: Steven Hearne, Eduardo Aleman, or Katherine Hsu, Special Counsels in the Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Regulation S-K,¹ and rules and forms under the Securities Act of 1933 (Securities Act),² and the Securities Exchange Act of 1934 (Exchange Act).³ In Regulation S-K, the Commission is proposing to amend Items 10,⁴ 1100,⁵ 1112,⁶

¹ 17 CFR 229.10 through 1123.

² 15 U.S.C. 77a *et seq.*

³ 15 U.S.C. 78a *et seq.*

⁴ 17 CFR 229.10.

⁵ 17 CFR 229.1100.

⁶ 17 CFR 229.1112.

and 1114.⁷ Under the Securities Act, the Commission is proposing to amend Rules 134,⁸ 138,⁹ 139,¹⁰ 168,¹¹ 415,¹² 436,¹³ Form S-3,¹⁴ Form S-4,¹⁵ Form F-1,¹⁶ Form F-3,¹⁷ Form F-4,¹⁸ and Form F-9.¹⁹ The Commission is also proposing to amend Schedule 14A²⁰ under the Exchange Act.

I. Background

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,²¹ the Commission published for notice and public comment two rulemaking initiatives.²² The first proposes additional requirements for nationally recognized statistical rating organizations (NRSROs) that were directed at reducing conflicts of interests in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating process.²³ The

⁷ 17 CFR 229.1114.

⁸ 17 CFR 230.134.

⁹ 17 CFR 230.138.

¹⁰ 17 CFR 230.139.

¹¹ 17 CFR 230.168.

¹² 17 CFR 230.415.

¹³ 17 CFR 230.436.

¹⁴ 17 CFR 239.13.

¹⁵ 17 CFR 239.25.

¹⁶ 17 CFR 239.31.

¹⁷ 17 CFR 239.33.

¹⁸ 17 CFR 239.34.

¹⁹ 17 CFR 239.39.

²⁰ 17 CFR 240.14a-101.

²¹ Pub. L. No. 109-291, 120 Stat. 1327 (2006).

²² Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-57967 (Jun. 16, 2008).

²³ See Press Release No. 2008-110 (Jun. 11, 2008). As described in more detail below, an NRSRO is an organization that issues ratings that assess the creditworthiness of an obligor itself or with regard to specific securities or money market instruments, has been in existence as a credit rating

second is designed to improve investor understanding of the risk characteristics of structured finance products. These proposals address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in light of the role they played in determining the security ratings for securities that were the subject of the recent turmoil in the credit markets.

Today's proposals comprise the third of these three rulemaking initiatives relating to security ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on security ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial Markets, the Financial Stability Forum on Enhancing Market and Institutional Resilience, and the Technical Committee of the International Organization of Securities Commissions.²⁴ Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to security ratings in its rules and forms has, in effect, placed an "official seal of approval" on ratings that could adversely affect the quality of due diligence and investment analysis. The Commission believes that today's proposals could reduce undue reliance on ratings and result in improvements in the analysis that underlies investment decisions.

agency for at least three years, and meets certain other criteria. The term is defined in section 3(a)(62) of the Exchange Act (15 U.S.C. 78c(a)(62)). A credit rating agency must apply with the Commission to register as an NRSRO, and currently there are nine registered NRSROs.

²⁴ See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (March 2008), available at www.ustreas.gov; The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (April 2008), available at www.fsforum.org; Technical Committee of the International Organization of Securities Commissions, Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets (March 2008), page 9, available at www.iosco.org.

In 1981, the Commission issued a statement of policy regarding its view of disclosure of security ratings in registration statements under the Securities Act.²⁵ This statement marked a clear delineation between the Commission's historic practice of precluding the disclosure of security ratings in these filings and the Commission's then-developing acknowledgement of the growing importance of ratings in the securities markets and in the regulation of those markets. Soon thereafter, the Commission adopted rules that not only set forth its new policy of permitting the voluntary disclosure of security ratings in registration statements but that also encouraged such disclosure by the issuer.²⁶ The rules permitted the voluntary disclosure of security ratings in a communication deemed not to be a prospectus and provided that a security rating by an NRSRO is generally not part of a registration statement or report prepared or certified by a person within the meaning of Sections 7²⁷ and 11²⁸ of the Securities Act.

Concurrent with the adoption of these rules regarding security ratings, the Commission adopted Securities Act Form S-3, the short-form Securities Act registration statement for eligible domestic issuers.²⁹ The Commission adopted a provision in Form S-3 that a primary offering of non-convertible debt securities may be eligible for

²⁵ See Disclosure of Ratings in Registration Statements, Release No. 33-6336 (Aug. 6, 1981) [46 FR 42024]. The Commission first began using ratings by an NRSRO in 1975 for purposes of determining capital charges on different grades of debt securities under Rule 15c3-1 under the Exchange Act (Net Capital Rule). See 17 CFR 240.15c-31(c)(2)(vi)(E) and Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34-11497 (Jun. 26, 1975) [40 FR 29795].

²⁶ See Adoption of Integrated Disclosure System, Release No. 33-6383 (Mar. 3, 1982) [47 FR 11380] ("Integrated Disclosure Release").

²⁷ 15 U.S.C. 77g.

²⁸ 15 U.S.C. 77k.

²⁹ 17 CFR 239.13 and the Integrated Disclosure Release.

registration on the form if rated investment grade.³⁰ This provision provided debt securities issuers whose public float did not reach the required threshold, or that did not have a public float, with an alternate means of becoming eligible to register offerings on Form S-3.³¹ In adopting this requirement, the Commission specifically noted that commenters believed that the component relating to investment grade ratings was appropriate because nonconvertible debt securities are generally purchased on the basis of interest rates and security ratings.³² Consistent with Form S-3, the Commission adopted a provision in Form F-3 providing for the eligibility of a primary offering of investment grade non-convertible debt securities by eligible foreign private issuers.³³

Since the adoption of those rules relating to security ratings and Form S-3 and Form F-3, other Commission forms and rules have included requirements that likewise

³⁰ See General Instruction I.B.2 of Form S-3. A non-convertible security is an "investment grade security" for purposes of form eligibility if at the time of sale, at least one NRSRO has rated the security in one of its generic rating categories which signifies investment grade, typically one of the four highest rating categories. See *id.*

³¹ Pursuant to the recently adopted revisions to Form S-3 and Form F-3, issuers also may conduct primary securities offerings on these forms without regard to the size of their public float or the rating of debt securities being offered, so long as they satisfy the other eligibility conditions of the respective forms, have a class of common equity securities listed and registered on a national securities exchange, and the issuers do not sell more than the equivalent of one-third of their public float in primary offerings over any period of 12 calendar months. See Revisions to Eligibility Requirements for Primary Offerings on Forms S-3 and F-3, Release No. 33-8878 (Dec. 19, 2007) [72 FR 73534].

³² See Section III.A.1 of the Integrated Disclosure Release. Later, in 1992, the Commission expanded the eligibility requirement to delete references to debt or preferred securities and provide Form S-3 eligibility for other investment grade securities (such as foreign currency or other cash settled derivative securities). See Simplification of Registration Procedures for Primary Securities Offerings, Release No. 33-6964 (Oct. 22, 1992) [57 FR 48970].

³³ General Instruction I.B.2 of Form F-3. See Adoption of Foreign Issuer Integrated Disclosure System, Release No. 33-6437 (Nov. 19, 1982) [47 FR 54764]. In 1994, the Commission expanded the eligibility requirement to delete references to debt or preferred securities and provide Form F-3 eligibility for other investment grade securities (such as foreign currency or other cash settled derivative securities). See Simplification of Registration of Reporting Requirements for Foreign Companies, Release No. 33-7053A (May 12, 1994) [59 FR 25810].

rely on the ratings issued to a security.³⁴ Among them include Form F-9,³⁵ Forms S-4 and F-4,³⁶ and Exchange Act Schedule 14A.³⁷ Shelf registration requirements for asset-backed securities also depend on a security ratings component.³⁸ In 1983, the Commission adopted Securities Act Rule 415 which permits certain mortgage related securities, among others, to be offered on a delayed basis.³⁹ A mortgage related security is defined in Section 3(a)(41) of the Exchange Act,⁴⁰ as, among other things, “a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.”⁴¹ In 1992, the Commission expanded the Form S-3 eligibility provisions to provide for the registration of investment grade asset-backed securities offerings, regardless of the issuer’s reporting history or public float.⁴² In addition, if they are related to investment grade rated securities, certain registration statements and other requirements afford foreign private issuers with an option to comply with less extensive U.S. GAAP reconciliation requirements.⁴³

³⁴ This release addresses rules and forms filed by issuers under the Securities Act and Exchange Act. In separate releases, the Commission is proposing to address other rules and forms that rely on an investment grade ratings component.

³⁵ See General Instruction I. of Form F-9.

³⁶ See General Instruction B.1 of Form S-4 and General Instruction B.1(a) of Form F-4.

³⁷ See Note E and Item 13 of Schedule 14A.

³⁸ General Instruction I.B.5 of Form S-3.

³⁹ 17 CFR 230.415(a)(1)(vii). See Shelf Registration, Release No. 33-6499 (Nov. 17, 1983) [48 FR 5289].

⁴⁰ 15 U.S.C. 78c(a)(41).

⁴¹ See discussion of mortgage related securities in Section II.A.2. below.

⁴² See Simplification of Registration Procedures for Primary Securities Offerings, Release No. 33-6964 (Oct. 22, 1992) [57 FR 32461].

⁴³ See Exchange Act Forms 20-F (17 CFR 249.220f) and 40-F (17 CFR 249.240f), Securities Act Forms F-1 (17 CFR 239.31), F-3 (17 CFR 239.33), and F-4 (17 CFR 239.34), and Form F-9 (17 CFR 239.39) and Rule 502(b)(2)(i)(C) of Regulation D (17 CFR 230.502(b)(2)(i)(C)).

At various times since the adoption of these form requirements and rules, however, the Commission has reviewed and reconsidered its permissive views toward the disclosure of ratings in filings and the reliance on ratings in the Commission's form requirements. For example, in 1994, the Commission published a proposing release that would have mandated disclosure in Securities Act prospectuses of a rating given by an NRSRO whenever a rating with respect to the securities being offered is "obtained by or on behalf of an issuer."⁴⁴ The proposals would have required disclosure of specified information with respect to security ratings, whether or not disclosed voluntarily or mandated by the proposed new rules. In addition, the 1994 Ratings Release sought comment on various areas relating to the disclosure of security ratings.

The 1994 Ratings Release also proposed to require the disclosure on a Form 8-K current report of any material change in the security rating assigned to the registrant's securities by an NRSRO.⁴⁵ Later, in 2002, the Commission again proposed to require an issuer to file a Form 8-K current report when it received a notice or other communication from any rating agency regarding, for example, a change or withdrawal of a particular rating.⁴⁶ The Commission did not adopt this proposal, noting that it would continue to consider the appropriate regulatory approach for rating agencies.⁴⁷

⁴⁴ See Disclosure of Security Ratings, Release No. 33-7086 (Aug. 31, 1994) [59 FR 46304] (the "1994 Ratings Release"). A concept release on this subject was published in Disclosure of Security Ratings, Release No. 33-5882 (Nov. 3, 1977) [42 FR 58414].

⁴⁵ See the 1994 Ratings Release.

⁴⁶ See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8106 (Jun. 17, 2002) [67 FR 42914].

⁴⁷ See Additional Form 8-K Filing Requirements and Acceleration of Filing Date, Release No. 33-8400 (Mar. 16, 2004) [69 FR 15594], amended by Release No. 33-8400A (Aug. 4, 2004) [69 FR 48370].

In 2003, the Commission issued a concept release requesting comment on whether it should cease using the NRSRO designation and, as an alternative to the ratings criteria, provide for Form S-3 eligibility where investor sophistication or large size denomination criteria are met.⁴⁸ The Commission also requested comment on alternatives to Form S-3 ratings reliance with regard to offerings of asset-backed securities. In the 2004 adopting release for Regulation AB,⁴⁹ while retaining the eligibility provision for investment grade rated asset-backed securities, the Commission noted that it was engaged in a broad review of the role of credit rating agencies in the securities markets, including whether security ratings should continue to be used for regulatory purposes under the securities laws.⁵⁰ The release made note of the 2003 concept release and the comments received on possible alternatives to using the investment grade requirement for determining Form S-3 eligibility for asset-backed securities.

In 2005, the Commission adopted rules and form amendments to modify the framework for the registration, communications, and offerings processes, relaxing restrictions and requirements on the largest issuers.⁵¹ These large issuers, defined as well-known seasoned issuers, include issuers that have issued for cash more than an aggregate of \$1 billion in non-convertible securities, other than common equity, through

⁴⁸ See Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Release No. 33-8236 (Jun. 4, 2003) [68 FR 35258]. Comments on the concept release are available at: <http://www.sec.gov/rules/concept/s71203.shtml>. As discussed above, recent events have highlighted the need to revisit our reliance on NRSRO ratings in the context of these developments. See also the extensive discussion of market developments in Release No. 34-57967.

⁴⁹ 17 CFR 229.1100 through 1123.

⁵⁰ See Section III.A.3.c of Asset-Backed Securities, Release No. 33-8518 (Dec. 22, 2004) [70 FR 1506, 1524].

⁵¹ See Securities Offering Reform, Release No. 33-8591 (July 19, 2005) [70 FR 44722].

registered primary offerings over the prior three years.⁵² In adopting this definition, the Commission did not rely on investment grade ratings, noting in the adopting release that the securities included in the calculation for determining whether the \$1 billion threshold has been met need not be investment grade securities.⁵³

II. Proposed Amendments

A. Shelf Registration for Issuers of Asset-Backed Securities

1. Form S-3 Eligibility for Offerings of Asset-Backed Securities

Under the existing requirements, an offering of asset-backed securities, or ABS, as defined in Item 1101 of Regulation AB,⁵⁴ may be eligible for registration on Form S-3 and may therefore be offered on a delayed or continuous basis⁵⁵ if they are rated investment grade by an NRSRO and meet certain other conditions.⁵⁶ The Commission now proposes to amend this requirement in Form S-3 for ABS to replace the component that relies on investment grade ratings with an alternate provision.

In the 2004 proposing release for Regulation AB, the Commission requested comment on whether the investment grade reliance component of the Form S-3 eligibility requirements for ABS offerings was appropriate and whether alternative criteria such as

⁵² See definition of well-known seasoned issuer in Rule 405. 17 CFR 230.405.

⁵³ See Section II.A.1.b of Release No. 33-8591.

⁵⁴ 17 CF 229.1101.

⁵⁵ General Instruction I.B.5 of Form S-3. The Commission expanded the use of Form S-3 to all types of asset-backed securities in 1992. See Simplification of Registration Procedures for Primary Securities Offerings, Release No. 33-6964 (Oct. 22, 1992) [57 FR 48970].

⁵⁶ As discussed below, two additional conditions also apply in order for ABS offered for cash to be Form S-3 eligible: (1) delinquent assets do not constitute 20% or more, as measured by dollar volume, of the asset pool as of the measurement date; and (2) with respect to securities that are backed by leases other than motor vehicle leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases, as determined in accordance with the transaction agreements for the securities, does not constitute 20% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date. General Instruction I.B.5(a) of Form S-3.

investor sophistication, minimum denomination, or experience criteria were more appropriate.⁵⁷ The Commission received four comment letters in response that provided suggestions on possible alternatives to the investment grade requirement for Form S-3 eligibility purposes for ABS offerings.⁵⁸ One commenter recommended that the Commission replace the investment grade ratings requirement with a sponsor⁵⁹ experience requirement (e.g., Exchange Act reporting).⁶⁰ Another commenter suggested that the Commission either (1) eliminate the use of the ratings as a bright line test for the Form S-3 eligibility criteria, thereby eliminating the incentive to shop for ratings simply to satisfy a regulatory requirement; or (2) reflective of developing market practice, require an investment grade rating which is the lower of two ratings.⁶¹

Two commenters recommended that the Commission adopt a minimum denomination requirement (e.g., \$100,000 or \$250,000) that would determine form eligibility, limiting investment in the offering to investors who had such capital.⁶² One of these commenters recommended that the Commission make short-form registration

⁵⁷ See Section III.A.3.c of Asset-Backed Securities, Release No. 33-8419 (May 3, 2004) [69 FR 16650]. In the 2003 concept release where the Commission requested comment on alternatives to the ratings reliance requirement in Form S-3 for corporate debt, the Commission requested comment on alternatives to ratings reliance with respect to ABS offerings. No comment letters submitted in response to the concept release provided specific suggestions on alternatives for ABS offerings. See Release No. 33-8236.

⁵⁸ See letters commenting on Release No. 33-8419 from the American Bar Association (ABA), Kutak Rock, LLP (Kutak), State Street Global Advisors (State Street), and Moody's Investor Service (Moody's). The public comments received are available for inspection in our Public Reference Room at 100 F Street, NE, Washington, DC 20549 in File No. S7-21-04, or may be viewed at <http://www.sec.gov/rules/proposed/s72104.shtml>.

⁵⁹ While "sponsor" is a commonly used term for the entity that initiates the asset-backed securities transaction, the terms "seller" or "originator" also are often used in the market. In some instances the sponsor is not the originator of the financial assets but has purchased them in the secondary market. See footnote 46 of Release No. 33-8518.

⁶⁰ See letter from State Street.

⁶¹ See letter from Moody's.

⁶² See letters from ABA and Kutak.

available to otherwise eligible non-investment grade rated or unrated classes of asset-backed securities provided that sales are made in minimum denominations and initial sales of classes of securities are made only to qualified institutional buyers (as defined in Securities Act Rule 144A(a)(1))⁶³ and institutional accredited investors (as defined in Rule 501⁶⁴ of Regulation D).⁶⁵ The commenter reasoned that such restrictions should ensure that securities are sold and subsequently resold only to investors who are capable of undertaking their own analysis of the merits and risks of their investment.⁶⁶

In light of our effort to reduce regulatory reliance on security ratings, the Commission has revisited the comments in 2004 and now proposes to replace the investment grade component in the Form S-3 eligibility requirement for ABS offerings with a minimum denomination requirement for initial and subsequent sales and a requirement that initial sales of classes of securities be made only to qualified institutional buyers. The eligibility requirement, as proposed to be revised, would retain the other provisions relating to delinquency concentration and residual value percentages for offerings of securities backed by leases other than motor vehicle leases.⁶⁷ Thus, as proposed, asset-backed securities offered for cash may be Form S-3 eligible provided:

- Initial and subsequent resales are made in minimum denominations of \$250,000;
- Initial sales are made only to qualified institutional buyers (as defined in Rule 144A(a)(1));

⁶³ 17 CFR 230.144A(a)(1).

⁶⁴ 17 CFR 230.501.

⁶⁵ See letter from ABA.

⁶⁶ Id.

- Delinquent assets do not constitute 20% or more, as measured by dollar volume, of the asset pool as of the measurement date; and
- With respect to securities that are backed by leases other than motor vehicle leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases, as determined in accordance with the transaction agreements for the securities, does not constitute 20% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date.⁶⁸

This proposed amendment would limit use of a short-form shelf registration statement for asset-backed securities to offerings to large sophisticated and experienced investors without, we believe, causing undue detriment to the liquidity of the asset-backed securities market.⁶⁹ In keeping with that purpose and given the unique nature and structure of asset-backed securities, we are proposing at this time only to include qualified institutional buyers rather than also including institutional accredited investors as suggested by the commenter in 2004.

2. Mortgage Related Securities and Securities Act Rule 415

In addition to being shelf eligible by meeting the requirements of Form S-3, a particular subset of ABS may also be shelf eligible by meeting the requirements in Securities Act Rule 415,⁷⁰ which enumerates the securities which are permitted to be offered on a continuous or delayed basis. Among those securities are “mortgage related

⁶⁷ See proposed General Instruction I.B.5(a)(iii) and (iv) of Form S-3.

⁶⁸ See proposed General Instruction I.B.5(a) of Form S-3.

⁶⁹ We are aware of two types of asset-backed offerings that may not meet these new criteria, unit repackaging and securitization of insurance funding agreements but believe that they can be effectively registered using Form S-1 instead of Form S-3.

securities, including such securities as mortgage-backed debt and mortgage participation or pass through certificates.”⁷¹ By specifically referring to mortgage related securities, Rule 415 has permitted such securities to be offered on a delayed basis, even if the offering cannot be registered on the Form S-3 short form registration statement because it does not meet the eligibility requirements of Form S-3.

Currently, the term “mortgage related securities” is defined by Section 3(a)(41) of the Exchange Act⁷² as, among other things, “a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.” Given that the term mortgage related securities also depends on a ratings component, it would be a logical extension of our amendments here to amend the Rule 415 reference to a mortgage related security to add that the sale of such security must be in compliance with the additional requirements that initial sales are made to qualified institutional buyers and initial and subsequent sales are made in certain minimum denominations. Given that reliance on security ratings could just as easily impact an investor’s investment decision in mortgage-backed securities as it could for other asset-backed securities,⁷³ we believe it is appropriate that mortgage-backed securities be treated the same as all asset-backed securities.⁷⁴

⁷⁰ 17 CFR 230.415.

⁷¹ 17 CFR 230.415(a)(vii).

⁷² 15 U.S.C. 78c(a)(41). Section 3(a)(41) was added by the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) (Pub. L. No. 98-440-98 Stat. 1690). In 1984, contemporaneous with the enactment of SMMEA, the Commission amended Rule 415, which is known as the shelf rule, to allow SMMEA-eligible mortgage related securities to use the shelf offering process. See Shelf Registration, Release No. 33-6499 (Nov. 17, 1983) [48 FR 5289].

⁷³ The President’s Working Group has noted that one of the principal underlying causes of the current global market turmoil relating to the mortgage-backed securities industry was the credit rating agencies’ assessments of subprime residential mortgage-backed securities and other complex structured credit products that held residential mortgage-backed and other asset-backed

Therefore, under the proposed revision to Rule 415, mortgage-backed securities, having the same characteristics as mortgage related securities under the Section 3(a)(41) definition, regardless of the security rating, could be offered on a delayed basis provided that:

- initial sales and any resales of the securities are made in minimum denominations of \$250,000;⁷⁵ and
- initial sales of the securities are made only to qualified institutional buyers (as defined in Rule 144A(a)(1)).

Request for Comment

- Is the proposed amendment to the Form S-3 eligibility requirement for asset-backed securities appropriate? Is there a better alternative to the investment grade ratings component? If so, what is that alternative and why is it better?
- Is the proposed amendment requiring that initial and subsequent sales be made in a minimum denomination appropriate? Should the denomination level be higher or lower (e.g., \$400,000 or \$100,000)?
- We understand that non-convertible securities may typically be held in book entry form with a depository. Are there any system issues or processes at the depository that may affect the ability to limit transferability based on a minimum denomination? If yes, what are those issues or processes and how

securities. See Section I of the Policy Statement on Financial Market Developments. See n. 24 above.

⁷⁴ Indeed, mortgage-backed securities are merely a type of, or subset of, asset-backed securities. We believe that there have not been any recent offerings that have relied on Rule 415(a)(vii) for shelf eligibility rather than through meeting the requirements of Form S-3.

⁷⁵ Denominations of any amounts above \$250,000 would meet this requirement.

should the rule provisions be revised to prohibit subsequent transfers below the minimum denominations?

- Should there be any restriction on permitting purchasers from allocating securities in denominations lower than \$250,000 if the purchasers are acquiring the nonconvertible securities for more than one account? For example, if an investment advisor acquires the securities for more than one qualified institutional buyer, should it be allowed to allocate securities to the accounts of the qualified institutional buyers in denominations lower than \$250,000?
- Should Form S-3 limit initial sales of eligible asset-backed securities to qualified institutional buyers? Should the requirement include sales to an additional group of investors (e.g., institutional accredited investors)? If so, why? Should subsequent sales be limited as well? Would it be appropriate to eliminate the minimum denomination requirements after some period of time, such as after six months or one year from the date of issuance? Are there particular kinds of ABS offerings that are sold to investors other than qualified institutional buyers?
- What would be the impact on liquidity in the ABS secondary market if Form S-3 registration required that initial sales be limited to qualified institutional buyers, institutional accredited investors, or other groups of sophisticated investors? What would be the impact on liquidity in the secondary market if resales of securities that were originally offered and sold off of the Form S-3 were so limited? What would be the impact on the cost of capital for ABS

sponsors if Form S-3 registration required that initial sales or resales were limited to qualified institutional buyers or other groups of sophisticated investors?

- Would a better standard than qualified institutional buyer be any purchaser that owns and invests on a discretionary basis not less than \$25,000,000? Would a threshold like this that does not limit the purchasers to institutions be appropriate, particularly in light of recent market events? Should there be other thresholds for particular investors, such as owning and investing on a discretionary basis not less than \$50,000,000 for government or political subdivisions, agencies or instrumentalities of a government? Should we use Qualified Investor as defined in Exchange Act Section 3(a)(54)⁷⁶ rather than qualified institutional buyer?
- We note that there are two types of ABS offerings that may not meet this new criteria, unit repackagings, and securitizations of insurance funding agreements. Can the offer and sale of these securities be effectively registered on Form S-1? We note that these securities are typically listed on a national securities exchange. Should we instead add an alternative eligibility requirement that would provide eligibility to use Form S-3 for securities listed on a national securities exchange?
- Should we instead assess Form S-3 and shelf eligibility in a manner similar to what we are proposing for corporate debt that is discussed in the next section? If so, what would be the appropriate amount of required issuance? Should the

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15 U.S.C. 78c(a)(54).

issuance amount be measured only for the same sponsor, same asset class, and same structure? Should it matter if the assets are purchased by the sponsor rather than originated by the sponsor or an affiliate?

- Is the proposed revision to Securities Act Rule 415 appropriate? Is there any reason why mortgage related securities should be treated differently from other asset-backed securities for purposes of delayed offerings?
- Are there SMMEA eligible loans that could not be securitized in circumstances meeting the proposed threshold for S-3 eligibility?
- Should Rule 415 be amended as proposed? In the alternative, should the reference to mortgage related securities in Rule 415 be deleted (i.e., so that mortgage-backed securities could only be offered on a delayed basis if eligible for registration on Form S-3)? Are there securities that are currently offered pursuant to Rule 415(a)(1)(vii) that do not meet the current requirements of Form S-3 and would not meet the requirements of the proposal?

B. Primary Offerings of Non-convertible Securities

1. Form S-3 and Form F-3

Forms S-3 and F-3 are the “short forms” used by eligible issuers to register securities offerings under the Securities Act. These forms allow eligible issuers to rely on reports they have filed under the Exchange Act to satisfy many of the disclosure requirements under the Securities Act. Form S-3 eligibility for primary offerings also enables form eligible issuers to conduct primary offerings “off the shelf” under Securities Act Rule 415. Rule 415 provides considerable flexibility in accessing the public securities markets in response to changes in the market and other factors. Issuers that are

eligible to register these primary “shelf” offerings under Rule 415 are permitted to register securities offerings prior to planning any specific offering and, once the registration statement is effective, offer securities in one or more tranches without waiting for further Commission action. To be eligible to use Form S-3 or F-3, an issuer must meet the form’s eligibility requirements as to registrants, which generally pertain to reporting history under the Exchange Act,⁷⁷ and at least one of the form’s transaction requirements.⁷⁸ One such transaction requirement permits registrants to register primary offerings of non-convertible securities if they are rated investment grade by at least one NRSRO.⁷⁹ Instruction I.B.2 provides that a security is “investment grade” if, at the time of sale, at least one NRSRO has rated the security in one of its generic rating categories, typically the four highest, which signifies investment grade.

The Form S-3 investment grade requirement was originally proposed by the Commission in a 1982 release.⁸⁰ Prior to adopting Form S-3, the Commission had previously provided a short form registration statement on Form S-9, which permitted the registration of issuances of certain high quality debt securities.⁸¹ The criteria for use of Form S-9 related primarily to the quality of the issuer.⁸² While these eligibility criteria

⁷⁷ See General Instruction I.A to Forms S-3 and F-3.

⁷⁸ See General Instruction I.B to Forms S-3 and F-3.

⁷⁹ See General Instruction I.B.2 to Forms S-3 and F-3.

⁸⁰ See Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, Release No. 33-6331 (Aug. 6, 1981) [46 FR 41902] (“the S-3 Proposing Release”).

⁸¹ Form S-9 was rescinded on December 20, 1976, because it was being used by only a very small number of registrants. The Commission believed the lack of usage was due in part to interest rate increases which made it difficult for many registrants to meet the minimum fixed charges coverage standards required by the form. Adoption of Amendments to Registration Forms and Guide and Rescission of Registration Form, Release No. 33-5791 (Dec. 20, 1976) [41 FR 56301].

⁸² The criteria included net income during each of the registrant’s last five fiscal years, no defaults in the payment of principal, interest, or sinking funds on debt or of rental payments for leases, and various fixed charge coverages. The use of fixed charges coverage ratios, typically 1.5, was common in state statutes defining suitable debt investments for banks and other fiduciaries.

delineated the type of issuer of high quality debt for which Form S-9 was intended, the Commission believed that certain of its requirements may have overly restricted the availability of the form.⁸³ The Commission believed that security ratings were a more appropriate standard on which to base Form S-3 eligibility than specified quality of the issuer criteria, citing letters from commenters indicating that short form prospectuses are appropriate for investment grade debt because such securities are generally purchased on the basis of interest rates and security ratings.⁸⁴

Today we are proposing to revise the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 and F-3. As proposed, the instructions to these forms would no longer refer to security ratings by an NRSRO as a transaction requirement to permit issuers to register primary offerings of non-convertible securities for cash. Instead, these forms would be available to register primary offerings of non-convertible securities if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash more than \$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years.⁸⁵

We are proposing to revise the form criteria using the same method and threshold by which the Commission defined an issuer of non-convertible securities, other than common equity, that does not meet the public equity float test as a “well-known seasoned

⁸³ See the S-3 Proposing Release.

⁸⁴ See the Integrated Disclosure Release.

⁸⁵ See proposed General Instruction I.B.2 of Forms S-3 and F-3. We are also proposing to delete Instruction 3 to the signature block of Forms S-3 and F-3.

issuer.”⁸⁶ Similar to our approach with well-known seasoned issuers, we believe that having issued \$1 billion of registered non-convertible securities over the prior three years would lead to a wide following in the marketplace. These issuers generally have their Exchange Act filings broadly followed and scrutinized by investors and the markets.⁸⁷ The Commission intends for the number of issuers eligible under the proposed criteria to register primary offerings of non-convertible securities on Forms S-3 and F-3 to not be significantly reduced, or to differ significantly from, the number of those eligible under the current form requirements.⁸⁸ Using the \$1 billion threshold, we preliminarily believe that for issuances that have occurred thus far this year, the proposed change would result in approximately six issuers filing on Form S-1 instead of on a short-form registration statement. This approach is designed to provide assurance that eligible issuers are followed by the markets such that it is appropriate to allow forward incorporation by

⁸⁶ See Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005) [70 FR 44722]. Rule 405 under the Securities Act defines a “well-known seasoned issuer” as an issuer that meets the registrant requirements of Form S-3 or F-3, and either has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of \$700 million or more, or has issued in the last three years, in registered offerings, at least \$1 billion aggregate principal amount of non-convertible securities in primary offerings for cash. 17 CFR 230.405

⁸⁷ See Securities Offering Reform, Release No. 33-8501 (Nov. 3, 2004) [69 FR 67392].

⁸⁸ We preliminarily anticipate that under the proposed threshold some additional high yield debt issuers would be eligible to use the Forms.

reference and delayed offering. We realize that it is now possible that some offerings of non-investment grade securities, such as high-yield bonds (also known as “junk bonds”) may be registered for sale on Form S-3.

These issuers also would have to satisfy the other conditions of the form eligibility requirement. In determining compliance with this threshold:

- issuers may aggregate the amount of non-convertible securities, other than common equity, issued in registered primary offerings during the prior three years;
- issuers may include only such non-convertible securities that were issued in registered primary offerings for cash – they may not include registered exchange offers;⁸⁹ and
- parent company issuers only may include in their calculation the principal amount of their full and unconditional guarantees, within the meaning of Rule 3-10 of Regulation S-X,⁹⁰ of non-convertible securities, other than common equity, of their majority-owned subsidiaries issued in registered primary offerings for cash during the three-year period.

The aggregate principal amount of non-convertible securities that may be counted toward the \$1 billion issuance threshold may have been issued in any registered primary offering

⁸⁹ Issuers may not include the principal amount of securities that were offered in registered exchange offers by the issuer when determining compliance with the \$1 billion non-convertible securities threshold. A substantial portion of these offerings involve registered exchange offers of substantially identical securities for securities that were sold in private offerings. In those cases, the original sale to investors in the private offering, relying upon, for example, the exemptions of Securities Act Section 4(2) and Rule 144A, is not registered and is not carried out under the Securities Act’s disclosure or liability standards. Moreover, in the subsequent registered exchange offers purchasers may not be able, in certain cases, to avail themselves effectively of the remedies otherwise available to purchasers in registered offerings for cash.

⁹⁰ 17 CFR 210.3-10.

for cash, on any form (other than Form S-4 or Form F-4). Non-convertible securities need not be investment grade securities to be included in the calculation. In calculating the \$1 billion amount, issuers generally may include the principal amount of any debt and the greater of liquidation preference or par value of any non-convertible preferred stock that were issued in primary registered offerings for cash.⁹¹

Request for Comment

- The recent turmoil in the credit markets, particularly in the structured finance market, strongly suggests that there has been undue reliance on security ratings and that the ratings for many issuers did not reflect the risks of the investment. We are proposing thresholds on the amount of issuance in order to move away from reliance on security ratings in the Commission's rules. Does the proposed eligibility based on the amount of prior registered non-convertible securities issued serve as an adequate replacement for the investment grade eligibility condition? Would the cumulative offering amount for the most recent three-year period reflect market following? Since most of the problems in the market have occurred with respect to asset-backed securities, should we retain the current eligibility requirement for investment grade non-convertible securities?
- Would the specific issuers eligible under the investment grade condition be different from the issuers eligible under the proposal? Would certain

⁹¹ In determining the dollar amount of securities that have been registered during the preceding three years, issuers should use the same calculation that they use to determine the dollar amount of securities they are registering for purposes of determining fees under Rule 457. 17 CFR 230.457.

investors, such as pension funds, be impacted if investment grade securities could not be offered on Form S-3?

- If the Commission adopts a Form S-3 eligibility requirement designed to reflect the market following of a debt issuer, should the condition be sensitive to the number of debt holders? Is it reasonable to expect that analysts would be more likely to follow issuers with a larger number of debt holders insofar as such holders are potential customers of the analysts' products? If so, how should we determine the number of holders?
- Should there be an eligibility requirement based on a minimum number of holders of record of non-convertible securities offered for cash? If so, should this number be 300 or 500, by analogy to our registration and deregistration rules relating to equity securities? Would linking the eligibility requirement to the number of holders of record help to assure market following?
- Is the cumulative offering amount for the most recent three-year period the appropriate threshold at which to differentiate issuers? Should the threshold be higher (e.g., \$1.25 billion) or lower (e.g., \$800 million), and, if so, at what level should it be set? Are there any transactions that currently meet the requirements of current General Instruction I.B.2. that would not be eligible to use the form under the proposed revision? Are there any transactions that do not meet the current Form S-3 or Form F-3 eligibility requirements for investment grade securities but now would be eligible under the proposed revision that should not be eligible? If practicable, provide information on the frequency such offerings are made.

- Would the proposed threshold increase or decrease the number of issuers eligible to use Forms S-3 and F-3 under the current investment grade criteria? Is there a reason that this Form S-3 eligibility requirement should not mirror the debt only well-known seasoned issuer definition?
- Should the measurement time period for \$1 billion of issuance be longer than three years (e.g., four or five years)? If so, why? Would it be more appropriate for the threshold to include non-convertible securities, other than common equity, outstanding rather than issued over the prior three years?
- Is there a better alternative by which Form S-3 eligibility for non-convertible securities could be required? By what metrics could one measure the market following for debt issuers? Is there an alternative definition of “investment grade debt securities” that does not rely on NRSRO ratings and adequately meets the objective of relating short-form registration to the existence of widespread following in the marketplace?
- Should there be a different standard for foreign private issuers eligible to use Form F-3? If so, explain why and what would be a more appropriate criteria.
- Does the \$1 billion threshold of offering in the prior three years present any issues that are unique to foreign private issuers, especially those that may undertake U.S. registered public offerings as only a portion of their overall plan of financing, and how might these problems be addressed? Would it be appropriate to provide a longer time period for measurement, or to include public offerings of securities for cash outside the United States?

2. U.S. GAAP Reconciliation Requirements

The Commission's rules relating to U.S. GAAP reconciliation requirements for foreign filers also rely on ratings. Forms F-1, F-3, and F-4 under the Securities Act permit foreign private issuers registering offerings of investment grade securities to provide financial information in accordance with Item 17 of Exchange Act Form 20-F. Item 17 requires foreign private issuers to reconcile their financial statements and schedules to U.S. GAAP if they are prepared in accordance with a basis of accounting other than U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board. This reconciliation need only include a narrative discussion of reconciling differences, a reconciliation of net income for each year and any interim periods presented, a reconciliation of major balance sheet captions for each year and any interim periods, and a reconciliation of cash flows for each year and any interim periods. Item 18 of Form 20-F, by contrast, requires that a foreign private issuer provide all of the information required by U.S. GAAP and Regulation S-X, in addition to the reconciling information for the line items specified in Item 17.⁹² Foreign private issuers of investment grade rated securities are permitted to provide the less-extensive U.S. GAAP reconciliation disclosure pursuant to Item 17 in registration statements and annual reports.

The definition of "investment grade" is the same as in the Form S-3 eligibility requirements. A security is "investment grade" if, at the time of sale, at least one NRSRO has rated it in one of its generic rating categories that signifies investment grade. Also, a foreign private issuer conducting a private placement of investment grade

⁹² See also Foreign Issuer Reporting Enhancements, Release No. 33-8900 (Feb. 29, 2008) [73 FR 13404] at Section III.A.

securities under Regulation D can provide Item 17 information to the extent the issuer is able to do so in a registration statement.⁹³

The Commission recently proposed to require foreign private issuers offering investment grade securities, among others, to file financial statements that comply with the more complete Item 18 level of reconciliation, thus eliminating the option of providing Item 17 financial disclosure.⁹⁴ The Commission reasoned that “a reconciliation that includes footnote disclosures required by U.S. GAAP and Regulation S-X⁹⁵ can provide important additional information.”⁹⁶ The Commission specifically requested comment, however, on whether foreign private issuers should continue to be permitted to provide Item 17 financial disclosure for offerings of, and periodic reporting relating to, investment grade securities.⁹⁷ We now also propose to remove from these requirements the components relying on investment grade ratings and instead permit foreign private issuers to comply with the less extensive U.S. GAAP reconciliation requirements under Item 17 in a registration statement or private offering document if the issuer would meet the proposed Form F-3 eligibility requirements (*i.e.*, if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash more than \$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years).

⁹³ Rule 502 requires a foreign private issuer to provide the same kind of information the issuer would be required to include in a registration statement on a form the issuer would be eligible to use if any sales are made to investors who are not accredited investors. See 17 CFR 230.502(b)(2)(i)(C).

⁹⁴ See Release No. 33-8900.

⁹⁵ 17 CFR 210.1-01 *et seq.*

⁹⁶ Release No. 33-8900 at Section III.A.

⁹⁷ See Request for Comment No. 23 of Release No. 33-8900.

Request for Comment

- If the Commission does not adopt the proposal in Release No. 33-8900 that would eliminate the ability of a foreign private issuer to comply with the less extensive U.S. GAAP reconciliation requirements under Item 17 for filings with respect to investment grade securities, should the Commission revise the requirements as proposed to permit a foreign private issuer to comply with the less extensive U.S. GAAP reconciliation requirements under Item 17 if the issuer has met the proposed Form F-3 eligibility criteria for debt issuers? Are there different criteria that should be used?

3. Form F-9

Form F-9 allows certain Canadian issuers to register investment grade debt or investment grade preferred securities that are offered for cash or in connection with an exchange offer, and which are either non-convertible or not convertible for a period of at least one year from the date of issuance.⁹⁸ Under the Form's requirements, a security is rated "investment grade" if it has been rated investment grade by at least one NRSRO, or at least one Approved Rating Organization (as defined in National Policy Statement No. 45 of the Canadian Securities Administrator).⁹⁹ This eligibility requirement was adopted as part of a 1993 revision to the multijurisdictional disclosure system originally adopted by the Commission in 1991 in coordination with the Canadian Securities Administrators.¹⁰⁰ Consistent with the Commission's proposal to reduce reliance on

⁹⁸ Securities convertible after a period of at least one year may only be convertible into a security of another class of the issuer.

⁹⁹ See General Instruction I.A to Form F-9.

¹⁰⁰ See Amendments to the Multijurisdictional Disclosure System for Canadian Issuers, Release No. 33-7025 (Nov. 3, 1993) [58 FR 62028]. See also Multijurisdictional Disclosure and Modifications

security ratings in its rules and regulations the Commission is proposing to eliminate the eligibility requirement of Form F-9 that allows Canadian issuers to register certain debt and preferred securities if they are rated investment grade by at least one NRSRO. As with our proposals regarding Forms S-3 and F-3, this requirement would be replaced by a requirement that the issuer has issued in the three years immediately preceding the filing of the Form F-9 registration statement at least \$1 billion of aggregate principal amount of debt or preferred securities for cash in primary offerings registered under the Securities Act.

The proposed revision would not change a Canadian issuer's ability to use Form F-9 to register debt or preferred securities meeting the requirements of current General Instruction I.A if the securities are rated "investment grade" by at least one Approved Rating Organization (as defined in National Policy Statement No. 45 of the Canadian Securities Administrators). While the proposal would still permit Canadian issuers to register certain securities rated investment grade by an Approved Rating Organization, the Commission believes this approach is appropriate and consistent with the Commission's intent in adopting the multijurisdictional disclosure system to look to form eligibility requirements under Canadian rules.¹⁰¹ To the extent that the Canadian securities regulators revise similar requirements to remove references to investment grade ratings, we may revise Form F-9 to mirror those revisions.

to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 33-6902 (Jun. 21, 1991) [56 FR 30036].

¹⁰¹ See Release No. 33-6902, section II.

Request for Comment

- The Commission requests comment on whether the proposed threshold for issuances of debt or preferred securities in the three years immediately preceding the filing of the registration statement is appropriate. Should the Form F-9 eligibility requirements continue to permit the use of ratings by Approved Rating Organizations? Is a different threshold or measurement period more appropriate for Form F-9?

4. NRSRO Ratings Reliance in Other Forms and Rules

a. Forms S-4 and F-4 and Schedule 14A

Issuing investment grade securities confers benefits that extend to other forms and rules as well. Forms S-4 and F-4 allow registrants that meet the registrant eligibility requirements of Form S-3 or F-3 and are offering investment grade securities to incorporate by reference certain information.¹⁰² Similarly, Schedule 14A permits a registrant to incorporate by reference if the Form S-3 registrant requirements are met and the registrant is offering investment grade securities.¹⁰³ Because the Commission proposes to change the eligibility requirements in Forms S-3 and F-3 to remove references to ratings by an NRSRO, the Commission believes the same standard should apply to the disclosure options in Forms S-4 and F-4 based on Form S-3 or F-3 eligibility. That is, a registrant will be eligible to use Forms S-4 and F-4 to register non-convertible debt or preferred securities if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash more than \$1 billion in non-convertible

¹⁰² See General Instruction B.1 of Forms S-4 and Form F-4.

¹⁰³ See Note E and Item 13 of Schedule 14A.

securities, other than common equity, through registered primary offerings over the prior three years. Similarly, we propose to amend Schedule 14A to refer simply to the requirements of General Instruction I.B.2. of Form S-3, rather than to “investment grade securities.”

b. Securities Act Rules 138, 139 and 168

The reliance on security ratings is also evident in other Securities Act rules. Rules 138, 139, and 168 under the Securities Act provide that certain communications are deemed not to be an offer for sale or offer to sell a security within the meaning of Sections 2(a)(10)¹⁰⁴ and 5(c)¹⁰⁵ of the Securities Act when the communications relate to an offering of non-convertible investment grade securities. These communications include the following:

- under Securities Act Rule 138, a broker’s or dealer’s publication about securities of a foreign private issuer that meets F-3 eligibility requirements (other than the reporting history requirements) and is issuing non-convertible investment grade securities;
- under Securities Act Rule 139, a broker’s or dealer’s publication or distribution of a research report about an issuer or its securities where the issuer meets Form S-3 or F-3 registrant requirements and is or will be offering investment grade securities pursuant to General Instruction I.B.2 of Form S-3 or F-3, or where the issuer meets Form F-3 eligibility requirements (other than

¹⁰⁴ 15 U.S.C. 77b(a)10.

¹⁰⁵ 15 U.S.C. 77e(c).

the reporting history requirements) and is issuing non-convertible investment grade securities; and

- under Securities Act Rule 168, the regular release and dissemination by or on behalf of an issuer of communications containing factual business information or forward-looking information where the issuer meets Form F-3 eligibility requirements (other than the reporting history requirements) and is issuing non-convertible investment grade securities.

The Commission proposes to revise Rules 138, 139, and 168 to be consistent with the proposed revisions to the eligibility requirements in Forms S-3 and F-3 since in order to rely on these rules the issuer must either satisfy the public float threshold of Form S-3 or F-3, or issue non-convertible investment grade securities as defined in the instructions to Form S-3 or F-3 as proposed to be revised.

Request for Comment

- Should the Commission revise Rules 138, 139, and 168 as proposed?

c. Item 1100 of Regulation AB

Under the existing Item 1100(c) of Regulation AB,¹⁰⁶ if a significant obligor¹⁰⁷ meets the registrant requirements for Form S-3 or Form F-3 and the pool assets relating to the obligor are non-convertible investment grade rated securities, then an ABS issuer's filings may include a reference to the financial information of the obligor rather than presenting the full financial information of the obligor. The Commission now proposes to amend this provision of Item 1100(c) to remove the ratings reference and permit

¹⁰⁶ 17 CFR 229.1100(c).

¹⁰⁷ The term "significant obligor" is defined in Item 1101(k) of Regulation AB [17 CFR 229.1101(k)].

incorporation by reference of third party financial statements if the third party meets the registrant requirements of Form S-3 and the pool assets relating to such third party are non-convertible securities, other than common equity, that were issued in a primary offering for cash that was registered under the Securities Act. The Commission believes that, for the most part, non-convertible securities that were issued in a registered offering constitute higher quality securities than securities issued under an exemption under, for example, Securities Act Rule 144A, and then subsequently exchanged for registered securities because such securities are subject to the Securities Act.

Request for Comment

- Should the Commission revise Item 1100 of Regulation AB as proposed? If not, explain why?

d. Items 1112 and 1114 of Regulation AB

Items 1112 and 1114 of Regulation AB require the disclosure of certain financial information regarding significant obligors of an asset pool and significant credit enhancement providers relating to a class of asset-backed securities. An instruction to Item 1112(b)¹⁰⁸ provides that no financial information on a significant obligor, however, is required if the obligations of the significant obligor as they relate to the pool assets are backed by the full faith and credit of a foreign government and the pool assets are investment grade securities. Item 1114 of Regulation AB contains a similar instruction that relieves an issuer from providing financial information when the obligations of the credit enhancement provider are backed by a foreign government and the enhancement provider has an investment grade rating. Under both Items 1112 and 1114, to the extent

¹⁰⁸ Instruction 2 to 17 CFR 229.1112(b).

that pool assets are not investment grade securities, information required by paragraph (5) of Schedule B of the Securities Act may be provided in lieu of the required financial information.¹⁰⁹

We are now proposing to revise these instructions so that these exceptions based on investment grade ratings to the requirements of Items 1112 and 1114 of Regulation AB would no longer apply and information required by paragraph (5) of Schedule B would be required in all situations when the obligations of a significant obligor are backed by the full faith and credit of a foreign government. We are not aware of any benchmark comparable to an investment grade rating here and the requirement would not impose substantial costs or burdens to an ABS issuer, as such information should be readily available.

Request for Comment

- Should the Commission revise the instructions that rely on investment grade ratings in Items 1112 and 1114, as proposed? In the alternative, should the Commission instead permit issuers to omit all information relating to the obligors and credit enhancement providers when the obligations are backed by the full faith and credit of the foreign government? Are there any risks in doing so? Should the Commission allow incorporation by reference of the information required by paragraph (5) of Schedule B of the Securities Act in lieu of providing the information to the extent such information is contained in a filing with the Commission?

¹⁰⁹

Paragraph 5 of Schedule B requires disclosure of three years of the issuer's receipts and expenditures classified by purpose in such detail and form as the Commission prescribes.

- Are there any other provisions in Regulation AB or other rules applicable to asset-backed securities that should be revised?

C. The Commission's Policy on Security Ratings

As noted above, in 1981 the Commission issued its policy on disclosure of security ratings, articulated in Item 10(c) of Regulation S-K,¹¹⁰ that permits, but does not require, issuers to disclose in Commission filings security ratings assigned by credit rating agencies to classes of debt securities, convertible debt securities, and preferred stock.¹¹¹ In 1994, the Commission proposed to change from permissible to mandated disclosure of security ratings.¹¹² While the Commission did not adopt mandatory disclosure at that time, it signaled concerns relating to adequate disclosure to the markets regarding new financial products and security ratings. In the proposal we noted the dramatic proliferation in the types of securities offered in the marketplace with the development of the market for mortgage- and asset-backed securities and other highly structured or derivative financial obligations. In response to the growth of this market, we adopted new and amended rules and forms to address comprehensively the registration, disclosure, and reporting requirements for asset-backed securities.¹¹³ The adoption of Regulation AB in 2004 codified disclosure requirements and assisted in providing more disclosure with greater comparability for investors in the asset-backed securities markets. While the adoption of Regulation AB has enhanced the disclosure

¹¹⁰ 17 CFR 229.10(c).

¹¹¹ See the Integrated Disclosure Release. See also Release No. 33-6336. The release indicated that a debt rating was simply "an evaluation of the likelihood that an issuer will be able to make timely interest payments and will be able to repay principal."

¹¹² See the 1994 Ratings Release.

¹¹³ Release No. 33-8518.

about asset-backed securities, it did not significantly address securities ratings disclosure.

Because mandating disclosure of, and about, securities ratings might unduly emphasize or over rely on ratings, the Commission is at this time retaining the current Item 10(c) policy on security ratings, with minor changes to accommodate our proposed changes to Rule 436(g),¹¹⁴ which asks registrants to consider, but does not require, certain additional disclosure if a registration statement includes disclosure of a rating. While the Commission has not determined to propose mandatory disclosure, we are again requesting comment as to whether we should require disclosure by issuers regarding ratings in their Securities Act registration statements and their Exchange Act periodic reports. The goal of such disclosure requirements would be to enhance security rating disclosure so that investors are better able to understand the terms of a security rating and the limitations on the rating.

We are proposing to amend Rule 436(g) so that applicability would no longer be limited to just NRSROs. Securities Act Rule 436(g)¹¹⁵ provides that a security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock is not a part of a registration statement prepared or certified by a person or a report or valuation prepared or certified by a person within the meaning of sections 7 and 11 of the Securities Act. We propose to amend the reference to “nationally recognized statistical rating organization” in Rule 436(g) to expand the relief to any “credit rating agency” as defined in 15 U.S.C. 78c(a)(61). By proposing to permit issuers to disclose security ratings provided by any credit rating agency without requiring

¹¹⁴ 17 CFR 230.436(g).

¹¹⁵ 17 CFR 230.436(g).

consents, the Commission believes this relief may foster competition between credit rating agencies.¹¹⁶

Request for Comment

- Prior to 1981 the Commission precluded disclosure regarding security ratings in registration statements under the Securities Act. Should we revise our disclosure policy to prohibit disclosure of security ratings in an issuer's Securities Act registration statements or Exchange Act periodic reports? Should we simply delete Item 10(c) and provide no established disclosure policy regarding credit ratings?
- In 1994, the Commission noted "the extensive use of, and reliance on, ratings, and the wide disparity in the meaning and significance of the rating" as important factors in its decision to propose mandated disclosure.¹¹⁷ In light of the recent turmoil in the credit markets, some of the factors for the proposed disclosure may be no less of concern today than they were in 1994. Should the Commission require disclosure like the disclosure we currently recommend in Item 10(c) of Regulation S-K in order to enhance issuers' security rating disclosure so that investors are better able to understand the terms of a security rating and the limitations on that rating? Would requiring disclosure of a security rating place the Commission's "official seal of approval" on security ratings such that it could adversely affect the quality of due diligence and investment analysis?

¹¹⁶ See also Section II.B.1 of the 1994 Ratings Release where the Commission requested comment on eliminating the consent requirement for credit rating agencies that are not NRSROs.

¹¹⁷ See Section II.A of the 1994 Proposing Release.

- Item 10(c) of Regulation S-K currently refers to “security ratings” while the 2006 Credit Rating Agency Reform Act added the definition of “credit rating” to the Exchange Act, which means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments. Should we revise the reference to “security rating” in Item 10(c) to refer to “credit rating” instead? Would such a revision increase or decrease the scope of ratings covered by 10(c)? Would such a change limit the types of ratings that could be disclosed in a registration statement? In particular, are there any types of ratings that are issued that would not be covered by the term “credit rating,” particularly for ABS or structured products that should be covered by Item 10(c)? Are there any other changes we should make to Item 10(c) to align it with the Credit Rating Agency Reform Act or otherwise modernize it? For instance, should we specifically delineate structured products and asset-backed securities in the list of securities covered by the item since it currently only lists debt securities, convertible debt securities and preferred stock?
- While Item 10(c) currently only recommends disclosure, commenters on the 1994 Ratings Release expressed that most issuers provide this disclosure in their Securities Act filings. Do issuers generally provide this disclosure today? Is disclosure about an issuer’s securities rating appropriate disclosure for their Securities Act filings? Is it appropriate disclosure for their periodic Exchange Act filings? Is there any reason that this disclosure should only be recommended rather than required?

- In addition to the information Item 10(c) currently recommends disclosure regarding security ratings would it be valuable for investors to have additional disclosure of all material scope limitations of the rating and any related designation (or other published evaluation) of non-credit payment risks assigned by the rating agency with respect to the security assist investors in better understanding the credit rating and assessing the risks of an investment in the securities? What additional disclosure would be helpful to investors in making these assessments?
- If we were to mandate security rating disclosure, should disclosure be required for any published designation that reflects the results of any evaluation, other than a credit risk evaluation, done by a credit rating agency? Should disclosure be required for any evaluation by a credit rating agency that is communicated to the issuer, regardless of whether it is published?
- If the Commission were to require security rating disclosure, when should an issuer be required to provide that disclosure? In 1994, we proposed to require disclosure: if a registrant has obtained a security rating from an NRSRO with respect to a class of securities being registered under the Securities Act; if the rating is used in the offer or sale of the securities by any participant in an offering; or if the registrant voluntarily discloses a security rating. Should disclosure about the security rating be required under those circumstances? If not, under what circumstances, if any, should disclosure be required?
- Should we require disclosure of unsolicited ratings? It has been suggested that such ratings may not reflect the level of information on the security that is

reflected in a solicited rating, at least in part because of a lack of access to the issuer by the unsolicited credit rating agency.¹¹⁸ Is there a difference between solicited and unsolicited ratings such that they should be treated disparately? Should it matter if the issuer uses the unsolicited rating in the offer and sale of the securities being rated? If we were to require disclosure of unsolicited ratings, should there be limitations on how many ratings or which credit rating agencies ratings should be required to be disclosed? At what point would this create too great a burden on the issuer?

- In Release 34-57967, we expressed our concerns about ratings shopping by issuers and the potential for credit rating agencies to use less conservative rating methodologies in order to gain business, presumably lessening the value of the ratings. If an issuer would be required to provide ratings disclosure where the issuer has obtained either a preliminary security rating or a final security rating from a rating agency, would such disclosure enhance investors' understanding of, and therefore the value of, the ratings? Would it help to address our concerns with ratings shopping? If you do not believe such disclosure would be helpful, how would you suggest that we address these concerns? Should we include a disclosure requirement for indications of a rating prior to a preliminary rating? Would disclosure of indication from a credit rating agency of a likely or possible rating be appropriate?

¹¹⁸

However, in the corollary release amending rules for NRSROs, the Commission proposed various changes to Exchange Act Rule 17g-5 [17 CFR 240.17g-5] that would provide the opportunity for other credit rating agencies to use the information to develop "unsolicited ratings" for certain rated asset-backed securities. See proposed amendments to Rule 17g-5 in Release No. 34-57967 (Jun. 16, 2008).

- If we were to interpret that a security rating is “obtained” if: it is solicited by or on behalf of an issuer from a credit rating agency; or the issuer pays a credit rating agency for services related to a rating issued by that credit rating agency, would the standard capture sufficient disclosure about an issuer’s security ratings and the credit rating agencies that have issued them? Could that lead to non-substantive or procedural modifications to the practice of assigning ratings so that issuers could avoid the disclosure requirement? Would that lead to disclosure of security ratings that would not be useful to investors? What standard would provide the most useful information for investors? Could this threshold lead to ratings being obtained in connection with an offering but not being disclosed?
- In the 1994 Ratings Release, we proposed to require issuers to disclose any material differences between the terms of the security as assumed in rating the security and (1) the terms of the security as specified in the governing instruments, and (2) the terms of the security as marketed to investors. The terms of the securities are required to be disclosed in the prospectus, a prospectus supplement, or a post-effective amendment, as applicable. Would this disclosure assist investors? Would requiring this disclosure in periodic filings assist investors in the secondary market in making their investment decisions?
- Having previously proposed requiring material changes in security ratings be reported on Form 8-K under the Exchange Act,¹¹⁹ we recognize that such security rating changes can be important information to an investor in making investment and voting decisions. We note, however, that issuer-paid rating agencies make

¹¹⁹ See the 1994 Ratings Release and Release No. 33-8106.

their rating designations public. The current failures of security ratings, particularly in the asset-backed securities markets, have led us to re-evaluate the required level of disclosure regarding security ratings. Would requiring detailed current and/or periodic reporting of an issuer's security ratings provide investors and the markets sufficient, timely information about an issuer's security ratings to assist them in making their investment decisions? Would a Form 8-K provide investors with material and timely information about an issuer's security ratings and changes in those ratings? Would periodic reports on Form 10-K, Form 20-F, Form 10-Q and Form 10-D provide investors with material and timely information about an issuer's security ratings and changes in those ratings? Is the information that would be provided regarding a material change in a rating in a Form 8-K already provided by the credit rating agency? Would a Form 8-K be unduly burdensome? Should a Form 8-K requirement be limited to solicited ratings? If a credit rating agency does not publicly disclose the security rating of an issuer's securities, should we require disclosure of the rating in a Form 8-K or in the issuer's periodic reports? How would the existence of subscriber paid credit rating agencies affect your response?

- We are only proposing to amend Item 10(c) to remove references to consents in conjunction with our proposed amendments to Rule 436(g) to no longer requiring consents from any credit rating agencies for inclusion of their ratings in an issuer's registration statement. Should there be a written consent requirement? Would a written consent requirement create any issues if the Commission were to

require disclosure regarding those ratings? Would issuers find it problematic or costly to obtain consents?

- Should we require the consent of a credit rating agency for the use of its security rating by an issuer? What would be the additional costs of such a requirement? Would a consent requirement result in fewer ratings being obtained?
- Should we continue to limit the consent requirement to non-NRSROs as our rules currently do? Does our proposed regulatory oversight and additional disclosure regarding the ratings process and results of ratings justify allowing the use of NRSROs ratings without requiring consents? Would such a provision provide a “seal of approval” for NRSROs? Would there be any competitive effect on non-NRSRO credit rating agencies?
- Are there any issues with periodic disclosure regarding security ratings that are particular to ABS issuers? For instance, how would the responsibility to monitor changes or development in security ratings impact ABS offerings?

D. Other Rules Referencing Security Ratings

Other rules under the Securities Act also reference security ratings assigned by NRSROs. Rule 134(a)(17)¹²⁰ permits the disclosure of security ratings in certain communications deemed not to be a prospectus or free writing prospectus. We are not proposing to eliminate this reference to security ratings in our rules. However, we are proposing to revise the rule to allow for disclosure of ratings assigned by any credit rating agency, not just NRSROs. In addition, disclosure must also note that the credit rating agency is not an NRSRO, if that is the case.

¹²⁰

17 CFR 230.134(a)(17).

Under Rule 100(b)(2) of Regulation FD, disclosures to an entity whose primary business is the issuance of security ratings are excluded from coverage provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available. We believe this exception for disclosures to credit rating agencies is appropriate given the purpose of Regulation FD and are therefore not proposing to revise that provision.

Request for Comment

- Should we continue to allow disclosure of security ratings in “tombstones” to be deemed not to be a prospectus or free writing prospectus? Is it appropriate to allow such disclosure of a security rating by any credit rating agency and not limit the allowance to NRSROs? If the credit rating agency is not an NRSRO, is it appropriate to require additional disclosure to that effect?
- Should we revise Rule 100(b)(2) of Regulation FD to eliminate the requirement that the entity's ratings be publicly available or to require public disclosure of information submitted to credit rating agencies by issuers? If so, please explain the basis for recommending the change and discuss how to implement such changes.
- How would requiring disclosure under Regulation FD affect security ratings?

III. General Request for Comments

We request and encourage any interested person to submit comments regarding:

- the proposed amendments that are the subject of this release;
- additional or different changes; or

- other matters that may have an effect on the proposals contained in this release.

We request comment from the point of view of companies, investors, and other market participants. With regard to any comments, we note that such comments are of great assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

In addition, we request comment on the following:

- Should the Commission include a phase-in for issuers beyond the effective date to accommodate pending offerings? If so, should a phase-in apply only to particular rules, such as Form S-3 eligibility? As proposed, compliance with the new standards would begin on the effective date of the new rules. Will a significant number of issuers have their offerings limited by the proposed rules? If a phase-in is appropriate, should it be for a certain period of time or only for the term of a pending registration statement?
- What impact on competition should the Commission expect were it to adopt the proposed non-convertible debt eligibility requirements? Would any issuers that currently take advantage, or are eligible to take advantage of the investment grade condition and are planning to do so, be adversely affected? Is the ability to offer debt off the shelf a significant competitive advantage that the Commission should be concerned about limiting to only large debt issuers?

IV. Paperwork Reduction Act

A. Background

Certain provisions of the proposed rule amendments contain a “collection of information” within the meaning of the Paperwork Reduction Act of 1995 (PRA).¹²¹ The Commission is submitting these proposed amendments and proposed rules to the Office of Management and Budget (OMB) for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid control number. The titles for the collections of information are:¹²²

“Regulation S-K” (OMB Control No. 3235-0071);

“Regulation C” (OMB Control No. 3235-0074);

“Form S-1” (OMB Control No. 3235-0065);

“Form S-3” (OMB Control No. 3235-0073);

“Form S-4” (OMB Control No. 3235-0324);

“Form F-1” (OMB Control No. 3235-0258);

“Form F-3” (OMB Control No. 3235-0256); and

“Form F-4” (OMB Control No. 3235-0325).

We adopted all of the existing regulations and forms pursuant to the Securities Act or the Exchange Act. These regulations and forms set forth the disclosure requirements for periodic reports and registration statements that are prepared by issuers

¹²¹ 44 U.S.C. 3501 *et seq.*; 5 CFR 1320.11.

¹²² The paperwork burden from Regulation S-K and S-B is imposed through the forms that are subject to the requirements in those regulations and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens and for administrative convenience, we assign a one-hour burden to Regulation S-K.

to provide investors with information to make investment decisions in registered offerings and in secondary market transactions. Our proposed amendments to existing forms and regulations are intended to replace rule and form requirements of the Securities Act and the Exchange Act that rely on security ratings with alternative requirements.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. There is no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

B. Summary of Collection of Information Requirements

The threshold we are proposing for issuers of non-convertible securities who are otherwise ineligible to use Form S-3 or Form F-3 to conduct primary offerings because they do not meet the aggregate market value requirement is designed to capture those issuers with an active market following. The Commission expects that under the proposed threshold, approximately the same number of issuers who are currently eligible will be eligible to register on Form S-3 or Form F-3 for primary offerings of non-convertible securities for cash. In addition, because these proposed amendments relate to those forms' eligibility requirements, rather than the disclosure requirements, the Commission does not expect that the proposed revisions will impose any new material recordkeeping or information collection requirements. Issuers may be required to ascertain the aggregate principal amount of non-convertible securities issued in registered primary offerings for cash, but the Commission believes that this information should be readily available and easily calculable.

Our proposed amendments to Form S-3 and Rule 415 for ABS offerings is intended to limit the investors purchasing asset-backed securities in a delayed offering and off a short-form registration statement to sophisticated and experienced investors without creating an undue detriment to the liquidity of the asset-backed securities market. The Commission expects preliminarily that the proposed amendments for ABS offerings would not substantially change the number of ABS issuers registering their offerings on Form S-3.¹²³

C. Paperwork Reduction Act Burden Estimates

For purposes of the Paperwork Reduction Act, we estimate that there will be no annual incremental increase in the paperwork burden for issuers to comply with our proposed collection of information requirements.

D. Solicitation of Comments

We request comments in order to evaluate: (1) whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) the accuracy of our estimate of the burden of the proposed collection of information; (3) whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) 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.¹²⁴

¹²³ As noted above, we have identified two areas of exception: unit repackagings and securitizations of insurance funding agreements. We do not believe that changes in these areas would substantially change the number of issuers that would be eligible under the proposed Form S-3 eligibility requirement for ABS offerings.

¹²⁴ We request comment pursuant to 44 U.S.C. 3506(c)(2)(B).

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-18-08. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-18-08, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. Cost-Benefit Analysis

A. Proposed Amendments

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that

commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed to address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings. Today's proposals seek to replace rule and form requirements of the Securities Act and the Exchange Act that rely on security ratings by NRSROs with alternative requirements that do not rely on ratings.

The Commission is proposing to revise the transaction eligibility requirements of Forms S-3, F-3, and F-9. Currently, these forms allow issuers who do not meet the forms' other transaction eligibility requirements to register primary offerings of non-convertible securities for cash if such securities are rated investment grade by an NRSRO.¹²⁵ The proposed rules would replace the current eligibility requirement with a requirement that for primary offerings of non-convertible securities for cash, an issuer must have issued in the three years (as of a date within 60 days prior to the filing of the registration statement) at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in registered primary offerings for cash. In addition, the Commission proposes to replace the Form S-3 eligibility requirement for

¹²⁵

The proposed revisions to Form F-9 would eliminate a Canadian issuer's ability to rely on security ratings by NRSROs, but would continue to rely on ratings issued by Approved Rating Organizations, as defined in National Policy Statement No. 45 of the Canadian Securities Administrator.

ABS offerings to require that initial sales of eligible offerings be made only to qualified institutional buyers and that initial and subsequent resales of the securities in the eligible offerings be made only in denominations of at least \$250,000. In conjunction with this proposal, the Commission proposes to amend Rule 415 to provide for delayed offerings of mortgage related securities, regardless of the security ratings, only if they meet the same criteria as proposed for ABS offerings on Form S-3.

Currently, issuers are required to obtain consent from a rating agency that is not an NRSRO for disclosure of a security rating issued by that rating agency in a registration statement or report. The Commission is also proposing to amend Securities Act Rule 436(g) and related rules to expand the relief from the consent requirements for security ratings currently provided to NRSROs to other credit rating agencies that are not NRSROs. In addition, the proposed revision to Rule 134 of the Securities Act would permit an issuer to disclose the security rating of any credit rating agency, but would require an issuer to provide, if it elects to include a security rating in a communication under Rule 134, a statement as to whether the entity issuing the rating is an NRSRO.

B. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to investors of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in our rules. An over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information. The purpose of the proposed rule amendments is to encourage investors to examine more than a single source of information in making an investment decision. Eliminating reliance on ratings

in the Commission's rules could also result in greater investor due diligence and investment analysis. In addition, the Commission believes that eliminating the reliance on ratings in its rules would remove any appearance that the Commission has placed its imprimatur on certain ratings.

The Commission believes that the proposed amendments to the Form S-3 eligibility requirements for ABS offerings and eligibility to rely on Rule 415(a)(vii) for mortgage-backed securities are designed to make shelf eligibility and short-form registration available to sophisticated and experienced investors. The proposed requirement to permit initial sales only to qualified institutional buyers is intended to limit the market to investors who understand the risks involved with an ABS offering. The proposed requirement that initial sales and subsequent resales of the securities are in minimum denominations of \$250,000 is designed to limit offerings to investors with such capital, increasing the probability that these investors have the resources to analyze and comprehend the risks involved with an investment decision in the ABS offering. As with the other amendments to our rules and form requirements relying on investment grade ratings, the Commission believes that these proposals would reduce or eliminate undue reliance on ratings.

The proposed revision to Rule 134 of the Securities Act would require an issuer to provide, if it elects to include a security rating in a communication under Rule 134, a statement as to whether the entity issuing the rating is an NRSRO. The Commission believes that disclosure of this information would be beneficial to investors in evaluating the value of the rating.

Under our proposed amendment to Rule 436(g), an issuer would not be required to obtain consent from the rating agency even with respect to a rating disclosed in a registration statement or report that is issued by a credit rating agency that is not an NRSRO. We believe that our proposed change would foster competition between credit rating agencies.¹²⁶

C. Costs

We are proposing to revise the transaction eligibility criteria for registering primary offerings of non-convertible securities on short-form registration statements. Forms S-3 and F-3 would be available to register primary offerings of non-convertible securities if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash more than \$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years. The proposed eligibility thresholds may be more difficult to ascertain for some issuers than an NRSRO rating and impose some burden on issuers to ascertain the information. In addition, while we do not anticipate that fewer issuers will be eligible, to the extent that the proposal results in fewer issuers eligible to use Forms S-3 and F-3 to register primary offerings of non-convertible securities, this could result in increased costs of preparing and filing registration statements.¹²⁷ Issuers who do not meet the proposed threshold and are not otherwise eligible to use Forms S-3 and F-3, would have to register offerings on

¹²⁶ This would be consistent with our proposed amendments to the rules governing NRSROs in Release No. 34-57967. As discussed in that release, such competition could promote ease of comparability between ratings.

¹²⁷ The ability to conduct primary offerings on short form registration statements confers significant advantages on eligible companies in terms of cost savings and capital formation. The time required to prepare Form S-3 or F-3 is significantly lower than that required for Forms S-1 and F-1 primarily because registration statements on Forms S-3 and F-3 can be automatically updated. Forms S-3 and F-3 permit registrants to forward incorporate required information by reference to disclosure in their Exchange Act filings.

Forms S-1 or F-1. This could result in additional time spent in the offering process, and issuers may incur costs associated with preparing and filing post-effective amendments to the registration statement.

The Commission does not expect the proposed changes to Forms F-1, F-3 and F-4 to impact substantially the number of registrants able to provide information required by Item 17 of Form 20-F in lieu of Item 18 information. However, because the Commission is proposing changes to the provisions of the forms that provide the eligibility requirements for registrants to provide Item 17 information instead of Item 18, registrants who do not meet the proposed criteria could incur more costs as a result of being required to provide Item 18 information instead.

For the most part, the Commission believes that there would be minimal costs involved with the adoption of the proposed ABS offering Form S-3 eligibility requirements and eligibility to rely on Rule 415(a)(vii) for mortgage-backed securities.¹²⁸ Some costs may be incurred on the part of issuers to ensure that sales of the securities in an offering on Form S-3 are made only to qualified institutional buyers and in the prescribed denominations; however, the Commission believes these costs are not significant. To the extent that some issuers would no longer be able to use Form S-3 to register their offerings, those issuers may face some additional costs, such as those arising from no longer being able to utilize certain rules permitting the use of offering materials.

The proposed revision to Rule 134 could impose a disclosure burden of ascertaining whether the entity is an NRSRO, but the Commission believes this burden is

slight given the limited number of NRSROs, the availability of this information from public filings, and the issuer's relationship with the credit rating agency.

D. Request for Comments

We seek comments and empirical data on all aspects of this Cost-Benefit Analysis. Specifically, we ask the following:

- Are there any costs involved with tracking whether the initial purchaser is a qualified institutional buyer? Are most ABS offerings on Form S-3 sold to such purchasers? What kind of asset-backed securities are sold to retail investors?
- Are there any costs entailed with tracking the denominations of the sale for the purposes of meeting the proposed ABS offering Form S-3 eligibility requirements?
- Would there be any significant transition costs imposed on issuers as a result of the proposals, if adopted? Please be detailed and provide quantitative data or support, as practicable.

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

Section 23(a) of the Exchange Act¹²⁹ requires the Commission, when making rules and regulations under the Exchange Act, to consider the impact a new rule would have on competition. Section 23(a)(2) prohibits the Commission from adopting any rule which would impose a burden on competition not necessary or appropriate in furtherance

¹²⁸ ABS issuers generally provide the same disclosure in Form S-1 and Form S-3 registration statements. As such, there may not be the same cost concerns for ABS issuers that no longer qualify for registration on Form S-3 as for other issuers.

¹²⁹ 15 U.S.C. 78w(a).

of the purposes of the Exchange Act. Section 2(b) of the Securities Act¹³⁰ and Section 3(f) of the Exchange Act¹³¹ require the Commission, when engaging in rulemaking, to consider whether an action is necessary or appropriate in the public interest, and in addition, to consider the protection of investors and whether the action would promote efficiency, competition, and capital formation.

The proposed amendments would eliminate reliance on ratings by an NRSRO in various rules and forms under the Securities Act and the Exchange Act. If adopted, the Commission believes that these amendments would reduce the potential for over-reliance on ratings, and thereby promote investor protection. The Commission anticipates that these proposed amendments would improve investors' ability to make informed investment decisions, which will therefore lead to increased efficiency and competitiveness of the U.S. capital markets. The Commission expects that this increased market efficiency and investor confidence also may encourage more efficient capital formation. Specifically, the proposed amendments would:

- Seek to limit the investors purchasing asset-backed securities off a short-form registration statement to sophisticated and experienced investors without creating an undue detriment to the liquidity of the asset-backed securities market; and
- Seek to limit the issuers eligible to register primary offerings of non-convertible securities on Forms S-3 and F-3 and incorporate by reference to issuers that are actively followed by the markets; and
- Enhance the ability of credit rating agencies to offer security ratings to issuers.

¹³⁰ 15 U.S.C. 77b(b).

The Commission solicits comment on whether the proposed amendments would change the Forms S-3 and F-3 eligibility requirements for registering primary offerings of non-convertible securities, if adopted, would promote or burden efficiency, competition, and capital formation. The Commission also requests comment on whether the proposed amendments would have harmful effects on investors or on issuers who could use Form S-3 and Form F-3 for primary offerings of non-convertible securities, and what options would best minimize those effects. The Commission requests comment on whether the proposed changes to the eligibility requirement on Form S-3 for offerings of asset-backed securities would promote or burden efficiency, competition, and capital formation. The Commission requests comment on whether the proposed eligibility criterion is less efficient than using the current NRSRO criterion? Additionally, the Commission solicits comment on whether the proposed expansion of the ability of credit rating agencies to proffer their security ratings without being required to provide a consent for an issuer to disclose those ratings would promote or burden efficiency, competition, and capital formation. Finally, the Commission requests comment on the anticipated effect of disclosure requirements on competition in the market for credit rating agencies. The Commission requests commenters to provide empirical data and other factual support for their views, if possible.

VII. Regulatory Flexibility Act Certification

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that the amendments contained in this release, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments would:

¹³¹

15 U.S.C. 78c(f).

- Amend the Securities Act Form S-3 eligibility requirements for offerings of asset-backed securities by replacing the investment grade component with a minimum denomination requirement for initial and subsequent sales and require that initial sales of classes of securities only be made to qualified institutional buyers;
- Amend Rule 415 of the Securities Act that references mortgaged related securities by adding the requirement that an initial and subsequent sale of such a security must meet certain minimum denominations, and initial sales must be made to qualified institutional buyers;
- Amend the Securities Act Form S-3 and Form F-3 eligibility requirements for primary offerings of non-convertible securities if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash more than \$1 billion in non-convertible securities, other than common stock, through registered primary offerings, within the prior three years;
- Amend Form F-9 which requires securities to be rated investment grade to instead require that the issuer have issued in the prior three years at least \$1 billion of aggregate principle amount of debt or preferred securities for cash in registered primary offerings;
- Amend Forms S-4 and F-4 and Schedule 14A to conform with the proposed Form S-3/F-3 eligibility requirements;
- Amend Securities Act Rules 138, 139, and Rules 168 to be consistent with the proposed Form S-3/F-3 eligibility requirements;
- Amend Item 10(c) to conform to our proposed Rule 436(g) changes;

- Amend Rule 134(a)(17) to allow for disclosure of ratings assigned by any Credit Rating Agency—not just NRSROs; and
- Amend Rule 436(g) to replace the current reference to “nationally recognized statistical rating organization” with a reference to “credit rating agency.”

We are not aware of any issuers that currently rely on the rules that we propose to change or any issuers that would be eligible to register under the affected rules that is a small entity. In this regard, we note that credit rating agencies rarely, if ever, rate the securities of small entities. We further note most security ratings that will be disclosed are expected to be ratings obtained and used by the issuer. Issuers are required to pay for these security ratings and the cost of these ratings relative to the size of a debt or preferred securities offering by a small entity would generally be prohibitive. Finally, based on an analysis of the language and legislative history of the Regulatory Flexibility Act, we note that Congress did not intend that the Act apply to foreign issuers. Accordingly, some of the entities directly affected by the proposed rule and form amendments will fall outside the scope of the Act.

For these reasons, the proposed amendments would not have a significant economic impact on a substantial number of small entities.

VIII. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,¹³² a rule is “major” if it has resulted, or is likely to result in:

- an annual effect on the U.S. economy of \$100 million or more;
- a major increase in costs or prices for consumers or individual industries; or

¹³² Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

- significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a “major rule” for purposes of the Small Business Regulatory Enforcement Fairness Act. We solicit comment and empirical data on:

- the potential effect on the U.S. economy on an annual basis;
- any potential increase in costs or prices for consumers or individual industries;
and
- any potential effect on competition, investment, or innovation.

IX. Statutory Authority and Text of Proposed Rule and Form Amendments

We are proposing the amendments contained in this document under the authority set forth in Sections 6, 7, 10, 19(a) of the Securities Act and Sections 12, 13, 14, 15(d) and 23(a) of the Exchange Act.

List of Subjects

17 CFR Parts 229, 230, 239, and 240

Reporting and recordkeeping requirements, Securities.

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

PART 229 -- STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 -- REGULATION S-K

1. The authority citation for part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c),

80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Amend § 229.10, paragraph (c)(1)(i) by:
 - a. Removing the second sentence;
 - b. Revising “NRSRO” in the third sentence to read, “credit rating agency (as defined in 15 U.S.C. 78c(a)(61))”; and
 - c. Revising the phrase “Instruction to paragraph (a)(2)” in the fourth sentence to read, “paragraph A.2.(B)”.

3. Amend § 229.1100 by revising paragraph (c)(2)(ii)(B) to read as follows:

§ 229.1100 (Item 1100) General.

* * * * *

- (c) * * *
- (2) * * *
- (ii) * * *

(B) The third party meets the requirements of General Instruction I.A. of Form S-3 or General Instructions 1.A.1, 2, 3, 4, and 6 of Form F-3 and the pool assets relating to such third party are non-convertible securities, other than common equity, that were issued in a primary offering for cash that was registered under the Securities Act.

* * * * *

4. Amend § 229.1112 by:
 - a. Removing Instruction 2 to Item 1112(b);

- b. Redesignating Instructions 3 and 4 to Items 1112(b) as Instructions 2 and 3 to Item 1112(b).
- 5. Amend § 229.1114 by:
 - a. Revising the heading for “Instructions to Item 1114:” to read “Instructions to Item 1114(b):”.
 - b. Removing Instruction 3 to Item 1114.
 - c. Redesignating Instructions 4 and 5 to Item 1114 as Instructions 3 and 4 to Item 1114.

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

- 6. 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.

* * * * *

- 7. Amend §230.134 by:
 - a. Revising paragraph (a)(17)(i);
 - b. Redesignating paragraph (a)(17)(ii) as paragraph (a)(17)(iii); and
 - c. Adding new paragraph (a)(17)(ii).

The revision and addition read as follows:

§ 230.134 Communications not deemed a prospectus.

* * * * *

(a) * * *

(17) * * *

(i) Any security rating assigned, or reasonably expected to be assigned, by a credit rating agency, as that term is defined in 15 U.S.C. 78c(a)(61), and the name or names of the credit rating agencies that assigned or is or are reasonably expected to assign the rating(s);

(ii) If the credit rating agency or agencies that assigned or is or are reasonably expected to assign the rating(s) is not a nationally recognized security rating organization, as that term is defined in 15 U.S.C. 78c(a)(62), include a statement to that effect; and

* * * * *

8. Amend §230.138 by revising paragraph (a)(2)(ii)(B)(2) to read as follows:

§ 230.138 Publications or distributions of research reports by brokers or dealers about securities other than those they are distributing.

(a) * * *

(2) * * *

(ii) * * *

(B) * * *

(2) Is issuing non-convertible securities and the registrant meets the provisions of General Instruction I.B.2 of Form F-3; and

* * * * *

9. Amend §230.139 by revising paragraphs (a)(1)(i)(A)(1)(ii) and

(a)(1)(i)(B)(2)(ii) to read as follows:

§ 230.139 Publications or distributions of research reports by brokers or dealers distributing securities.

(a) * * *

(1) * * *

(i) * * *

(A)(1) * * *

(ii) At the date of reliance on this section, is, or if a registration statement has not been filed, will be, offering non-convertible securities and meets the requirements for the General Instruction I.B.2 of Form S-3 or Form F-3; or

* * * * *

(B) * * *

(2) * * *

(ii) Is issuing non-convertible securities and meets the provisions of General Instruction I.B.2. of Form F-3; and

* * * * *

10. Amend §230.168 by revising paragraph (a)(2)(ii)(B) to read as follows:

§ 230.168 Exemption from sections 2(a)(10) and 5(c) of the Act for certain communications of regularly released factual business information and forward-looking information.

* * * * *

(a) * * *

(2) * * *

(ii) * * *

(B) Is issuing non-convertible securities and meets the provisions of General Instruction I.B.2 of Form F-3; and

* * * * *

11. Amend §230.415 by revising paragraph (a)(1)(vii) to read as follows:

§ 230.415 Delayed or continuous offering and sale of securities.

(a) * * *

(1) * * *

(vii) Mortgage backed securities, including such securities as mortgage backed debt and mortgage participation or pass through certificates, provided that:

(A) Initial sale and any resales of the securities are made in minimum denominations of \$250,000; and

(B) Initial sales of the securities are made only to qualified institutional buyers (as defined in §230.144A(a)(1)); and

(C) Either of the following is true:

(1) Represents ownership of one or more promissory notes or certificates of interest or participation in such notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of such notes, certificates, or participations of amounts payable under, such notes, certificates, or participations), which notes:

(i) Are directly secured by a first lien on a single parcel of real estate, including stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure, on a residential manufactured home as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974, whether such manufactured home is considered real or personal property under the laws of the State in which it is to be located, or on one or more parcels of real estate upon which is located one or more commercial structures; and

(ii) Were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or by a mortgage approved by the Secretary of Housing and Urban Development pursuant to sections 203 and 211 of the National Housing Act, or, where such notes involve a lien on the manufactured home, by any such institution or by any financial institution approved for insurance by the Secretary of Housing and Urban Development pursuant to section 2 of the National Housing Act; or

(2) Is secured by one or more promissory notes or certificates of interest or participations in such notes (with or without recourse to the issuer thereof) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the requirements of paragraphs (a)(1)(vii)(C)(1) (i) and (ii) of this section or certificates of interest or participations in promissory notes meeting such requirements.

Note to paragraph (a)(1)(vii): For purposes of paragraph (a)(1)(vii) of the section, the term “promissory note,” when used in connection with a manufactured home, shall also include a loan, advance, or credit sale as evidence by a retail installment sales contract or other instrument.

* * * * *

12. Amend §230.436 by revising paragraph (g) and removing the authority citations following the section to read as follows:

§ 230.436 Consents required in special cases.

* * * * *

(g) Notwithstanding the provisions of paragraphs (a) and (b) of this section, the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a credit rating agency as defined in 15 U.S.C. 78c(a)(61), or with respect to registration statements on Form F-9 (§239.39 of this chapter) by any other rating organization specified in the Instruction to paragraph A of General Instruction I of Form F-9, shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.

PART 239 --FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

13. 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, 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.

* * * * *

14. Amend Form S-3 (referenced in §239.13) by:

- a. Revising General Instructions I.B.2 and I.B.5; and
- b. Removing Instruction 3 to the signature block.

The revisions read as follows:

Note -The text of Form S-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form S-3

* * * * *

B. Transaction Requirements* * *

2. Primary Offerings of Non-convertible Securities. Non-convertible securities to be offered for cash by or on behalf of a registrant, provided the registrant, as of a date within 60 days prior to the filing of the registration statement on this Form, has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Act.

* * * * *

5. Offerings of Asset-backed Securities.

(a) Asset-backed securities (as defined in 17 CFR 229.1101) to be offered for cash, provided:

(i) Initial sales and any resales of the securities are made in minimum denominations of \$250,000;

(ii) Initial sales of the securities are made only to qualified institutional buyers (as defined in 17 CFR 230.144A(a)(1));

(iii) Delinquent assets do not constitute 20% or more, as measured by dollar volume, of the asset pool as of the measurement date; and

(iv) With respect to securities that are backed by leases other than motor vehicle leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases, as determined in accordance with the

transaction agreements for the securities, does not constitute 20% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date.

Instruction. For purposes of making the determinations required by paragraphs (a)(iii) and (a)(iv) of this General Instruction I.B.5, refer to the Instructions to Item 1101(c) of Regulation AB (17 CFR 229.1101(c)).

* * * * *

15. Amend Form S-4 (referenced in §239.25) by revising General Instruction B.1.a.(ii)(B) to read as follows:

Note – The text of Form S-4 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM S-4

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information with Respect to the Registrant.

1. * * *

a. * * *

(ii) * * *

(B) Non-convertible debt or preferred securities are to be offered pursuant to this registration statement and the requirements of General Instruction I.B.2. of Form S-3 have been met; or

* * * * *

16. Amend Form F-1 (referenced in § 239.31) by revising Item 4.c, including

the Instructions to read as follows:

Note – The text of Form F-1 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM F-1

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

Item 4. Information with Respect to the Registrant and the Offering.

* * * * *

c. Information required by Item 17 of Form 20-F may be furnished in lieu of the information specified by Item 18 thereof if:

1. The only securities being registered are non-convertible securities offered for cash and the registrant, as of a date within 60 days prior to the filing of the registration statement on this Form, has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash registered under the Act; or

2. The only securities to be registered are to be offered:

i. Upon the exercise of outstanding rights granted by the issuer of the securities to be offered, if such rights are granted on a pro rata basis to all existing security holders of the class of securities to which the rights attach and there is no standby underwriting in the United States or similar arrangement; or

ii. Pursuant to a dividend or interest reinvestment plan; or

iii. Upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer of the securities to be offered, or by an affiliate of such issuer.

Instruction: Attention is directed to section 10(a)(3) of the Securities Act.

* * * * *

17. Amend Form F-3 (referenced in §239.33) by:
 - a. Revising General Instruction I.B.2; and
 - b. Deleting Instruction 3 to the signature block.

The revision to General Instruction I.B.2 reads as follows:

Note – The text of Form F-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM F-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form F-3

* * * * *

B. Transaction Requirements * * *

2. Primary Offerings of Non-convertible Securities. Non-convertible securities to be offered for cash provided the issuer, as of a date within 60 days prior to the filing of the registration statement on this Form, has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Act. In the case of securities registered pursuant to this paragraph, the financial statements included in this registration statement may comply with Item 17 or 18 of Form 20-F.

* * * * *

18. Amend Form F-4 (referenced in §239.34) by:

- a. revising General Instruction B.1(a)(ii)(B); and
- b. revising the following in Part I.B: Instruction 1 to Item 11 following paragraph (a)(3); the first sentence in paragraph (b)(2) to Item 12; Instruction 1 to Item 13 following paragraph (b); and paragraph (h) to Item 14.

The revisions read as follows:

Note – The text of Form F-4 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM F-4

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information with Respect to the Registrant

1. * * *

a. * * *

(ii) * * *

(B) Non-convertible debt or preferred securities are to be offered pursuant to this registration statement and the requirements of General Instruction I.B.2. of Form F-3 have been met; or

* * * * *

PART I -- INFORMATION REQUIRED IN THE PROSPECTUS

* * * * *

B. INFORMATION ABOUT THE REGISTRANT

* * * * *

Item 11. Incorporation of Certain Information by Reference.

* * * * *

(a) * * *

(3) * * *

Instructions

1. All annual reports or registration statements incorporated by reference pursuant to Item 11 of this Form shall contain financial statements that comply with Item 18 of Form 20-F except that financial statements of the registrants may comply with Item 17 of Form 20-F if the only securities being registered are non-convertible securities offered for cash and the requirements of General Instruction I.B.2 of Form F-3 have been satisfied.

* * * * *

Item 12. Information With Respect to F-3 Registrants.

* * * * *

(b) * * *

(2) Include financial statements and information as required by Item 18 of Form 20-F, except that financial statements of the registrant may comply with Item 17 of Form 20-F if the requirements of General Instruction I.B.2 of Form F-3 have been satisfied. * * *

* * * * *

Item 13. Incorporation of Certain Information by Reference.

* * * * *

(b) * * *

Instructions

1. All annual reports incorporated by reference pursuant to Item 13 of this Form shall contain financial statements that comply with Item 18 of Form 20-F, except that financial statements of the registrants may comply with Item 17 of Form 20-F if the only securities being registered are non-convertible securities offered for cash and the requirements of General Instruction I.B.2 of Form F-3 have been satisfied.

* * * * *

Item 14. Information With Respect to Foreign Registrants Other Than F-3

Registrants.

* * * * *

(h) Financial statements required by Item 18 of Form 20-F, except that financial statements of the registrants may comply with Item 17 of Form 20-F if the only securities being registered are non-convertible securities offered for cash and the requirements of General Instruction I.B.2 of Form F-3 have been satisfied, as well as financial information required by Rule 3-05 and Article 11 of Regulation S-X with respect to transactions other than that pursuant to which the securities being registered are to be issued (Schedules required by Regulation S-X shall be filed as "Financial Statement Schedules" pursuant to Item 21 of this Form); and

* * * * *

19. Amend Form F-9 (referenced in §239.39) by:
- a. Revising General Instruction I.A;
 - b. Removing Instruction D to the signature block.

The revision reads as follows:

Note – The text of Form F-9 does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM F-9

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

* * * * *

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form F-9

A. Form F-9 may be used for the registration under the Securities Act of 1933 (the “Securities Act”) for an offering of debt or preferred securities if:

(1) The debt or preferred securities to be offered are:

(A) Offered for cash or in connection with an exchange offer; and

(B) Either non-convertible or not convertible for a period of at least one year from the date of issuance and, except as noted in E. below, are thereafter only convertible into a security of another class of the issuer; and

(2) Either of the following are true:

(A) The registrant, as of a date within 60 days prior to the filing of the registration statement on this Form, has issued in the last three years at least \$1 billion of aggregate principal amount of debt or preferred securities for cash in primary offerings registered under the Act; or

(B) The securities are investment grade debt or investment grade preferred securities. Securities shall be “investment grade” for purposes of this requirement if, at the time of sale, at least one Approved Rating Organization (as defined in National Policy Statement No. 45 of the Canadian Securities Administrator, as the same may be amended

from time to time) has rated the security in one of its generic rating categories that signifies investment grade; typically the four highest rating categories (within which there may be subcategories or gradations indicating relative standing) signify investment grade.

* * * * *

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

20. The authority citations 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.

* * * * *

21. Amend § 240.14a-101 by revising Note E(2)(ii) to read as follows:

§ 240.14a-101 Schedule 14A. Information required in proxy statement.

* * * * *

Notes

* * * * *

E. * * *

(2) * * *

(ii) Action is to be taken as described in Items 11, 12, and 14 of this schedule which concerns non-convertible debt or preferred securities issued by a registrant meeting the requirements of General Instruction I.B.2 of Form S-3; or

* * * * *

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 1, 2008

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 242, and 249

[Release No. 34-58070; File No. S7-17-08]

RIN 3235-AK17

REFERENCES TO RATINGS OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of three releases that the Securities and Exchange Commission ("Commission") is publishing simultaneously relating to the use in its rules and forms of credit ratings issued by nationally recognized statistical rating organizations ("NRSROs"). In this release, the Commission proposes to amend various rules and forms under the Securities Exchange Act of 1934 ("Exchange Act") that rely on NRSRO ratings. The proposed amendments are designed to address concerns that the reference to NRSRO ratings in Commission rules and forms may have contributed to an undue reliance on NRSRO ratings by market participants.

DATES: Comments should be received on or before September 5, 2008.

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-17-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

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Paper comments:

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

All submissions should refer to File Number S7-17-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, Thomas K. McGowan, Assistant Director, Randall W. Roy, Branch Chief, , and Joseph I. Levinson, Attorney (Net Capital Requirements and Customer Protection) at (202) 551-5510; Michael Gaw, Assistant Director, Brian Trackman, Special Counsel, and Sarah Albertson, Attorney (Alternative Trading Systems) at (202) 551-5602; Paula Jenson, Deputy Chief Counsel, Joshua Kans, Senior Special Counsel, Linda Stamp Sundberg, Senior Special Counsel (Confirmation of Transactions) at (202) 551-5550; Josephine J. Tao, Assistant Director, Elizabeth A. Sandoe, Branch Chief, and Bradley Gude, Special Counsel (Regulation M) at (202) 551-5720; or Catherine Moore, Counsel to the Director at (202) 551-5710, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549-6628.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,¹ the Commission published for notice and comment two rulemaking initiatives.² The first proposes additional requirements for NRSROs³ that were directed at reducing conflicts of interests in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating process.⁴ The second is designed to improve investor understanding of the risk characteristics of structured finance products. Those proposals address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in light of the role they played in determining the credit ratings for securities that were the subject of the recent turmoil in the credit markets.

Today's proposals comprise the third of these three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on credit ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial

¹ Pub. L. No. 109-291, 120 Stat. 1327 (2006).

² Proposed Rules for National Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008).

³ As described in more detail below, an NRSRO is an organization that issues ratings that assess the creditworthiness of an obligor itself or with regard to specific securities or money market instruments, has been existence as a credit rating agency for at least three years, and meets certain other criteria. The term is defined in section 3(a)(62) of the Securities Exchange Act. A credit rating agency must apply with the Commission to register as an NRSRO, and currently there are nine registered NRSROs.

⁴ See Press Release No. 2008-110 (June 11, 2008).

Markets (“PWG”), the Financial Stability Forum (“FSF”), and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”).⁵ Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an “official seal of approval” on ratings that could adversely affect the quality of due diligence and investment analysis. The Commission believes that today’s proposals could reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions

II. BACKGROUND

The Commission first used the term NRSRO in our rules in 1975 in the net capital rule for broker-dealers, Rule 15c3-1 under the Exchange Act (“Net Capital Rule”)⁶ as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, we have used the designation in a number of regulations under the federal securities laws. Although we originated the use of the term NRSRO for a narrow purpose in our own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, rules issued by other financial regulators, in the United States and abroad, and private financial contracts.

Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear

⁵ See President’s Working Group on Financial Markets, Policy Statement on Financial Market Developments (March 2008), available at www.ustreas.gov (“PWG Statement”); The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (April 2008), available at www.fsforum.org (“FSF Report”); Technical Committee of the International Organization of Securities Commissions, Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets (March 2008), page 9, available at www.iosco.org.

⁶ 17 CFR 240.15c3-1.

disadvantages of using the term in many of our regulations. Foremost, there is a risk that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events,⁷ there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process. In light of this, the Commission proposes to amend the regulations.

We have identified a small number of rules and forms, however, where we believe it is appropriate to retain the reference to NRSRO ratings. These rules and forms generally relate to non-public reporting or recordkeeping requirements we use to evaluate the financial stability of large brokers or dealers or their counterparties and are unlikely to contribute to any undue reliance on NRSRO ratings by market participants.⁸

III. PROPOSED AMENDMENTS

We are proposing to remove references to NRSROs in the following rules and forms: Rule 3a1-1, Rule 10b-10, Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, Regulation ATS, Form ATS-R, Form PILOT, and Form X-17A-5 Part IIB.

A. Proposed Amendments to Rule 3a1-1, Regulation ATS, Form ATS-R, and Form PILOT

⁷ See Proposed Rules for National Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967.

⁸ These include Rules 15c3-1g(c)(1)(i), 15c3-1g(e)(2)(i), 17i-5, and 17i-8, which impose certain recordkeeping and reporting requirements for ultimate holding companies of broker-dealers and of supervised investment bank holding companies, and Forms 17-H and X-17A-5 Part IIB, which require reports regarding the risk exposures of large broker-dealers and OTC derivatives dealers.

In 1998, we established a new framework for the regulation of exchanges and alternative trading systems ("ATSs").⁹ That framework allowed an ATS to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with the requirements of Regulation ATS. As part of this framework, we adopted Rule 3a1-1 under the Exchange Act,¹⁰ Regulation ATS,¹¹ and Forms ATS and ATS-R.

Rule 3a1-1(a) provides an exemption from the Exchange Act definition of "exchange" – and thus the requirement to register as an exchange – for a trading system that, among other things, is in compliance with Regulation ATS.¹² Rule 3a1-1(b) contains an exception to the exemption from the exchange definition. Under this exception, the Commission may require a trading system that is a "substantial market" to register as a national securities exchange if it finds that such action is necessary or appropriate in the public interest or consistent with the protection of investors.¹³ Specifically, the Commission may – after notice to an ATS and an opportunity for it to respond – require the ATS to register as an exchange if, during three of the preceding four calendar quarters, the ATS had: (1) 50% or more of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading

⁹ See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Adopting Release").

¹⁰ 17 CFR 240.3a1-1.

¹¹ 17 CFR 242.300 to 242.303.

¹² See 17 CFR 240.3a1-1(a)(2).

¹³ See 17 CFR 240.3a1-1(b); Regulation ATS Adopting Release, 63 FR at 70857.

volume in any class of securities; or (2) 40% or more of the average daily dollar volume in any class of securities.¹⁴

As the Commission explained in the Regulation ATS Adopting Release, it was reserving the right to require a "dominant" ATS to register as an exchange.¹⁵ The Commission noted, for example, that "it may not be consistent with the protection of investors or in the public interest for a trading system that is the dominant market, in some important segment of the securities market, to be exempt from registration as an exchange if competition cannot be relied upon to ensure fair and efficient trading structures."¹⁶ The Commission also stated that it might be necessary to require an ATS to register as an exchange if it "would create systemic risk or lead to instability in the securities markets' infrastructure."¹⁷ The Commission made clear that its authority under Rule 3a1-1 was discretionary: "Although the standard for denying or withholding the exemption is based on objective factors, the Commission has discretion to initiate any process to consider whether to revoke a particular entity's exemption under the rule."¹⁸ Thus, while observing that some ATSS likely were above the volume thresholds of Rule 3a1-1, the Commission did not at the time believe it was appropriate to revoke the exemption for any such ATS.¹⁹

¹⁴ See 17 CFR 240.3a1-1(b)(1).

¹⁵ See 63 FR at 70857.

¹⁶ Id. at 70858.

¹⁷ Id.

¹⁸ Id. at 70857-58.

¹⁹ See id. at 70858.

The Commission set forth eight classes of securities in any one of which an ATS might achieve "dominant" status: (1) equity securities; (2) listed options; (3) unlisted options; (4) municipal securities; (5) investment grade corporate debt securities; (6) non-investment grade corporate debt securities; (7) foreign corporate debt securities; and (8) foreign sovereign debt securities.²⁰ Under the definitions provided in Rule 3a1-1, investment grade and non-investment grade corporate debt securities have three elements in common. They are securities that: (1) evidence a liability of the issuer of such security; (2) have a fixed maturity date that is at least one year following the date of issuance; and (3) are not exempted securities, as defined in Section 3(a)(12) of the Exchange Act.²¹ The distinguishing characteristic of an investment grade corporate debt security under our current rules is that it has been rated in one of the four highest categories by at least one NRSRO. A non-investment grade corporate debt security under our current rules is a corporate debt security that has not received such a rating.

We preliminarily believe that distinguishing investment grade corporate debt securities and non-investment grade corporate debt securities as separate classes of securities under Rule 3a1-1 is not necessary to fulfill the purposes of that rule. We preliminarily believe instead that combining all corporate debt securities into a single class for purposes of assessing whether an alternative trading system is "dominant" is appropriate. Accordingly, we propose to amend Rule 3a1-1 by replacing paragraphs (b)(3)(v) and (b)(3)(vi) which define investment grade corporate debt securities and non-investment grade debt securities,

²⁰ See 17 CFR 240.3a1-1(b)(3).

²¹ Compare 17 CFR 240.3a1-1(b)(3)(v) with 17 CFR 240.3a1-1(b)(3)(vi).

respectively, with a single category "corporate debt securities" in paragraph (b)(3)(v).²² This new definition would retain verbatim the three elements common to the existing definitions of investment grade and non-investment grade debt securities. The 5% and 40% thresholds also would remain unchanged. Under the proposed amendment to Rule 3a1-1, the Commission could, for example, determine that an ATS must register as an exchange if the system had – during three of the preceding four calendar quarters – 50% or more of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading volume in corporate debt securities, or 40% of the average daily dollar trading volume in corporate debt securities.²³

The Commission preliminarily believes that exceeding a volume threshold for a combined class of all corporate debt securities would be a sufficient indication that an ATS should be required to register as an exchange, and that it is not necessary or appropriate to assess trading volumes in the narrower segments of investment grade and non-investment grade corporate debt securities. While the proposed amendment could reduce the likelihood that an ATS could be required to register as an exchange,²⁴ we preliminarily believe that this

²² Existing paragraphs (b)(3)(vii) and (b)(3)(viii) would be unchanged but redesignated as paragraphs (b)(3)(vi) and (b)(3)(vii), respectively.

²³ The other six classes of securities – equity securities, listed options, unlisted options, municipal securities, foreign corporate debt securities, and foreign sovereign debt securities – would remain unchanged. Therefore, as under existing Rule 3a1-1, the Commission also could determine that an ATS must register as an exchange if the system exceeded either volume threshold in any of these other classes of securities.

²⁴ For example, under existing Rule 3a1-1, an ATS that has 40% of the average daily dollar trading volume in non-investment grade corporate debt securities and 0% of the average daily dollar trading volume in investment grade corporate debt securities for three consecutive months could be required by the Commission to register as an exchange. Under the proposed amendment, the Commission could not do so because the ATS's combined average daily dollar trading volume in corporate debt securities would be less than 40%.

change would nevertheless be appropriate. At this time, there does not appear to be a continuing need to analyze "dominance" in separate classes of investment grade and non-investment grade corporate debt securities, particularly in view of the fact that the Commission would continue to analyze for dominance in six other classes of securities (in addition to the new single class for corporate debt securities). The Commission notes that, in over nine years since the adoption of Rule 3a1-1, the Commission has never determined to require an ATS to register as an exchange because it had become "dominant." Moreover, the Commission would continue to be able to exercise discretion about whether to revoke the exemption for any ATS that exceeded either threshold in Rule 3a1-1. The Commission seeks comment on whether, in light of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class, it should adopt lower thresholds at which an ATS that trades corporate debt securities should be required to register as an exchange. If so, what should those thresholds be and why?

We are proposing similar changes to Regulation ATS, which establishes certain requirements applicable to ATSs that choose to register as broker-dealers and comply with Regulation ATS in lieu of exchange registration. Rule 301(b)(5) of Regulation ATS imposes a "fair access" requirement, whereby an ATS that exceeds certain volume thresholds in any class of securities must establish written standards for granting access to trading on its system and not unreasonably prohibit or limit any person in respect to access to the services it offers.²⁵ The fair access standard applies if an ATS has 5% or more of the average daily volume during at least four of the preceding six calendar months in any of the following: (1)

²⁵ See 17 CFR 242.301(b)(5).

any individual NMS stock;²⁶ (2) any individual equity security that is not an NMS stock and for which transactions are reported to a self-regulatory organization; (3) municipal securities; (4) investment grade corporate debt securities; and (5) non-investment grade corporate debt securities.²⁷ The terms investment grade and non-investment grade debt security are defined in Rule 300 of Regulation ATS.

We propose to amend Rules 300 and 301(b)(5) to establish a single class of corporate debt securities and to eliminate the existing separate classes of investment grade and non-investment grade corporate debt securities. Accordingly, paragraphs (i) and (j) of Rule 300 would be replaced with a new paragraph (i) defining "corporate debt security" to mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; and (3) is not an exempted security, as defined in Section 3(a)(12) of the Exchange Act. Existing paragraphs (i)(D) and (i)(E) of Rule 301(b)(5) would be replaced with a new paragraph (i)(D) providing that an ATS must comply with the access requirements set out in Rule 301(b)(5) if, with respect to corporate debt securities, such system accounts for 5% or more of the average daily volume traded in the United States for the requisite number of months. The 5% threshold at which an

²⁶ See 17 CFR 240.600(a)(47) (defining "NMS stock").

²⁷ In proposing Regulation ATS, the Commission requested comment "on whether categories of debt securities should be further divided based on an instrument's maturity, credit rating, or other criteria." Securities Exchange Act Release No. 39884 (April 21, 1998), 63 FR 23504, 23519 (April 29, 1998). However, in adopting Regulation ATS, the Commission did not employ these narrower classes of debt securities. See Regulation ATS Adopting Release, 63 FR at 70873.

ATS would have to grant fair access to its system also would remain unchanged.²⁸ As with the proposed changes to Rule 3a1-1, the other classes of securities would remain unchanged.

In addition, Rule 301(b)(6) of Regulation ATS²⁹ requires an ATS that exceeds certain volume thresholds in any class of securities to comply with standards regarding the capacity, integrity, and security of its automated systems. Five classes of securities are currently identified in Rule 301(b)(6): (1) NMS stocks; (2) equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization; (3) municipal securities; (4) investment grade corporate debt securities; and (5) non-investment grade corporate debt securities.³⁰ Consistent with the other proposed changes to Regulation ATS, the Commission also proposes to eliminate separate classes for investment grade and non-investment grade debt securities in Rule 301(b)(6) and replace them with a single category for "corporate debt securities," which would be defined in Rule 300. Existing paragraphs (i)(D) and (i)(E) of Rule 301(b)(6) would be replaced with a new paragraph (i)(D) providing that an ATS must comply with the capacity, integrity, and security requirements of Rule 301(b)(6) if, with respect to corporate debt securities, such system accounts for 20% or more of the average daily volume traded in the United States for the requisite number of months. The 20% threshold and the other three classes of securities would remain unchanged.

For the same reasons we are proposing to amend Rule 3a1-1, we preliminarily believe that these proposed amendments to Regulation ATS would be appropriate, and that a volume

²⁸ When the Commission originally adopted Regulation ATS, it set the fair access threshold at 20%. It later lowered the threshold to 5% in connection with the adoption of Regulation NMS. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37550 (June 29, 2005).

²⁹ 17 CFR 242.301(b)(6).

³⁰ 17 CFR 242.301(b)(6)(i).

threshold for a combined class of all corporate debt securities would be sufficient for the fair access requirement and the capacity, integrity, and security requirements. The Commission preliminarily believes that the purposes of Regulation ATS would still be fulfilled if investment grade and non-investment grade corporate debt securities were combined into a single class. ATSS would continue to be subject to the fair access requirements and the capacity, integrity, and security requirements with respect to the other existing classes of securities and at the same volume thresholds (5% and 20%, respectively). The Commission seeks comment on whether, in light of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class, it should adopt lower thresholds for fair access and the capacity, security, and integrity requirements under Regulation ATS. If so, what should those thresholds be and why?

We are also proposing revisions to Form ATS-R, which is used by ATSS to report certain information about their activities on a quarterly basis.³¹ Currently, Form ATS-R requires each ATS to report the total unit volume and total dollar volume in the previous quarter for various categories of securities, including investment grade and non-investment grade corporate debt securities. Consistent with the proposed amendments to Regulation ATS described above, we also propose to revise Form ATS-R to eliminate the separate categories for investment grade and non-investment grade corporate debt securities, and instead create a single category for "corporate debt securities." As with the proposed changes to Regulation ATS, "corporate debt securities" would be defined in the instructions to Form ATS-R to mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; and (3) is not

³¹ Each ATS must file a Form ATS-R within 30 days of the end of each calendar quarter, and within ten days of a cessation of operations. See 17 CFR 242.301(b)(9).

an exempted security, as defined in Section 3(a)(12) of the Exchange Act. Because separate classes for investment grade and non-investment grade corporate debt securities are proposed to be eliminated for purposes of the thresholds in Rule 3a1-1 and Rules 301(b)(5) and 301(b)(6) of Regulation NMS, no purpose would be served by requiring ATSS to separately report their trading volumes for investment grade and non-investment grade debt securities on Form ATS-R. The figures for the separate classes would be added together and reported as a single item on the amended form. The Commission is not proposing any other changes to Form ATS-R.

We are also proposing to revise Form PILOT consistent with the proposed changes to Form ATS-R. Ordinarily, Section 19 of the Exchange Act³² and Rule 19-4 thereunder³³ require a self-regulatory organization ("SRO") to file with the Commission proposed rule changes on Form 19b-4 regarding any changes to any material aspect of its operations, including any trading system. Rule 19b-5 under the Exchange Act³⁴ sets forth a limited exception to that requirement by permitting an SRO to operate a pilot trading system without filing proposed rule changes with respect to that system if certain criteria are met. One of those criteria is that the SRO file a Form PILOT in accordance with the instructions on that form. Like Form ATS-R, Form PILOT currently requires quarterly reporting of trading activity by classes of securities, including investment grade and non-investment grade corporate debt securities. For the same reasons we propose to amend Rule 3a1-1 and Regulation ATS, we also propose to revise Form PILOT to eliminate these two categories,

³² 15 U.S.C. 78s.

³³ 17 CFR 240.19b-4.

³⁴ 17 CFR 240.19b-5.

replacing them with a single category of "corporate debt securities." Corporate debt securities would be defined identically in Form PILOT and Form ATS-R. The Commission preliminarily believes that it is appropriate to obtain trading volumes from pilot trading systems for the combined class of corporate debt securities, and that separate reporting of the two classes is not necessary to adequately monitor the development of pilot trading systems. The Commission notes that, in over nine years since Rule 19b-5 and Form PILOT were adopted, no SRO has ever established a pilot trading system pursuant to Rule 19b-5 to trade corporate debt securities.

We generally request comment on all aspects of the proposed elimination of the reference to NRSRO ratings in Rule 3a1-1, Regulation ATS, Form ATS-R, and Form PILOT. In addition, we request comment on the following specific questions:

- Would the proposed amendments to Rule 3a1-1 have any significant impact on investors, market participants, the national market system, or the public interest?
- Would the proposed amendments to Regulation ATS have any significant impact on investors, market participants, the national market system, or the public interest?
- Would the proposed amendments affecting the fair access standards have other consequences, whether on investors, market participants, the national market system, or the public interest? Have investors experienced difficulty obtaining access to ATSS trading corporate debt securities? Would the proposed amendments impair or limit current investor access to ATSS?
- Would the proposed changes to Regulation ATS as they relate to the capacity, integrity, and security requirements have any adverse impact on investors, market participants, or the national market system as a whole?

- In view of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class for purposes of Rule 3a1-1 and Regulation ATS, should the Commission also lower the thresholds in those rules for the combined class of corporate debt securities? If so, what should those thresholds be? Why are those suggested thresholds appropriate?
- Should the Commission retain investment grade and non-investment grade corporate debt securities as separate classes of securities under Rule 3a1-1 and Regulation ATS and instead use a different definitions of those terms that do not rely on NRSRO ratings? If so, how should investment grade and non-investment grade be defined?
- Would the proposed amendments to Form ATS-R or Form PILOT have any significant impact on investors, market participants, the national market system, or the public interest?

B. Proposed Amendments to Rule 10b-10

We propose to amend Rule 10b-10,³⁵ the transaction confirmation rule for broker-dealers, to delete paragraph (a)(8) of that rule.³⁶ Rule 10b-10 generally requires broker-dealers that effect transactions for customers in securities, other than U.S. savings bonds or municipal securities, which are covered by Municipal Securities Rulemaking Board rule G-15 (which applies to all municipal securities brokers and dealers), to provide customers with written notification, at or before the completion of each transaction, of certain basic transaction terms. This transaction confirmation must disclose, among other information:

³⁵ 17 CFR 240.10b-10.

³⁶ Consistent with that change, we also are proposing to redesignate paragraph (a)(9) of the rule, related to broker-dealers that are not members of the Securities Investor Protection Corporation (“SIPC”), as paragraph (a)(8).

the date of the transaction; the identity, price, and number of shares bought or sold³⁷; the capacity of the broker-dealer;³⁸ the dollar price or yield at which a transaction in a debt security was effected;³⁹ and, under specified circumstances, the amount of compensation paid to the broker-dealer and whether the broker-dealer receives payment for order flow.⁴⁰

The rule's requirements, portions of which have been in effect for over 60 years, provide basic investor protections by conveying information that allows investors to verify the terms of their transactions, alerts investors to potential conflicts of interest with their broker-dealers, acts as a safeguard against fraud, and provides investors a means to evaluate the costs of their transactions and the execution quality.⁴¹

Paragraph (a)(8) of Rule 10b-10 requires transaction confirmations for debt securities, other than government securities, to inform the customer if the security is unrated by an NRSRO. When we adopted paragraph (a)(8) in 1994, it was intended to prompt a dialogue between the customer and the broker-dealer if the customer had not previously been informed of the unrated status of the debt security. We stated that this disclosure was not intended to suggest that an unrated security is inherently riskier than a rated security.⁴² Upon

³⁷ See 17 CFR 240.10b-10(a)(1) (the confirmation must also include either the time of the transaction or the fact that it will be furnished upon written request).

³⁸ See 17 CFR 240.10b-10(a)(2).

³⁹ See 17 CFR 240.10b-10(a)(5) and (6).

⁴⁰ See, e.g., 17 CFR 240.10b-10(a)(2)(i)(B), (C) and (D).

⁴¹ See Securities Exchange Act Release No. 34962 (November 10, 1994), 59 FR 59612, 59613 (November 17, 1994).

⁴² See Securities Exchange Act Release No. 34962 (November 10, 1994), 59 FR 59612 (November 17, 1994) (File No. S7-6-94).

further consideration and in light of present concerns regarding undue reliance on NRSRO ratings and confusion about the significance of those ratings, we believe it would be appropriate to delete this requirement. However, in proposing to no longer require broker-dealers to include in transaction confirmations the information that a debt security is unrated, we do not mean to suggest that information about an issuer's creditworthiness is not a relevant subject for discussion and consideration prior to purchasing a debt security. We would encourage investors to seek to understand all of the risks of securities, including credit-related risks, before buying. In addition, we note that deleting this requirement would not prevent broker-dealers from voluntarily continuing to include this information in transaction confirmations.

We generally request comment on all aspects of the proposed elimination of the NRSRO reference in Rule 10b-10. In addition, we request comment on the following specific questions:

- Have investors have found confirmation disclosure about the fact that a debt security is not rated by an NRSRO to be useful?
- Are there any possible alternatives to deletion that would address concerns about undue reliance on NRSRO ratings or avoid confusion about the significance of those ratings? For example, should the confirmation disclose that the security is rated or not rated by an NRSRO, as the case may be, instead of just that the security is not rated?

C. Proposed Amendments to Rule 15c3-1

Under the Net Capital Rule, broker-dealers are required to maintain, at all times, a minimum amount of net capital. The rule generally defines "net capital" as a broker-dealer's

net worth (assets minus liabilities), plus certain subordinated liabilities, less certain assets that are not readily convertible into cash (e.g., fixed assets), and less a percentage (haircut) of certain other liquid assets (e.g., securities).⁴³ Broker-dealers are required to calculate net worth using generally accepted accounting principles.

In computing their net capital under the provisions of the Net Capital Rule, broker-dealers are required to deduct from their net worth certain percentages of the market value of their proprietary securities positions. A primary purpose of these “haircuts” is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions. We apply a lower haircut to certain types of securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute since those securities typically were more liquid and less volatile in price than securities that were not so highly rated.⁴⁴

We are proposing to remove, with limited exceptions, all references to NRSROs from the Net Capital Rule.⁴⁵ The broker-dealers subject to the Net Capital Rule are sophisticated

⁴³ See 17 CFR 240.15c3-1(c)(2).

⁴⁴ See 17 CFR 240.15c3-1(c)(2)(vi)(E) (haircuts applicable to commercial paper), 17 CFR 240.15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities), and 17 CFR 240.15c3-1(c)(2)(vi)(H) (haircuts applicable to cumulative nonconvertible preferred stock). The term NRSRO is also used in appendices to the Net Capital Rule. See 17 CFR 240.15c3-1a(b)(1)(i)(C) (defining the term “major market foreign currency”) and 17 CFR 240.15c3-1f(d) (determining the capital charge for credit risk arising from certain OTC derivatives transactions).

⁴⁵ In 2003, the Commission published a concept release in which we sought comment on the use of NRSRO ratings in our rules, and specifically sought comment on eliminating the minimum quality standards established with the use of NRSRO ratings in Exchange Act Rule 15c3-1. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Securities Exchange Act Release No. 47972 (June 4, 2003), 68 FR 35258 (June 12, 2003). (Comments on the concept release are available at: <http://www.sec.gov/rules/concept/s71203.shtml>.) As discussed above, recent events have

market participants regulated by at least one SRO.⁴⁶ As regulated entities, broker-dealers must meet certain financial responsibility requirements, including maintaining minimum amounts of liquid assets as net capital, safeguarding customer funds and securities, and making and preserving accurate books and records. Accordingly, we preliminarily believe that broker-dealers would be able to assess the creditworthiness of the securities they hold without undue hardship and, therefore, that exclusive reliance on NRSRO ratings for the purposes of the Net Capital Rule is no longer necessary, although broker-dealers that wish to continue to rely on such ratings may do so.

We are proposing the substitution of two new subjective standards for the NRSRO ratings currently relied upon under the Net Capital Rule. For the purposes of determining the haircut on commercial paper,⁴⁷ we propose to replace the current NRSRO ratings-based criterion -- being rated in one of the three highest rating categories by at least two NRSROs -- with a requirement that the instrument be subject to a minimal amount of credit risk and have sufficient liquidity such that it can be sold at or near its carrying value almost immediately. For the purposes of determining haircuts on nonconvertible debt securities as well as on preferred stock,⁴⁸ we propose to replace the current NRSRO ratings-based criterion -- being rated in one of the four highest rating categories by at least two NRSROs --

highlighted the need to revisit our reliance on NRSRO ratings in the context of these developments. See also the extensive discussion of market developments in the Release No. 57967.

⁴⁶ The SROs regulating broker-dealers include the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, and the national securities exchanges.

⁴⁷ See 17 CFR 240.15c3-1(c)(2)(vi)(E).

⁴⁸ See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1) and (c)(2)(vi)(H).

with a requirement that the instrument be subject to no greater than moderate credit risk and have sufficient liquidity such that it can be sold at or near its carrying value within a reasonably short period of time. This latter formulation would apply as well to long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest.⁴⁹

We preliminarily believe that these new standards would continue to advance the purpose the NRSRO ratings-based standards were designed to advance, which is to enable broker-dealers to make net capital computations that reflect the market risk inherent in the positioning of those particular types of securities. The prior standards- being rated in one of the three or four highest rating categories by at least two NRSROs- were designed based on the practice of many credit rating agencies to have at least eight categories for their debt securities with the top four commonly referred to as “investment grade.”⁵⁰ While the proposed standards, like the prior standards, do not use the term “investment grade,” they are meant to serve the same purpose as the prior standards. As such, the category of securities that have “no greater than moderate credit risk” and can be sold at or near their carrying value within a reasonably short period of time should encompass all investment grade securities. The proposed new criteria for commercial paper to be used for net capital purposes are securities that are “subject to a minimal amount of credit risk” and can be sold at or near their carrying value almost immediately. In each case, the proposed liquidity

⁴⁹ See 17 CFR 240.15c3-1(c)(2)(vi)(F)(2).

⁵⁰ See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

standard would reflect the fact that only liquid assets are relevant for the purposes of the Net Capital Rule.

We further believe that broker-dealers have the financial sophistication and the resources necessary to make the basic determinations of whether or not a security meets the requirements in the proposed amendments and to distinguish between securities subject to minimal credit risk and those subject to moderate credit risk. The broker-dealer would have to be able to explain how the securities it used for net capital purposes meet the standards set forth in the proposed amendments.

Notwithstanding our belief that broker-dealers have the financial sophistication and the resources to make these determinations, we believe it would be appropriate, as one means of complying with the proposed amendments, for broker-dealers to refer to NRSRO ratings for the purposes of determining haircuts under the Net Capital Rule. As such, if we adopt the proposed amendments, after considering comments, we expect to take the view in the adopting release that securities rated in one of the three highest categories by at least two NRSROs would satisfy the requirements of proposed new paragraph (c)(2)(vi)(E) and securities rated in one of the four highest rating categories by at least two NRSROs to satisfy the requirements of proposed new paragraphs (c)(2)(vi)(F) and (c)(2)(vi)(H). We emphasize, however, that references to such NRSRO ratings would be just one means of satisfying the requirements of the proposed amendments but would not be the only means of doing so.

We are also proposing to remove references to NRSRO ratings from Appendices E and F to Rule 15c3-1 and make conforming changes to Appendix G of Rule 15c3-1 and the General Instructions to Form X-17 A-5, Part IIB.⁵¹ Appendix E of the Net Capital Rule sets

⁵¹ 17 CFR 240.15c3-1e, 240.15c3-1f, and 240.15c3-1g; see 17 CFR 249.617.

forth a program that allows a broker-dealer to use an alternative approach to computing net capital deductions, subject to certain conditions, most importantly the broker-dealer's ultimate holding company consenting to group-wide Commission supervision as a consolidated supervised entity ("CSE").⁵² Appendix F to the Net Capital Rule sets forth a similar program for OTC derivatives dealers. In each case, the program sets forth an alternative means of establishing net capital requirements under the Net Capital Rule by which the broker-dealer or OTC derivatives dealer, as applicable, may elect to determine counterparty risk. This may be done either based on NRSRO ratings by requesting Commission approval to determine credit risk weights based on internal calculations.

We are proposing to delete the provisions of Appendices E and F permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, a broker-dealer that is part of a CSE or a OTC derivatives dealer that wished to use the approach set forth Appendix E or F, respectively, to determine counterparty risks would be required, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit risk weights based on internal calculations. Based on the strength of the broker-dealer/CSE or OTC derivatives dealer's internal credit risk management system, we may approve the application. A broker-dealer or OTC derivatives dealer that obtained such approval would be required to make and keep current a record of the basis for the credit risk weight of each counterparty. To date, a total of seven entities have applied for and been granted permission to use the methods set forth in Appendix E, while five have applied for and been granted permission to use the methods set forth in Appendix F. We do not currently anticipate that any additional firms

⁵² See 17 CFR 240.15c3-1e.

will apply for permission to use either Appendix E or Appendix F. All of the approved firms have already developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in the appendices as well as internal risk management control systems.⁵³ As such, each firm already employs the non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for determining counterparty credit risk under Appendices E and F. We are also proposing conforming amendments to Appendix G of Rule 15c3-1 and the General Instructions to Form X-17 A-5, Part IIB. The proposed amendments would delete references to the provisions of Appendices E and F, respectively, that are proposed to be deleted.

We generally request comment on all aspects of the proposed elimination of the use of NRSRO ratings in the Net Capital Rule. In addition, we request comment on the following specific questions:

- Would internal evaluations of individual debt securities by broker-dealers for purposes of determining the capital charges (“internal processes”) instead of reliance on NRSRO ratings accomplish the stated goals of the Commission’s net capital requirements?
- What are the benefits, other than those we have identified, of the use of internal processes?
- Besides the use of internal processes by broker-dealers, are there potential alternate means of establishing creditworthiness for the purposes of the Net

⁵³ See, e.g., Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Securities Exchange Act Release No. 49830 (June 8, 2004), 69 FR 33428 at 33456 (June 21, 2004).

Capital Rule without reference to NRSRO ratings? Commenters who believe that this is the case should include detailed descriptions of such alternate means.

- Are we correct in our preliminary belief that broker-dealers have the financial sophistication and the resources necessary to generate internal processes and make the basic determinations of whether or not a security meets the requirements in the proposed amendments and to distinguish between securities subject to minimal credit risk and those subject to moderate credit risk? If not, how should the proposed rule be modified to address those concerns?
- What would be the potential consequences of using internal processes for purposes of the net capital rule and how could these be addressed? For example, one concern is that a broker-dealer would have an incentive to downplay the credit risk associated with a particular security in order to minimize capital charges. How could this concern be addressed?
- If we provided for the use of internal processes, should we require that the persons responsible for developing a broker-dealer's internal processes and applying them to individual securities for the purposes of the Net Capital Rule be separate from employees who perform other functions for the broker-dealer, such as making proprietary investment decisions for the broker-dealer?
- What would be the appropriate level of regulatory oversight for broker-dealers employing internal processes?
- Should we require any policies and procedures with regard to the basic determinations as to whether a security meets the standards in the proposed amendments?

- Should we explicitly define the terms used in the proposed new standards in Rules 15c3-1(c)(2)(vi)(E), (F), and (H)?
- If we adopt the proposed standards, would broker-dealers find it useful to employ market-based models, including models using credit spreads to satisfy the requirements of the proposed standards? Should we provide guidance about the use of these models?
- What is the likelihood that small broker-dealers would purchase credit ratings or the models used to develop those ratings from large broker-dealers?
- If we adopt the proposed amendments after considering comments, should we take the view in the adopting release that securities rated in one of the three highest categories by at least two NRSROs satisfy the requirements of proposed new paragraph (c)(2)(vi)(E) and securities rated in one of the four highest rating categories by at least two NRSROs to satisfy the requirements of proposed new paragraphs (c)(2)(vi)(F) and (c)(2)(vi)(H)? Commenters should include detailed descriptions of any subset of broker-dealers they believe should be able to continue to rely on NRSRO ratings and the rationale therefor.
- What factors should we take into account when considering the potential regulatory compliance costs of removing references to NRSROs from the Net Capital Rule? Commenters should include detailed descriptions of any potential costs.

D. Proposed Amendment to Rule 15c3-3

Note G to Exhibit A of Rule 15c3-3 under the Exchange Act (the “Customer Protection Rule”), which provides the formula for the determination of broker-dealers’

reserve requirements, allows a broker-dealer to include as a debit in the formula the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that maintains the highest investment grade rating from an NRSRO.⁵⁴ This standard, which is one of four different means by which a registered clearing or derivatives organization can be judged to meet the requirements of paragraph (b)(1) of Note G,⁵⁵ is consistent with the customer protection function of Rule 15c3-3 and is necessary because of the unsecured nature of the customer positions in security futures products margin debit. We propose to replace this standard with a requirement that the registered clearing or derivatives organization to which customers' positions in security futures products are posted has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk.

We preliminarily believe that these new standards would continue to advance the purpose the NRSRO-ratings standard was designed to advance, namely to ensure both of the long-term financial strength of a clearing organization to which customers' positions in security futures products are posted and its general creditworthiness.⁵⁶ Although the rule was

⁵⁴ 17 CFR 240.15c3-3a(b)(1)(i).

⁵⁵ A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (2) that maintains at least \$3 billion in margin deposits; or (3) which does not meet the other requirements but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a(b)(1)(ii) - (iv).

⁵⁶ See Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products, Securities Exchange Act Release No. 50295 (August 31, 2004), 69 FR 54182, 54185 (September 7, 2004).

originally designed to provide an indication of long-term financial strength and general creditworthiness from an independent source,⁵⁷ we preliminarily believe that broker-dealers, as sophisticated market participants and regulated entities that are subject to financial responsibility requirements, have the financial sophistication and the resources necessary to make this determination. The broker-dealer would have to be able to explain how the registered clearing or derivatives organization to which customers' positions in security futures products are posted meets the standard in the proposed amendment.

We also believe, however, that it would be appropriate, as one means of complying with the proposed amendment, for broker-dealers to refer to NRSRO ratings for the purposes of paragraph (b) of Note G. As such, if we adopt the proposed amendments after considering comments, we expect to take the view in the adopting release that we would continue to consider a registered clearing agency or derivatives clearing organization that maintains the highest investment-grade rating from an NRSRO to satisfy the requirements of that provision. We emphasize, however, that the references to such NRSRO ratings would be just one means of satisfying the requirements of the proposed amendments and would not be the only means of doing so.

We request comment on the following specific questions in connection with Exhibit A to the Customer Protection Rule:

- As an alternative to relying on an NRSRO rating to distinguish the creditworthiness of a registered clearing agency or derivatives clearing organization, should we prescribe a minimum net worth or asset test for the organizations? Alternatively, should we prescribe a test based on a minimum level of members of the organization

⁵⁷ *Id.*

or minimum level of clearing deposits held by the organization? Commenters that support any of these proposals should provide details (e.g., the minimum levels in dollar amounts) as to how they should be implemented.

- Would it be more appropriate to delete current paragraph (b)(1)(i) of Note G to Exhibit A to the Customer Protection Rule in its entirety? Put differently, do the guidelines offered by current paragraphs (b)(1)(ii) - (iv) of Note G in and of themselves provide sufficient means by which a registered clearing or derivatives organization could be judged to meet the requirements of paragraph (b)(1) of Note G?
- If we adopted the proposed amendment to Note G to Exhibit A of Rule 15c3-3, should we explicitly define the terms used in the proposed new standard?
- Is it appropriate to allow broker-dealers to make the determination of whether a clearing organization possesses the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk? If not, what are suggested ways that the proposed rule could be amended to address that concern?
- Should we require any policies and procedures with regard to the determination whether a registered clearing or derivatives organization meets the standard in the proposed amendment?
- What would be the potential consequences of allowing broker-dealers to determine whether a clearing organization possessed the highest capacity to meet its financial obligations and was subject to no greater than minimal credit risk and how could these be addressed? For example, one concern is that a broker-dealer would have an incentive to downplay the credit risk associated with a particular clearing

organization in order to be able to post customers' positions in security futures products to it. How could this concern be addressed?

- If we adopt the proposed amendments after considering comments, should we take the view in the adopting release that we would consider a registered clearing agency or derivatives clearing organization that maintains the highest investment-grade rating from an NRSRO to satisfy the requirements of that provision? Commenters should include detailed descriptions of any subset of broker-dealers they believe should be able to continue to rely on NRSRO ratings and the rationale therefore.
- What factors should we take into account when considering the potential regulatory compliance costs of removing references to NRSROs from paragraph (b)(1) of Note G to Rule 15c-3a? Commenters should include detailed descriptions of any potential costs.

E. Proposed Amendments to Rules 101 and 102 of Regulation M

1. Regulation M

As a prophylactic, anti-manipulation set of rules, Regulation M is designed to protect the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for the offered security. Rules 101 and 102 of Regulation M specifically prohibit issuers, selling security holders, underwriters, brokers, dealers, other distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce

another person to bid for or purchase, a covered security until the applicable restricted period has ended.⁵⁸

2. Current Rule 101(c)(2) and Rule 102(d)(2) Exceptions

Both rules currently except “investment grade nonconvertible and asset-backed securities.”⁵⁹ These exceptions apply to nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade.⁶⁰ The current exceptions for certain investment grade debt and preferred securities rated by a NRSRO were originally based on the premise that these securities are traded on the basis of their yields and credit ratings, are largely fungible and, thus, are less likely to be subject to manipulation.⁶¹ With respect to asset-backed securities, the current exceptions were premised on the fact that asset-backed securities also trade primarily on the basis of yield and credit rating and that asset-backed securities investors are concerned with “the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities.”⁶²

3. Proposed Amendments’ Elimination of the NRSRO Reference

⁵⁸ “Covered security” is defined as “any security that is the subject of a distribution or any reference security.” 17 CFR 242.100.

⁵⁹ 17 CFR 242.101(c)(2) and 242.102(d)(2).

⁶⁰ Id.

⁶¹ Securities Exchange Act Release No. 19565 (March 4, 1983); 48 FR 10628 (March 14, 1983). See also Securities Exchange Act Release No. 18528 (March 3, 1982); 47 FR 11482 (March 16, 1982).

⁶² Securities Exchange Act Release No. 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).

In light of our effort to reduce undue reliance on NRSRO ratings, we believe that it is appropriate to alter the current exceptions in Rules 101 and 102 to eliminate the reference to NRSROs. We propose to remove Rules 101 and 102's current exceptions for investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities based on NRSRO ratings. In place of those exceptions, we propose new exceptions for nonconvertible debt securities and nonconvertible preferred securities based on the "well-known seasoned issuer" ("WKSI") concept of Securities Act of 1933 ("Securities Act") Rule 405.⁶³ We are also proposing to except asset-backed securities from Rules 101 and 102 if those securities are registered on Form S-3.⁶⁴

The proposed exceptions continue to be based on the premise that these securities are traded on factors such as their yields and are largely fungible. In addition we believe that the marketplace is more likely to have access to a significant amount of useful and high-quality public information concerning these securities that may assist investors in assessing the creditworthiness of the issuer on their own without needing to unduly rely on a NRSRO.⁶⁵ We understand that WKSI and Form S-3 issuers are some of the largest and highest quality issuers of nonconvertible debt, nonconvertible preferred securities and asset backed securities which makes default generally less likely. But the availability of this information or quality of underlying assets is not enough to justify the exceptions in and of itself, the security must

⁶³ 17 CFR 230.405.

⁶⁴ Asset-backed securities are defined out of the WKSI standard at subparagraph (1)(iv) of the definition and, further, could not meet the requirements of (1)(i)(A) or (B) of the definition because they are generally one-time issuers. Id.

⁶⁵ See Securities Exchange Act Release No. 52056 (July 19, 2005); 70 FR 44722 (August 3, 2005). See also Note 61, infra.

also trade in such a way that it is resistant to manipulation. This is why we are proposing to continue to limit these exceptions to nonconvertible debt, nonconvertible preferred, and asset-backed securities as those securities trade largely on the basis of their yield and are largely fungible.

a. Proposed Rules 101(c)(2)(i) and 102 (d)(2)(i) –Nonconvertible debt and preferred securities

The proposed exceptions for nonconvertible debt and nonconvertible preferred securities would require that the issuer of such securities meet the requirements of the WKSI definition and meet the requirements for nonconvertible securities other than common equity in paragraph (1)(i)(B)(1) of the definition of WKSI in Rule 405. As proposed, the exceptions would be available for nonconvertible debt or nonconvertible preferred securities issued by a WKSI issuer, regardless of the method the issuer used to attain WKSI status. However, in order to rely on the proposed exceptions, the security must be issued by an issuer who also meets the requirements of paragraph (1)(i)(B)(1) of the definition of WKSI in Rule 405.⁶⁶ This would require that the issuer have issued at least \$1 billion aggregate principal amount of nonconvertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act.⁶⁷ This would limit the exceptions to securities whose issuers have an existing public market in nonconvertible securities other than common equity that is publicly known and followed and, thus, are less likely to be subject to manipulation.

⁶⁶ A nonconvertible debt or nonconvertible preferred security issued by an issuer who is a WKSI based on the common equity calculation in paragraph (1)(i)(A) of the definition of WKSI in Rule 405 would still be able to rely on the proposed exception if the issuer can also meet the requirements of paragraph (1)(i)(B)(1) of the definition of WKSI in Rule 405.

⁶⁷ 17 CFR 230.405, paragraph (1)(i)(B)(1) of the definition of WKSI.

With respect to these proposed exceptions for nonconvertible debt and non-convertible preferred securities utilizing a WKSI requirement, we have noted that WKSI issuers:

[A]re followed by sophisticated institutional and retail investors, members of the financial press, and numerous sell-side and buy-side analysts that actively seek new information on a continual basis. Unlike smaller or less mature issuers, large seasoned public issuers tend to have a more regular dialogue with investors and market participants through the press and other media. The communications of these well-known seasoned issuers are subject to scrutiny by investors, the financial press, analysts, and others who evaluate disclosure when it is made.⁶⁸

Thus, we believe that the nonconvertible debt and nonconvertible preferred securities that fall within the proposed exceptions should be resistant to manipulation because of their fungibility, trading based on yield, and this wide industry following.

b. Proposed Rules 101(c)(2)(ii) and 102(d)(2)(ii) – Asset-backed securities

The proposed changes to the asset-backed securities exceptions would require that the offer and sale of the security is registered using Form S-3.⁶⁹ We believe that the proposed amendments should provide exceptions to only those asset-backed securities that are approximately the equivalent quality of securities that are currently excepted from Rules 101 and 102. Additionally, the proposal is also based on the premise that asset-backed securities trade primarily on the basis of yield and that asset-backed securities investors are primarily concerned with the structure of the class of securities and the nature of the assets pooled to

⁶⁸ Securities Exchange Act Release No. 52056 (July 19, 2005); 70 FR 44722 (August 3, 2005).

⁶⁹ The Commission is also proposing to revise the General Instruction I.B.5 to Form S-3 (which sets the eligibility requirements for asset-backed securities to use that form) to remove references to NRSROs. Securities Act Release No. 8940 (July 1, 2008) (File No. 27-18-08).

serve as collateral for those securities and, thus, such securities are less likely to be subject to manipulation.⁷⁰

4. Bright-line Alternative / Existing Benchmarks

We believe that the proposed amendments are appropriate replacements for the NRSRO investment grade standard for the following reasons. We believe that the proposals will capture securities that are more likely to be resistant to manipulation similar to the current exceptions because they are based on same premises as the current exceptions (such as high liquidity and fungibility).⁷¹ Second, the proposals provide a bright line demarcation and objective criteria for the exceptions. As both the WKSI and Form S-3 standards as utilized by this proposal are established benchmarks, they should be familiar to those persons subject to Rules 101 and 102 and easily applied by such persons seeking to rely on the proposed exceptions. Thus, we believe that the proposals are comparable in scope to the existing exceptions but use alternate benchmarks that provide an equally bright line that is not unduly reliant on NRSRO ratings.

5. Comments

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support alternative recommendations. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches.

⁷⁰ These were the reasons that we originally excepted such securities. Securities Exchange Act Release No. 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).

⁷¹ See Securities Exchange Act Release Number 19565 (March 4, 1983); 48 FR 10628 (March 14, 1983); Securities Exchange Act Release Number 18528 (March 3, 1982); 47 FR 11482 (March 16, 1982); and Securities Exchange Act Release Number 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).

- Are the WKSI requirements appropriate for use in a trading (as opposed to disclosure) context? What effect(s) of the proposed exceptions, if any, would you anticipate in the investment grade debt market and the high-yield debt market?
- Should the Rule 101(c)(2) and 102(d)(2) exceptions be based on criteria other than the WKSI requirements for nonconvertible debt and nonconvertible preferred securities and Form S-3 registration for asset backed securities?
- Would the WKSI nonconvertible debt and nonconvertible preferred securities excepted in the proposal be as resistant to manipulation as those same securities that meet the existing investment grade standard?
- Please provide comment as to whether the proposal would capture the same type and quantity of securities that fall within the current Rule 101(c)(2) and Rule 102(d)(2) exceptions.
- Do the proposed WKSI and Form S-3 benchmarks adequately identify nonconvertible debt, nonconvertible preferred securities, and asset-backed securities that are of high quality with low default risk? Please distinguish the characteristics of nonconvertible debt, nonconvertible preferred securities, and asset-backed securities that meet these proposed benchmarks and those that do not.
- Is the proposed WKSI criterion easily applied by all persons subject to Rules 101 and 102 with respect to nonconvertible debt and nonconvertible preferred securities issued by issuers who are WKSI by virtue of \$700 million market value of common equity?
- Would persons other than issuers who are subject to Rules 101 and 102 have access to adequate information to determine if a particular security fits into the exceptions?

- Should asset-backed securities registered on Form S-3 be excepted from Rules 101 and 102 of Regulation M? Have there been developments in the asset-backed securities market that might indicate whether such securities should be eliminated from the proposed exceptions or should continue to be excepted from Rules 101 and 102?
- How frequently is the current asset-backed exception from Rules 101 and 102 relied upon?
- Is it appropriate to also except asset-backed securities registered on Form F-3? If yes, please explain.
- We ask for specific comment as to any relevant changes to the debt market since Regulation M was adopted in 1996 and the way debt issues are brought to market and trade.
- Do nonconvertible debt securities continue to trade based on their yield and fungibility? Nonconvertible preferred securities? Asset-backed securities? Are there other factors that influence the trading of such securities?

IV. REQUEST FOR COMMENT

We generally request comment on all aspects of our proposal to end our regulatory reliance on NRSRO credit ratings. In addition, we request comment on the following specific questions:

- Should we eliminate the NRSRO designation from all our rules or only from select rules? Commenters who believe that certain rules should retain references to NRSROs or NRSRO ratings should identify each rule they believe should retain the use of the NRSRO concept and explain the rationale for doing so.

- Does the use of the NRSRO designation in our rules cause investors to overly rely on NRSRO credit ratings? Would its elimination mitigate this over reliance?
- Does the use of the NRSRO designation in our rules adversely impact competition among credit rating agencies by favoring those agencies that are registered as NRSROs? Would its elimination mitigate this negative impact?

V. PAPERWORK REDUCTION ACT

Certain provisions of the proposed amendments to the rules and forms contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995.⁷² The hours and costs associated with preparing and filing the disclosure, filing the forms and schedules and retaining records required by these regulations constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The titles of the affected information forms are Rule 10b-10 Confirmation of Transactions," (OMB Control Number 3235-0444), Rule 15c3-1 (OMB Control Number 3235-0200), Rule 15c3-3 (OMB Control Number 3235-0078), Form ATS-R (OMB Control Number 3235-0509), Form PILOT (OMB Control Number 3235-0507), and Form X-17A-5, Financial and Operational Combined Uniform Single Report, Part IIB, OTC Derivatives Dealer (OMB Control Number 3235-0498). For the reasons discussed below, we do not believe the proposed amendments if adopted would result in a material or substantive revision to these collections of information.⁷³

The proposed amendments to Form ATS-R and Form PILOT would revise the forms to provide that information which is currently reported as separate items, i.e., investment

⁷² 44 U.S.C. 3501 et seq.

⁷³ 5 CFR 1320.5(g).

grade debt corporate debt securities and non-investment grade corporate debt securities, would be combined and reported as a single item, i.e., corporate debt securities. In all other respects, the information collected on these forms would remain unchanged. Accordingly, we do not believe the proposed amendment would result in a substantive revision to those collections of information if adopted.

The proposed amendment to Rule 10b-10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This proposed amendment would alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings. Moreover, the proposed amendment is not expected to change the cost of generating and sending confirmations, and, we believe that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, we do not believe the proposed amendment would result in a material or substantive revision to these collections of information if adopted.

The proposed amendment to Rules 15c3-1 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. The proposed amendment would replace NRSRO ratings-based criteria for evaluating creditworthiness with new subjective standards based on the broker-dealer's own evaluation of creditworthiness, although broker-dealers would still be able to refer to NRSRO ratings for those purposes. The broker-dealer would have to be able to

explain how the securities it used for net capital purposes meet the standards set forth in the proposed amendments. As such, we believe that firms would be required to develop (if they have not already) criteria for assessing the creditworthiness of securities to be included in net capital calculations and apply those criteria to such securities. In addition, the expectation that the broker-dealer be able to explain that any securities used for net capital purposes meet the standards set forth in the proposed amendments would result in the creation and maintenance of records of those assessments.

We believe that all broker-dealers already have policies and procedures in place for evaluating the overall risk and liquidity levels of the securities they use for the purposes of the Net Capital Rule and that they keep records of the assessments of securities they make for net capital purposes; however, the proposed requirements, which specifically address credit risk, could result in additional burdens. The proposed amendments would apply to the approximately 550 broker-dealers that take haircuts on securities pursuant to the Net Capital Rule. We estimate that on average, broker dealers will spend ten hours developing a system of standards for evaluating creditworthiness for the purposes of the Net Capital Rule, resulting in an aggregate initial burden of 5,500 hours. This estimate is based on our belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness, while others would continue to refer to NRSRO ratings as the basis of their creditworthiness decisions.

We further estimate that, on average, each broker-dealer will spend an additional ten hours a year reviewing, adjusting, and applying its own standards for evaluating creditworthiness, for a total of 5,500 annual hours across the industry. Once again, this estimate reflects our belief that many of these broker-dealers already have their own criteria in place, while others would continue to refer to NRSRO ratings. We also estimate that firms would employ compliance attorneys, in many cases

relying on outside counsel, to review these standards, both initially and on an annual basis. We estimate the per-firm costs of outside counsel to be \$2,700 initially and \$1,350 on an annual basis, for an aggregate industry cost of \$1,485,000 initially and \$742,500 on an annual basis.⁷⁴

We generally request comment on all aspects of these proposed estimates. In addition, we request specific comment on the following items related to these estimates:

- Are we correct in our hours estimates and our belief that many broker-dealers already have their own criteria in place for evaluating creditworthiness?
- Are we correct in our belief that some broker-dealers would continue to refer to NRSRO ratings as the basis of their creditworthiness decisions?
- Are we correct in our estimation that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?

The proposed amendments to the appendices of Rule 15c3-1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. Specifically, the proposed amendments to Appendices E and F of Rule 15c3-1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, an

⁷⁴ For the purposes of this analysis, we are using salary data from the Securities Industry and Financial Markets Association (“SIFMA”) Report on Management and Professional Earnings in the Securities Industry 2007, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. We believe that the legal reviews required by the proposed amendments would be performed by compliance attorneys at an average rate \$270 per hour. Furthermore, we believe that the review process will entail ten hours of initial work and five hours on an annual basis. $\$270 \times 10 = \$2,700$ $\times 550 = \$1,485,000$; $\$270 \times 5 = \$1,350$ $\times 550 = \$742,500$.

entity that wished to use the approach set forth in these appendices to determine counterparty risks would be required, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit risk weights based on internal calculations and make and keep current a record of the basis for the credit risk weight of each counterparty.

We do not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendix E or F. Although the collection of information obligations imposed by the proposed amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary. To date, a total of seven entities have applied for and been granted permission to use the methods set forth in Appendix E, while five have applied for and been granted permission to use the methods set forth in Appendix F. We do not currently anticipate that any additional firms will apply for permission to use either Appendix E or Appendix F. All of the approved firms have already developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in the appendices as well as internal risk management control systems.⁷⁵ As such, each firm already employs the non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for determining counterparty credit risk under Appendices E and F. Since each entity already employs its own models to calculate market and credit risk and keeps current a record of the

⁷⁵ See, e.g., Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Securities Exchange Act Release No. 49830 (June 8, 2004), 69 FR 33428 at 33456 (June 21, 2004).

basis for the credit risk weight of each counterparty, the proposed amendments would therefore not alter the paperwork burden currently imposed by Appendices E and F.

The proposed amendment to Note G of Exhibit A to Rule 15c3-3 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. Currently, Note G to Exhibit A of Rule 15c3-3 allows a broker-dealer to include, as a debit in the formula for determining its reserve requirements, the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that meets one of four standards, including maintaining the highest investment grade rating from an NRSRO.⁷⁶ The proposed amendment would replace the NRSRO ratings-based standard with a requirement that the registered clearing or derivatives organization has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk. As such, we believe that firms that previously relied on NRSRO ratings for the purposes of Note G would be required to develop criteria for assessing the creditworthiness of registered clearing or derivatives organizations and apply those criteria to such securities, although one means of complying with the proposed amendment would be for broker-dealers to refer to NRSRO ratings. In addition, the expectation that the broker-dealer be able to explain that any such clearing or derivatives organizations meets the standard set forth in the proposed amendment would result in the creation and maintenance of records of those assessments.

⁷⁶ See 17 CFR 240.15c3-3a, Note G, (b)(1)(i). A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (2) that maintains at least \$3 billion in margin deposits; or (3) which does not meet any of the other criteria but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a, Note G, (b)(1)(ii) - (iv).

In the final release adding Note G to Exhibit A of Rule 15c3-3, we estimated that approximately 102 firms would be required to comply with the provisions of the Note.⁷⁷ In addition, we estimated in that release that under subparagraph (c) to Note G, each broker-dealer would spend approximately 0.25 hours to verify that the clearing organizations they used met the conditions of Note G, for an aggregate one-time total of 25.5 hours;⁷⁸ we believe that this estimate would apply to the verification of that status under the proposed amendment as well. We believe that the proposed amendment would impose an additional one-time burden for broker-dealers that chose to rely on the new standard of proposed Rule 15c3-3a(b)(1)(i). Given the additional options set forth in Note G, we estimate that only half, or 51, of the broker-dealers would choose this option, which we believe would result in the broker-dealer spending, on average, ten hours developing a system of standards for evaluating creditworthiness for the purposes of Note G, resulting in an aggregate initial burden of 510 hours.⁷⁹ We also estimate that firms would employ compliance attorneys, in many cases relying on outside counsel, to review these standards. We estimate the one-time costs of outside counsel to be \$1,350 per-firm, resulting in an aggregate industry cost of \$68,850.⁸⁰

We generally request comment on all aspects of these proposed estimates. In addition, we request specific comment on the following items related to these estimates:

⁷⁷ See Reserve Requirements for Margin Related to Security Futures Products, Exchange Act Release No. 34-50295 (August 31, 2004), 69 FR 54182 at 54188 (September 7, 2004).

⁷⁸ $0.25 \times 102 = 25.5$.

⁷⁹ $10 \times 51 = 510$.

⁸⁰ For the purposes of this analysis, we are using salary data from the SIFMA Report on Management and Professional Earnings in the Securities Industry 2007. We believe that the legal reviews required by the proposed amendments would be performed by compliance attorneys at an average rate of \$270 per hour. Furthermore, we believe that the review process will entail five hours of initial work. $\$270 \times 5 = \$1,350 \times 51 = \$68,850$.

- Are we correct in our estimate of the number of broker-dealers that would be affected by the proposed amendment to Note G?
- Are we correct in our estimate of the percentage of such broker-dealers that choose to rely on proposed Rule 15c3-3a(b)(1)(i)?
- Are we correct in our belief that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?

The instructions to Form X-17A-5 Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3-1f. Paragraph (d) of Rule 15c3-1f is proposed to be amended to remove that part of the credit risk calculation that is summarized in Form X-17A-5 Part IIB. Accordingly, we have proposed a conforming amendment to the form that would remove the summary of the credit risk calculation. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, we do not believe the proposed amendment would result in a substantive revision to these collections of information if adopted.

Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to:

- (1) Evaluate whether the proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility;
- (2) Evaluate and provide relevant data regarding the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- (3) Enhance the quality, utility and clarity of the information to be collected; and

(4) Minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Budget ("OMB"), Room 3208, New Executive Office Building, Washington, DC 20503; and (2) Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090 with reference to File No. S7-17-08. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collection of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-17-08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE., Washington, DC 20549-1110.

VI. COSTS AND BENEFITS OF THE PROPOSED RULEMAKING

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other

costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings. The proposed amendments to Rule 3a1-1, Rule 10b-10, Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Form ATS-R, Form PILOT, and Form X-17A-5 Part IIB would eliminate the reference to and requirement for the use of NRSRO ratings in these rules.

A. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to investors of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in our rules. An over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information. The purpose of the proposed rule amendments is to encourage investors to examine more than a single source of information in making an investment decision. Eliminating reliance on ratings in the Commission's rules could also result in greater investor due diligence and investment analysis. In addition, the Commission believes that eliminating the reliance on ratings in its rules would remove any appearance that the Commission has placed its imprimatur on certain ratings.

We expect that there would be little effect on broker-dealers or other market participants that are subject to the rules that are proposed to be amended. This is because the references to NRSROs

in these rules would be no longer necessary, can be replaced with an alternative bright-line standard, or can be used as one possible interpretation of a subjective standard set forth in a proposed amendment to the rule.

The proposed amendments to Rule 3a1-1, Rules 300 and 301 of Regulation ATS, Form ATS-R, and Form PILOT would eliminate the separate definitions of and references to investment grade corporate debt securities and non-investment grade corporate debt securities and would replace them with a single category “corporate debt securities.” For reasons discussed above, the Commission preliminarily believes that it is not necessary or appropriate to assess trading volumes in the narrower segments of investment grade and non-investment grade corporate debt securities to fulfill the purposes of those rules. The other classes of securities and the threshold levels themselves would remain unchanged.

Therefore, the proposed amendments to Rule 3a1-1 and Regulation ATS are not expected to significantly affect the regulatory treatment of ATSS. With respect to the proposed changes to Form ATS-R and Form PILOT, we expect that combining investment grade and non-investment grade corporate debt securities into a single class for purposes of those two forms would have only minimal impact, because the total units and total dollar volume of corporate debt securities transacted would still have to be reported.

The proposed amendments to Rule 10b-10 to eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. The other requirements of Rule 10b-10 would remain unchanged. Eliminating this requirement would avoid giving credit ratings an imprimatur that may inadvertently suggest to investors that an unrated security is inherently riskier than a rated security. Accordingly, we anticipate that investors and the marketplace would benefit

from the elimination of this requirement, in light of concerns about promoting over-reliance on securities ratings or creating confusion about the significance of those ratings. More generally, eliminating this requirement is consistent with the goal of promoting a dialogue between broker-dealers and their customers – prior to purchase – regarding the creditworthiness of issuers, and should help avoid promoting the use of credit ratings as an oversimplified shorthand that replaces a more complete discussion of credit quality issues.

We preliminarily believe that the proposed amendments to the Net Capital Rule, its appendices, and Exhibit A to the Customer Protection Rule would result in a better overall assessment of the risks associated with securities held by broker-dealers for the purposes of net capital calculations as well as of the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.⁸¹ Many broker-dealers already conduct their own risk evaluation. However, for those broker-dealers that do not, developing their own means of evaluating risk – including, as would be required by the proposed amendments to the Net Capital Rule, an evaluation of the degree of liquidity – would allow them to better incorporate the overall levels of various categories of risk associated with the securities they hold into their net capital calculations.

⁸¹ See, e.g., Inside the Ratings: What Credit Ratings Mean, Fitch, August 2007 (“Inside the Ratings”), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody’s Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor’s Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), p. 3.

A separate evaluation of risk by the broker-dealer should lead to a better understanding of the risks associated with those securities which would, we believe, lead to increased operational efficiency and potentially lowered net capital charges for those broker-dealers that currently do not conduct their own risk evaluation. We believe that allowing broker-dealers to employ their own criteria in determining credit risk for net capital purposes would, by reducing the reliance on NRSRO ratings and therefore more closely aligning a broker-dealer's net capital-related risk assessments with its general internal risk assessments, increase operational efficiency. Furthermore, we believe that the proposed amendments could result in more closely tailored capital charges, and thus lowered costs, for broker-dealers while still being designed to ensure net capital requirements sufficient to require maintenance of capital to achieve the goals of the Net Capital Rule.

We believe that the same reasoning applies to the proposed amendment to Exhibit A of the Customer Protection Rule. Broker-dealers that utilize their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted would better be positioned to incorporate the overall levels of various categories of risk associated with those organizations into their assessments.

In the case of the amendments to Rules 101 and 102 of Regulation M, we believe the proposed rule amendments would have benefits that justify any costs, if adopted. Because the exceptions in Rules 101 and 102 are narrowly-tailored, the proposed amendments should continue to promote investor confidence in the offering process and the market as a whole by only excepting those securities that are resistant to manipulation. Market integrity would also continue to be promoted, which benefits the market and all participants. Also, since the

proposals would be a bright-line, compliance with the proposed amendments would be easy for issuers and other persons subject to the rules. In fact, this proposal may lower costs for these people by eliminating the need to obtain an investment grade rating from a nationally recognized statistical rating organization. We believe that replacing the NRSRO investment grade requirement with the proposed exceptions should not result in broker-dealers hiring new compliance staff or making extensive systems changes because the proposals utilize existing bright-line benchmarks.

B. Costs

We anticipate that broker-dealers and other market participants could incur certain costs if the proposed amendments are adopted. Investors could incur additional costs if they perform a more detailed and comprehensive analysis before making an investment decision. Broker-dealers could incur additional costs if they perform their own risk evaluation, if they do not currently do so. Furthermore, the purpose of the proposal is to encourage investors not to place undue reliance on NRSRO ratings in making investment decisions. Investors could still choose to rely solely on NRSRO ratings without incurring additional costs.

The proposed amendments to Rule 3a1-1, Rules 300 and 301 of Regulation ATS, Form ATS-R, and Form PILOT would eliminate the separate definitions of and references to investment grade corporate debt securities and non-investment grade debt securities and would replace them with a single category "corporate debt securities." We preliminarily believe that these changes would not impose any significant costs on market participants.

The proposed amendments to Rule 3a1-1 and Regulation ATS would marginally reduce the likelihood of an ATS meeting the thresholds in those rules. For example, under existing Rule 3a1-1, an ATS that currently has 40% of the average daily dollar trading

volume in non-investment grade corporate debt securities and 0% of the average daily dollar trading volume in investment grade corporate debt securities for at least four of the preceding six calendar months could be required to register as an exchange. Under the proposed amendment to Rule 3a1-1, the Commission would no longer be able to require the ATS to register as an exchange, because its average daily dollar trading volume in corporate debt securities combined would be less than 40%. A potential cost of the proposed amendments to Rule 3a1-1 and Regulation ATS is that an ATS that exceeds one of the existing thresholds and thus becomes subject to additional regulatory requirements (in the case of Regulation ATS) or must register as an exchange (in the case of Rule 3a1-1) would no longer exceed the threshold and would not have to meet the attendant requirements. However, the Commission preliminarily believes that this possibility is remote, and that the proposed amendments are unlikely to impose any costs on investors, market participants, or the national market system generally.

We believe that any costs associated with the proposed changes to Form ATS-R and Form PILOT would be minimal. Respondents already determine and report the total units and total trading volume for investment grade and non-investment grade corporate debt securities separately. On the revised forms, respondents would report them together as a single item for "corporate debt securities." The cost of the proposed changes to these forms would be the cost of adding these previously separate items together.

We do not expect the proposed amendment to result in any significant changes in the costs associated with Rule 10b-10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the proposed amendment if adopted would not be expected to change the cost of generating and sending confirmations.

Moreover, we believe that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

We believe that the costs of compliance with the proposed amendments to the Net Capital Rule and its appendices as well as to Note G of Exhibit A of the Rule 15c3-3 would be minimal for entities that already employ their own criteria in determining credit risk for net capital purposes. In the event the broker-dealer inaccurately evaluates the creditworthiness and liquidity of its positions, a potential cost could be that the broker-dealer is required to take a larger haircut on its proprietary positions, and therefore reserve additional capital. This could affect its ability to hold its positions or to add to its positions. As for broker-dealers that do not currently employ such criteria, if the proposed amendments are adopted, after considering comment, we could take the view that securities rated by NRSROs would meet the standards in the rules as amended and this would provide a way for broker-dealers that do not determine credit risk on their own to avoid incurring any additional costs. If we were to adopt the view that NRSRO rated securities meet the standard in the proposed amendments, it would mean that any potential costs would be wholly voluntary. While we encourage broker-dealers that have not yet developed their own credit risk evaluation procedures to do so, such actions would proceed at the time and pace desired by the broker-dealers.

We expect the costs of the proposal to modify Rules 101 and 102 of Regulation M to be minimal to most persons subject to those rules who could rely on the proposed amendments as they relate to nonconvertible debt and preferred securities. The proposed exceptions are only triggered when the conditions in the exceptions are met which would

only occur in a limited number of situations. It is only when there is an offering of nonconvertible debt or nonconvertible preferred securities which qualifies as a distribution under Regulation M where a covered person bids for, purchases or attempts to induce another person to bid for or purchase the covered security during the applicable restricted period. Thus, there may be offerings of nonconvertible debt or preferred securities that do not constitute a distribution for purposes of Regulation M. In such case, the prohibitions of Regulation M are not triggered and neither the current nor the proposed exceptions would be necessary. Additionally, even if a distribution of the nonconvertible debt or nonconvertible preferred securities exists, a person subject to Regulation M's prohibitions could structure buying activity before or after the applicable restricted period so as not to incur any costs, even if minimal, associated with relying on the proposed exceptions. This holds true for asset-backed securities as well.

We believe that many of the issuers of these securities would already know if they are WKSI issuers based on the non-common equity standard because this analysis would have been already done as part of the offering process. Persons other than issuers who would be subject to Rules 101 and 102 should have access to the issuer's WKSI status as well via the issuer's 10K filings. Such persons should also be in a position with the issuer to obtain any other information needed to make a determination as to whether the proposed exception would apply to the security at issue. Thus, we believe that these persons should incur no significant costs under the proposal. There may be, however, costs to any person subject to Rules 101 or 102 to make minor system changes should the Commission adopt this proposal because of the proposed new standard.

We do believe, however, that there may be increased costs for issuers and other persons subject to Rules 101 and 102 as they relate to nonconvertible debt and preferred securities if that issuer is WKSI based on the common equity standard.⁸² Since the issuer in that case would not need to determine the aggregate principal amount of their nonconvertible securities other than common equity for purposes of Securities Act disclosure, new analysis would need to be conducted and communicated to other persons subject to Rules 101 and 102 to rely on the exception. This could likely result in increased costs not completely offset by not needing to obtain an investment grade rating.

With respect to asset-backed securities, we believe that there should not be any significant increased costs to persons subject to Rules 101 and 102. All persons who are subject to those rules should know what form the issuer is using to register the offering, including whether Form S-3 is being used. Thus, no new analysis would need to be conducted. We also expect that there could be a small number of securities taken out of this exception as a result of the proposed change. Costs for such issuers, selling shareholders, underwriters, brokers, dealers, any other distribution participants, or affiliated purchasers of any of these persons affected by this change would be more significant, but we do not expect there to be a significant number of these persons. There could also be minimal costs to train broker-dealer and self-regulatory organization staff and to update broker-dealer policies and procedures and make system changes regarding the new exceptions.

Request for Comment

⁸² 17 CFR 230.405. The common equity standard is at subparagraph (1)(i)(A) of the definition of “well-known seasoned issuer.”

We request data to quantify the costs and the benefits above. We seek estimates of these costs and benefits, as well as any costs and benefits not already described, which could result from the adoption of the proposed amendments. Specifically, would the proposal result in lower costs associated with debt and preferred securities covered by the new exception? What new costs, if any, would be associated with the proposal for persons subject to Rules 101 and 102 where the nonconvertible debt and nonconvertible preferred securities are issued by issuers who are WKSI based on the common equity standard? What costs, if any, would be related to the change for asset-backed securities? For these issues, what is the cost of determining the aggregate principal amount of nonconvertible debt securities other than common equity and then communicating the exception to other persons subject to Rules 101 and 102? Would any securities that currently fall within the existing exceptions not meet the exceptions as proposed? Would the proposal affect the cost to broker-dealers of generating transaction confirmations? Do investors benefit from the notification on the transaction confirmation? Does the confirmation help promote conversations about broker-dealers and their customers regarding unrated securities? Are there alternative means to promote such conversations that would not create over-reliance on NRSRO ratings?

VII. CONSIDERATION OF THE BURDEN ON COMPETITION, PROMOTION OF EFFICIENCY, AND CAPITAL FORMATION

Section 3(f) of the Exchange Act⁸³ requires the Commission, whenever it engages in rulemaking and is required to consider or to determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital

⁸³ 15 U.S.C. 78c(f).

formation. In addition, Section 23(a)(2) of the Exchange Act⁸⁴ requires the Commission, when promulgating rules under the Exchange Act, to consider the impact any such rules would have on competition. Section 23(a)(2) further provides that the Commission may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments would remove the reference to NRSRO ratings in several of our rules and forms. These include Rules 3a1-1, 10b-10, 15c3-1, 15c3-3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS-R and PILOT. The purpose of the proposed amendments is to address concerns that the references to NRSRO ratings in our rules and forms contributed to any over-reliance on credit ratings by investors.

We preliminarily believe that the proposed amendments to Rule 3a1-1 and Rules 300 and 301 of Regulation ATS would be unlikely to create any adverse impact on efficiency, competition, or capital formation. The Commission preliminarily believes that combining investment grade and non-investment grade corporate debt securities into a single class of securities for purposes of the thresholds in those rules is unlikely to affect whether an ATS crosses one of those thresholds. Moreover, the other classes of securities for which the thresholds are applied – and the levels of the thresholds themselves – would remain unchanged.

The proposed changes to Form ATS-R and Form PILOT would simplify reporting for ATSs and self-regulatory systems that operate pilot trading systems. Form ATS-R and Form PILOT respondents are already required to determine and report the volumes of corporate debt securities. A single reporting item for “corporate debt securities” would replace the

⁸⁴ 15 U.S.C. 78w(a)(2).

existing separate entries for “investment grade corporate debt securities” and “non-investment grade corporate debt securities.” Therefore, we preliminarily believe that the changes to Form ATS-R and Form PILOT would be unlikely to have any significant impact on efficiency, competition, or capital formation.

We do not believe that the proposed amendment to Rule 10b-10 would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed deletion of paragraph (a)(8) of that rule would not be expected to impose any significant additional costs upon broker-dealers (which in any event would not be prohibited from voluntarily including information that a particular debt security is unrated by an NRSRO). For similar reasons, we do not believe that this proposed amendment would impose any significant adverse effects on efficiency, competition or capital formation.

We preliminarily believe that the proposed amendments to the Net Capital Rule and its appendices or to Note G of Exhibit A of the Rule 15c3-3 would serve to promote efficiency and capital formation. As noted above, we believe that by relying on their own means of evaluating risk, broker-dealers would better incorporate the overall levels of risk associated with the securities they hold into their Net Capital Rule. In turn, we believe, this better understanding would more closely align a broker-dealer’s net capital-related risk assessments with its general internal risk assessments and lead to increased operational efficiency, potentially lowered net capital charges, and a more efficient allocation of capital. In addition, broker-dealers that developed their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers’ positions in security futures products are posted for purposes of Note G to Exhibit A of Rule 15c3-3 would better be positioned to incorporate the overall levels of various categories of

risk associated with those organizations into their assessments, creating a more efficient means of evaluating those organizations for the sake of the Rule 15c3-3 than simply relying on NRSRO credit ratings alone. We do not anticipate that the proposed amendments to the Net Capital Rule and its appendices or to Note G of Exhibit A of Rule 15c3-3 would have any impact on competition.

We preliminarily believe that the proposed amendments to Rules 101 and 102 of Regulation M are intended to promote capital formation. The proposed amendments should promote continued investor confidence in the offering process by proposing an exception from Regulation M's Rule 101 and 102 prohibitions limited to those securities which are resistant to manipulation. Such investor confidence in our markets should promote continued capital formation. We believe that the proposals should foster continued market integrity which should also translate into capital formation by only allowing for non-manipulative buying activity during distributions. Issuers of nonconvertible debt, nonconvertible preferred securities and asset-backed securities who fall within the proposed exceptions may be encouraged to engage in capital formation knowing that the proposed exceptions are available for their buying activity as well as the buying activity of distribution participants. Because the proposal eliminates the need to obtain an investment grade rating by an NRSRO, a hurdle to both relying on the exception and capital formation would be eliminated, which would also promote capital formation.

The proposal would provide an alternative to obtaining an investment grade rating but still would provide clear guidance to all persons subject to those rules. We preliminarily believe that the proposed Regulation M amendments would promote market efficiency by providing continued clarity to issuers, distribution participants, and their affiliated purchasers

as to the scope of permissible activity by providing a bright line test for compliance with the proposed exceptions comparable to the existing exception. In addition, the proposals continue to utilize existing benchmarks so as not to trigger inefficiencies that might result from use of a new standard. The proposal would also eliminate the need to obtain an investment grade rating from an NRSRO to rely on the exception, which will eliminate a potential inefficiency in the capital raising process. For these reasons, the Commission preliminarily believes that the proposed exceptions will promote efficient capital formation and competition.

We have considered the proposed amendments to Rules 101 and 102 of Regulation M in light of the standards cited in Section 23(a)(2) and believe preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. We preliminary believe that the use of the existing WSKI and Form S-3 standards would mean that any additional burdens the proposal may place on market participants should be minimal as market participants are already familiar with and utilize these benchmarks in other contexts. Additionally, the proposals would apply equally to all issuers, distribution participants, and their affiliated issuers. Thus, no person covered by Regulation M should be put at a competitive disadvantage, and the proposal would not impose a significant burden on competition not necessary or appropriate in furtherance of the Act.

We generally request comment on the effects of the proposed amendments to Rules 3a1-1, 10b-10, 15c3-1, 15c3-3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS-R and PILOT on efficiency, competition, and capital formation. Commenters should provide analysis and empirical data to support their views.

VIII. REGULATORY FLEXIBILITY ACT CERTIFICATION

Section 3(a) of the Regulatory Flexibility Act of 1980⁸⁵ requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rule on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.⁸⁶ Pursuant to Section 605(b) of the Regulatory Flexibility Act ("RFA"), the Commission hereby certifies that the proposed amendments to the rule, would not, if adopted, have a significant economic impact on a substantial number of small entities.

For purposes of Commission rulemaking in connection the RFA, small entities include broker-dealers with 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 Rule 17a-5(d) under the Exchange Act,⁸⁷ or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.⁸⁸

An alternative trading system that complies with Regulation ATS must, among other things, register as a broker-dealer.⁸⁹ Thus, the Commission's definition of small entity as it relates to broker-dealers also would apply to ATSS. An ATS that approaches the volume

⁸⁵ 5 U.S.C. 603(a).

⁸⁶ 5 U.S.C. 605(b).

⁸⁷ See 17 CFR 240.17a-5(d).

⁸⁸ See 17 CFR 240.0-10(c).

⁸⁹ See 17 CFR 242.301(b)(1).

thresholds for investment grade or non-investment grade corporate debt securities in Rule 3a1-1 or Regulation ATS would be very large and thus unlikely to be a small entity or small organization. With respect to the proposed changes to Form ATS-R, even if an ATS is a “small entity” or “small organization” for purposes of the RFA, the only change being proposed to the form is to eliminate the distinction between investment grade and non-investment grade corporate debt securities and to require reporting for the combined class of corporate debt securities. We believe this would impose only negligible costs on ATSs, even if they were small entities or small organizations.

Similarly, SROs are the only respondents to Form PILOT and are not “small entities” for purposes of the RFA. Accordingly, no small entities would be affected by the proposed amendments to Form PILOT.

We believe that the proposed amendment to Rule 10b-10 will not have a significant economic impact on a substantial number of small entities. While some broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) of that rule may be small entities, the proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with those transactions.

The proposed amendments to the securities haircut provisions in paragraphs (E), (F), and (H) of Rules 15c3-1(c)(2)(vi), if adopted, would not have a significant economic impact on a small number of entities. If the Commission adopts the proposed amendments, we would take the view in the adopting release that securities rated by NRSROs as currently required would meet the amended standards. Thus, the proposed amendments would allow for compliance without reference to the standards that are currently in the rule (i.e., NRSRO ratings), but broker-dealers that wish to use them would still be accommodated.

Accordingly, the rule would not have any economic impact on small entities because they would not have to change their current practices.

The proposed amendments to the Appendices E and F to Rule 15c3-1 (which include conforming amendments to Appendix G of Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB), if adopted, would not apply to small entities. Appendices E and G apply to broker-dealers that are part of a consolidated supervised entity and Appendix F and Form X-17A-5, Part IIB apply to OTC Derivatives Dealers that have applied to the Commission for authorization to compute capital charges as set forth in Appendix F in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi). All of these brokers or dealers would be larger than the definition of a small broker dealer in Rule 0-10.

The proposed amendments to Rule 15c3-3a, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to Rule 15c3-3a would apply only to broker-dealers that clear and carry positions in security futures products in securities accounts for the benefit of customers. None of those broker-dealers affected by the rule is a small entity as defined in Rule 0-10 (confirming this with OEA).

With respect to the amendments to Rules 101 and 102 of Regulation M, it is unlikely that any broker-dealer that is defined as a “small business” or “small organization” as defined in Rule 0-10⁹⁰ could be an underwriter or other distribution participant as they would not have sufficient capital to participate in underwriting activities. Small business or small organization for purposes of “issuers” or “person” other than an investment company is defined as a person who, on the last day of its most recent fiscal year, had total assets of \$5

⁹⁰ 17 CFR 240.0-10.

million or less.⁹¹ We believe that none of the various persons that would be affected by this proposal would qualify as a small entity under this definition as it is unlikely that any issuer of that size had investment grade securities that could rely on the existing exception. Therefore, we believe that these amendments would not impose a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to Rules 3a1-1, 10b-10, 15c3-1, 15c3-3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS-R and PILOT could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

IX. STATUTORY BASIS AND TEXT OF THE PROPOSED AMENDMENTS

The amendments to Rules 3a1-1, 10b-10, 15c3-1, 15c3-3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS-R, Pilot, 17-H, and X-17A-5 Part IIB under the Act are being proposed pursuant to the Sections 7,⁹² 17(a),⁹³ 19(a)⁹⁴ of the Securities Act, Sections 2,⁹⁵ 3,⁹⁶ 9(a),⁹⁷ 10,⁹⁸ 11,⁹⁹ 11A(c),¹⁰⁰ 12,¹⁰¹ 13,¹⁰² 14,¹⁰³ 15,¹⁰⁴

⁹¹ 17 CFR 240.0-10(a).

⁹² 15 U.S.C. 77g.

⁹³ 15 U.S.C. 77q(a).

⁹⁴ 15 U.S.C. 77s(a).

⁹⁵ 15 U.S.C. 78b.

⁹⁶ 15 U.S.C. 78c.

⁹⁷ 15 U.S.C. 78i(a).

15(c),¹⁰⁵ 15(g),¹⁰⁶ 17,¹⁰⁷ 17(a),¹⁰⁸ 23(a),¹⁰⁹ 30,¹¹⁰ and 36(a)(1)¹¹¹ of the Exchange Act, and Sections 23,¹¹² 30,¹¹³ and 38¹¹⁴ of the Investment Company Act of 1940.

List of Subjects

17 CFR Parts 240, 242, and 249

Broker, Reporting and recordkeeping requirements, Securities.

Text of Amendment

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

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- ⁹⁸ 15 U.S.C. 78j.
⁹⁹ 15 U.S.C. 78k.
¹⁰⁰ 15 U.S.C. 78k-1(c).
¹⁰¹ 15 U.S.C. 78l.
¹⁰² 15 U.S.C. 78m.
¹⁰³ 15 U.S.C. 78n.
¹⁰⁴ 15 U.S.C. 78o.
¹⁰⁵ 15 U.S.C. 78o(c).
¹⁰⁶ 15 U.S.C. 78o(g).
¹⁰⁷ 15 U.S.C. 78q.
¹⁰⁸ 15 U.S.C. 78q(a).
¹⁰⁹ 15 U.S.C. 78w(a).
¹¹⁰ 15 U.S.C. 78dd.
¹¹¹ 15 U.S.C. 78mm(a)(1).
¹¹² 15 U.S.C. 80a-23.
¹¹³ 15 U.S.C. 80a-29.
¹¹⁴ 15 U.S.C. 80a-37.

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

1. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Amend § 240.3a1-1 by revising paragraphs (b)(3)(v), (b)(3)(vi), and (b)(3)(vii) and by removing (b)(3)(viii) to read as follows:

§ 240.3a1-1 Exemption from the definition of “Exchange” under Section 3(a)(1) of the Act.

* * * * *

(b) * * *

(3) * * *

(v) Corporate debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such securities;

(B) Have a fixed maturity date that is at least one year following the date of issuance;

and

(C) Are not exempted securities, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12));

(vi) Foreign corporate debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such debt securities;

(B) Are issued by a corporation or other organization incorporated or organized

under the laws of any foreign country; and

(C) Have a fixed maturity date that is at least one year following the date of issuance;
and

(vii) Foreign sovereign debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such debt securities;

(B) Are issued or guaranteed by the government of a foreign country, any political subdivision of a foreign country, or any supranational entity; and

(C) Do not have a maturity date of a year or less following the date of issuance.

* * * * *

3. Section 240.10b-10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

4. Section 240.15c3-1 is amended by revising the introductory text of paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), and (c)(2)(vi)(F)(2), and by revising paragraph (c)(2)(vi)(H) to read as follows:

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

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(E) Commercial paper, bankers acceptances and certificates of deposit. In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and is subject to a minimal amount of credit risk and has sufficient liquidity such that

it can be sold at or near its carrying value almost immediately, or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(F) (1) Nonconvertible debt securities. In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which are subject to no greater than moderate credit risk and have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which are subject to no greater than moderate credit risk and have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time, if such securities have maturity dates:

* * * * *

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which is subject to no greater than moderate credit

risk and has sufficient liquidity such that it can be sold at or near its carrying value within a reasonably short period of time and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

* * * * *

5. Section 240.15c3-1e is amended by removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D) and redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C).

6. Section 240.15c3-1f is amended by:

- a. Removing the phrase “by a nationally recognized statistical rating organization (“NRSRO”)” in paragraph (d)(2)(i);
- b. Removing the phrase “by an NRSRO” in paragraphs (d)(2)(ii), (d)(3)(i), and (d)(3)(ii); and
- c. Revising the first and second sentences of paragraph (d)(4).

The revision reads as follows:

§ 240.15c3-1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3-1).

* * * * *

(d) * * *

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer’s internal credit risk management system, the Commission may approve the application. * * *

* * * * *

7. Section 240.15c3-1g is amended by revising paragraph (a)(3)(i)(F) to read as

follows:

§ 240.15c3-1g Conditions for ultimate holding companies of certain brokers or dealers (Appendix G to 17 CFR 240.15c3-1).

* * * * *

(a) * * *

(3) * * *

(i) * * *

(F) Credit risk weights shall be determined according to the provisions of paragraphs (c)(4)(vi)(A) of § 240.15c3-1e.

* * * * *

8. Section 15c3-3a is amended by revising Note G paragraph (b)(1)(i) to read as

follows:

§ 240.15c3-3a Exhibit A—formula for determination reserve requirement of brokers and dealers under § 240.15c3-3.

* * * * *

Note G. * * *

(b) * * *

(1) * * *

(i) Has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk; or

* * * * *

PART 242 -- REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

9. 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.

10. Section 242.101 is amended by revising paragraph (c)(2) to read as follows:

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) Nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, if:

(i) For nonconvertible debt securities and nonconvertible preferred securities, the issuer of such securities meets the requirements of “well-known seasoned issuer” as that term is used in § 230.405 of this chapter, but only if such issuer also meets the requirements of paragraph (1)(i)(B)(1) of that definition; or

(ii) For asset-backed securities, the offer and sale of the security is registered using Form S-3 (§ 239.13 of this chapter); or

* * * * *

11. Section 242.102 is amended by revising paragraph (d)(2) to read as follows:

§ 242.102 Activities by issuers and selling security holders during a distribution.

* * * * *

(d) * * *

(2) Nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, if:

(i) For nonconvertible debt securities and nonconvertible preferred securities, the issuer of such securities meets the requirements of “well-known seasoned issuer” as that term is used in § 230.405 of this chapter, but only if such issuer also meets the requirements of paragraph (1)(i)(B)(1) of that definition; or

(ii) For asset-backed securities, the offer and sale of the security is registered using Form S-3 (§ 239.13 of this chapter); or

* * * * *

12. Section 242.300 is amended by revising paragraph (i), removing paragraph (j), and redesignating paragraph (k) as paragraph (j).

The revision reads as follows:

§ 242.300 Definitions.

* * * * *

(i) Corporate debt security shall mean any security that:

(1) Evidences a liability of the issuer of such security;

(2) Has a fixed maturity date that is at least one year following the date of issuance;

and

(3) Is not an exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

* * * * *

13. Section 242.301 is amended by:

a. Adding the word “or” to the end of paragraph (b)(5)(i)(C);

b. Revising paragraph (b)(5)(i)(D);

c. Removing paragraph (b)(5)(i)(E);

- d. Adding the word "or" to the end of paragraph (b)(6)(i)(C);
- e. Revising paragraph (b)(6)(i)(D); and
- f. Removing paragraph (b)(6)(i)(E).

The revisions read as follows:

§ 242.301 Requirements for alternative trading systems

* * * * *

(b) * * *

(5) * * *

(i) * * *

(D) With respect to corporate debt securities, 5 percent or more of the average daily volume traded in the United States.

* * * * *

(6) * * *

(i) * * *

(D) With respect to corporate debt securities, 20 percent or more of the average daily volume traded in the United States.

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

14. The authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq., 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

15. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by

removing the phrase “by a nationally recognized statistical rating organization (“NRSRO”)” and the phrase “by an NRSRO” wherever it appears in the section “Credit risk exposure” under the heading “Computation of Net Capital and Required Net Capital” and before the heading “Aggregate Securities and OTC Derivatives Positions.”

Note: The text of Form X-17A-5 Part IIB does not and this amendment will not appear in the Code of Federal Regulations.

16. Form ATS-R (referenced in § 249.638) is amended by:

- a. In the instructions to the form, Section B, revising the second term and removing the third term; and
- b. In Section 4 of the form, revising Line L, to read “Corporate debt securities,” removing Line M, and redesignating Lines N and O as Lines M and N).

Note: The text of Form ATS-R does not and this amendment will not appear in the Code of Federal Regulations.

The revision reads as follows:

Form ATS-R, Quarterly Report of Alternative Trading System Activities

Form ATS-R Instructions

B. * * *

CORPORATE DEBT SECURITIES - shall mean any securities that (1) evidence a liability of the issuer of such securities; (2) have a fixed maturity date that is at least one year following the date of issuance; and (3) are not exempted securities, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12)).

* * * * *

17. Form PILOT (referenced in § 249.821) is amended by:

- a. In the instructions to the form, Section B, revising the second term and removing

the third term; and

b. In Section 9 of the form, revising Line J, to read "Corporate debt securities," removing Line K, and redesignating Lines L, M, N and O as Lines K, L, M and N.

Note: The text of Form PILOT does not and this amendment will not appear in the Code of Federal Regulations.

The revision reads as follows:

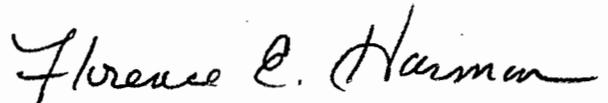
Form PILOT, Initial operation report, amendment to initial operation report and quarterly report for pilot trading systems operated by self-regulatory organizations.

Form PILOT Instructions

B. * * *

CORPORATE DEBT SECURITIES - shall mean any securities that (1) evidence a liability of the issuer of such securities; (2) have a fixed maturity date that is at least one year following the date of issuance; and (3) are not exempted securities, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12)).

By the Commission.



Florence E. Harmon
Acting Secretary

July 1, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58090 / July 2, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11393

In the Matter of

**MASSACHUSETTS FINANCIAL
SERVICES COMPANY, JOHN W.
BALLEN AND KEVIN R. PARKE**

Respondents.

**ORDER DIRECTING
DISBURSEMENT OF FAIR FUND**

On July 19, 2006, the Commission published a notice of the Plan of Distribution ("Plan") proposed by the Division of Enforcement in connection with this proceeding (Exchange Act Release No. 54175). The Commission received comments and, on July 24, 2007, the Plan was approved. See Exchange Act Release No. 56122 (July 24, 2007) (Order Approving Modified Distribution Plan); Exchange Act Release No. 56527 (September 25, 2007) (Revised Order Approving Modified Distribution Plan).

The Plan of Distribution provides that a Fair Fund consisting of approximately \$306 million in disgorgement and civil penalties, plus any accrued interest, be transferred in portions to Deutsche Bank to be distributed by the Plan Administrator to injured investors according to the methodology set forth in the Plan. The Plan provides that the Commission will arrange for distribution of a portion of the Fair Fund when a certification from the Independent Distribution Consultant describing the payees and listing the payment amounts and the total payment amount required to make the distribution has been received ("Payment File"). The certified Payment File for the tenth distribution of \$13,959,921.05 has been received and accepted.¹

¹ By Order Directing Disbursement of Fair Fund dated November 5, 2007, the Commission ordered the first disbursement, composed of \$31,487,520.04. See Exchange Act Release No. 34-56743 (November 5, 2007). By Order Directing Disbursement of Fair Fund dated December 6, 2007, the Commission

Accordingly, it is ORDERED that the Commission staff shall transfer \$13,959,921.05 of the Fair Fund to Deutsche Bank and the Plan Administrator shall distribute such monies to investors, as provided for in the Plan of Distribution.

For the Commission, by its Secretary, pursuant to delegated authority.


Florence E. Harmon
Acting Secretary

ordered the second disbursement, composed of \$26,479,321.81. *See* Exchange Act Release No. 56922 (December 6, 2007). By Order Directing Disbursement of Fair Fund dated January 9, 2008, the Commission ordered the third disbursement, composed of \$32,499,722.42. *See* Exchange Act Release No. 57117 (January 9, 2008). By Order Directing Disbursement of Fair Fund dated February 6, 2008, the Commission ordered the fourth disbursement, composed of \$25,838,712.81. *See* Exchange Act Release No. 57276 (February 6, 2008). By Order Directing Disbursement of Fair Fund dated February 28, 2008, the Commission ordered the fifth disbursement, composed of \$18,343,333.48. *See* Exchange Act Release No. 57396 (February 28, 2008). By Order Directing Disbursement of Fair Fund dated April 18, 2008, the Commission ordered the sixth disbursement, composed of \$43,501,260.12. *See* Exchange Act Release No. 57687 (April 18, 2008). By Order Directing Disbursement of Fair Fund dated May 6, 2008, the Commission ordered the seventh disbursement, composed of \$33,151,254.10. *See* Exchange Act Release No. 57783 (May 6, 2008). By Order Directing Disbursement of Fair Fund dated June 4, 2008, the Commission ordered the eighth disbursement, composed of \$32,286,863.16. *See* Exchange Act Release No. 57915 (June 4, 2008). By Order Directing Disbursement of Fair Fund dated June 17, 2008, the Commission ordered the ninth disbursement, composed of \$28,506,201.69. *See* Exchange Act Release No. 57980 (June 17, 2008).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 2, 2008

IN THE MATTER OF

WarpRadio.com, Inc.
Wireless Frontier Internet, Inc., and
World Associates, Inc.,

File No. 500-1

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of WarpRadio.com, Inc. because it has not filed any periodic reports since the period ended September 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Wireless Frontier Internet, Inc. because it has not filed any periodic reports since September 30, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of World Associates, Inc. because it has not filed any periodic reports since the period ended September 30, 2004.

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.

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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 July 2, 2008, through 11:59 p.m. EDT on July 16, 2008.

By the Commission.

A handwritten signature in cursive script, reading "Florence E. Harmon".

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 2, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13086

In the Matter of

WarpRadio.com, Inc.,
WellnessAmerica Online, Inc. (n/k/a
General Ventures, Inc.),
Wireless Frontier Internet, Inc., and
World Associates, Inc.,

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") against Respondents WarpRadio.com, Inc., WellnessAmerica Online, Inc. (n/k/a General Ventures, Inc.), Wireless Frontier Internet, Inc., and World Associates, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. WarpRadio.com, Inc. (CIK No. 1098692) is a Nevada corporation located in Greenwood Village, Colorado with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). WarpRadio 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, 2000, which reported a net loss of \$1.6 million for the prior nine months. As of June 26, 2008, the company's common stock (symbol "WRPR") was quoted on the Pink Sheets, had six market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

2. WellnessAmerica Online, Inc. (n/k/a General Ventures, Inc.) (CIK No. 1113657) is a Nevada corporation located in Fresno, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). WellnessAmerica is delinquent in its periodic filings with the Commission, having not

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filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of \$1,823 for the prior nine months. As of June 26, 2008, the company's common stock (symbol "GVSI") was quoted on the Pink Sheets, had six market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

3. Wireless Frontier Internet, Inc. (CIK No. 38981) is a void Delaware corporation located in Fort Stockton, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Wireless Frontier is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended September 30, 2004, which reported a net loss of \$3.5 million for the prior nine months. As of June 26, 2008, the company's common stock (symbol "WFRI") was quoted on the Pink Sheets, had ten market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

4. World Associates, Inc. (CIK No. 1092531) is a Nevada corporation located in Agoura Hills, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). World Associates is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended September 30, 2004, which reported a net loss of \$229,755 for the prior three months. As of June 26, 2008, the company's common stock (symbol "WAIV") was quoted on the Pink Sheets, had seven market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

5. 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.

6. 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).

7. 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)].

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, registered, or Express Mail, or by other means of verifiable delivery.

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

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of

the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.



Florence E. Harmon
Acting Secretary

Attachment

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8941; 34-58097; File No. 4-560]

Roundtable on Fair Value Accounting Standards

AGENCY: Securities and Exchange Commission.

ACTION: Notice of roundtable discussion; request for comment.

SUMMARY: On July 9, 2008, the Securities and Exchange Commission will hold a roundtable to facilitate an open discussion of the benefits and potential challenges associated with existing fair value accounting and auditing standards. The roundtable will be organized as two panels: the first panel to discuss fair value accounting issues from the perspective of larger financial institutions and the needs of their investors; and the second panel to discuss the issues from the perspective of all public companies, including small public companies, and the needs of their investors. The panels will include investors, preparers, auditors, regulators and other interested parties. Additionally, representatives from the Financial Accounting Standards Board, International Accounting Standards Board and Public Company Accounting Oversight Board will be present as observers.

The roundtable will be held in the auditorium at the SEC's headquarters at 100 F Street, N.E., Washington, D.C. The roundtable will be open to the public with seating on a first-come, first-served basis. The roundtable discussions also will be available via webcast on the SEC's Web site at www.sec.gov. The roundtable agenda and other materials related to the roundtable, including a list of participants and moderators, will be accessible at <http://www.sec.gov/spotlight/fairvalue.htm>. The Commission welcomes feedback regarding any of the topics to be addressed at the roundtable.

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DATES: Comments should be received on or before July 23, 2008.

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

Electronic Comments

- Use the Commission's Internet submission form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-560 on the subject line.

Paper Comments

- Send paper comments in triplicate to Florence Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. 4-560. 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 staff will post all comments on the Commission's Internet Web site (<http://www.sec.gov/comments/4-560/4-560.shtml>). Comments also will be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

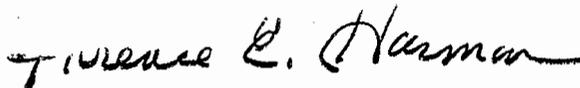
FOR FURTHER INFORMATION CONTACT: James L. Kroeker, Deputy Chief Accountant, or Rachel Mincin, Associate Chief Accountant, at (202) 551-5300, Office of

the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE,
Washington, DC 20549-6561.

SUPPLEMENTARY INFORMATION: The Commission welcomes feedback
regarding any of the topics to be addressed at the roundtable. The panel discussions will
focus on:

- the usefulness of fair value accounting to investors
- potential market behavior effects from fair value accounting
- practical experience and potential challenges in applying fair value accounting standards
- aspects of the current standards, if any, that can be improved
- experience with auditors providing assurance regarding fair value accounting.

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 3, 2008

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 241

[Release No. 34-58092]

Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations

AGENCY: Securities and Exchange Commission.

ACTION: Final rule and interpretation.

SUMMARY: The Securities and Exchange Commission ("Commission") is providing guidance regarding a rule under the Securities Exchange Act of 1934 ("Exchange Act") concerning filings with respect to proposed rule changes of self-regulatory organizations ("SROs") that the Commission expects will streamline the process by which SROs file proposed rule changes with the Commission and result in a broader range of rule changes qualifying for immediate effectiveness. Further, the Commission is amending its rules to delegate authority to the Director of the Division of Trading and Markets. These actions are intended to facilitate more expeditious handling of proposed rule changes submitted by SROs pursuant to Exchange Act Section 19(b).

EFFECTIVE DATE: [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Marlon Quintanilla Paz, Senior Counsel to the Director, at (202) 551-5703, or Richard Holley III, Senior Special Counsel, at (202) 551-5614, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

I. Introduction

Self-regulation, with oversight by the Commission, is a basic premise of the Exchange Act. For example, Congress recognized the regulatory role of national securities exchanges in

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Section 6 of the Exchange Act,¹ requiring all existing securities exchanges to register with the Commission and to function as self-regulatory organizations. SROs (such as exchanges, registered national securities associations, and clearing agencies) are subject to various requirements under the Exchange Act, including the requirement in Section 19(b) and Rule 19b-4 thereunder² to file their proposed rule changes with the Commission. Commission review and the public comment process are intended, among other things, to help ensure that SROs carry out the purposes of the Exchange Act.³

National securities exchanges registered under Section 6(a) of the Exchange Act⁴ face increased competitive pressures from entities that trade the same or similar financial instruments, such as foreign exchanges, futures exchanges,⁵ electronic communications networks (“ECNs”), and alternative trading systems (“ATs”). These competitors, however, can change their trading rules or trade new products with greater ease and without the required Commission review.⁶

The Commission previously has stated its belief that, “investors are best served by a regulatory structure that facilitates fair and vigorous competition among market participants and fosters investor protection” and that, “[e]nhancing the SROs’ ability to implement and to respond

¹ 15 U.S.C. 78f.

² 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively. See also Form 19b-4. The rule filing requirements of Section 19(b) also apply to other SROs, such as national securities associations, clearing agencies, and the Municipal Securities Rulemaking Board (“MSRB”).

³ See Section 19 of the Exchange Act, 15 U.S.C. 78s. See also Market 2000: An Examination Of Current Equity Market Developments, Study VI, Division of Market Regulation, U.S. Securities and Exchange Commission (January 1994).

⁴ 15 U.S.C. 78f(a).

⁵ Certain futures exchanges are also registered as national securities exchanges under Section 6(g) of the Exchange Act, 15 U.S.C. 78f(g), solely for the purpose of trading security futures products.

⁶ While a security futures exchange registered under Section 6(g) of the Exchange Act is required to file certain proposed rule changes with the Commission, few such filings must receive Commission approval under Section 19(b)(2). If they must be filed at all, most may be filed under Section 19(b)(3)(A) of the Exchange Act. See 15 U.S.C. 78f(g)(4)(B).

quickly to changes in the marketplace should encourage innovation and better services to investors....”⁷ Consequently, the Commission periodically has revised the SRO rule filing requirements to balance the needs of the exchanges in a competitive financial marketplace against maintaining the statutorily required Commission oversight of the SROs and the SRO rule change process.

In 1994, the Commission adopted amendments to Rule 19b-4 to allow certain non-controversial proposed rule changes and proposed rule changes for minor systems changes to “become immediately effective” upon filing and without Commission approval.⁸ In 1998, the Commission again amended Rule 19b-4 to allow for the listing and trading of certain derivative securities products without prior submission of a proposed rule change under Section 19(b).⁹ The 1998 rulemaking was intended to speed the introduction of new derivative securities products and enable exchanges to remain competitive with foreign and over-the-counter derivatives markets that are not subject to Section 19(b).

In 2001, the Commission proposed comprehensive changes to the SRO rule filing process.¹⁰ The Commission proposed to completely replace Rule 19b-4, the rule governing the requirements for SRO rule filings, with proposed new Rule 19b-6. Proposed Rule 19b-6, among other things, would have defined terms used in proposed Rule 19b-6 to allow most exchange trading rules, other than proposals involving fundamental market structure changes, to be immediately effective upon filing with the Commission pursuant to Section 19(b)(3)(A) of the

⁷ Securities Exchange Act Release No. 43860 (January 19, 2001), 66 FR 8912 (February 5, 2001) (S7-03-01) (“Rule 19b-6 Proposing Release”).

⁸ See Securities Exchange Act Release No. 35123 (December 20, 1994), 59 FR 66692 (December 28, 1994) (S7-17-94) (“Non-Controversial Rule Adopting Release”).

⁹ See Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998) (S7-13-98) (“New Products Adopting Release”).

¹⁰ See Rule 19b-6 Proposing Release, *supra* note 7.

Exchange Act. The Commission also proposed related changes that would have imposed a number of new obligations on SROs filing proposed rule changes with the Commission. For example, in proposed Rule 19b-6, the Commission would have required, among other things, that a senior SRO official certify the accuracy and completeness of the proposal. The Commission also proposed to eliminate the 30-day operational date and the five-day pre-filing requirement for non-controversial rule filings.

The Commission received 21 comment letters on proposed Rule 19b-6, many of which opposed various aspects of the proposal, though for widely divergent reasons. Four commenters explicitly supported the proposal to make certain trading rules effective upon filing.¹¹ Several SROs believed that the proposal provided only minor benefits that were potentially outweighed by new burdensome requirements.¹² A few commenters believed that the category of trading rules eligible for immediate effectiveness was too narrow, or that more objective standards were needed to determine what qualifies as a trading rule.¹³ In contrast, other commenters were concerned that the proposal might reduce the opportunity to comment on proposed rule

¹¹ See Comment letters from Nasdaq (dated April 6, 2001); the Pacific Exchange (dated April 24, 2001); Bloomberg Tradebook LLC (dated April 5, 2001); and the Chicago Stock Exchange (dated April 5, 2001).

¹² See, e.g., Comment letters from The Options Clearing Corporation (dated April 6, 2001); the Philadelphia Stock Exchange (dated April 6, 2001); the Chicago Stock Exchange (dated April 5, 2001); the International Securities Exchange (dated March 23, 2001); and the Chicago Board Options Exchange (dated April 11, 2001).

¹³ See, e.g., Comment letters from Credit Suisse First Boston (dated March 26, 2001); the International Securities Exchange (dated March 23, 2001); the Philadelphia Stock Exchange (dated April 6, 2001); the Pacific Exchange (dated April 24, 2001); Nasdaq (dated April 6, 2001); the Chicago Board Options Exchange (dated April 11, 2001); the Chicago Stock Exchange (dated April 5, 2001); and the Mercatus Center of George Mason University (dated April 9, 2001).

changes,¹⁴ and that the Commission might be hesitant to abrogate immediately effective filings.¹⁵

Several commenters explicitly opposed making certain types of trading rules immediately effective, noting that such rule changes may have particular importance to the public or have a major impact on market participants.¹⁶ Several commenters also opposed the proposal to remove the operative delay¹⁷ from Rule 19b-4(f)(6).¹⁸ In addition, several commenters expressed support for Commission issuance of notice of a proposed rule change within 10 business days or such longer period as the SRO consents.¹⁹

¹⁴ See, e.g., Comment letters from the Investment Company Institute (dated April 6, 2001); Bloomberg Tradebook LLC (dated April 5, 2001); Brunelle & Hadjickow (dated April 4, 2001); the Consumer Federation of America (dated April 6, 2001); the Securities Industry Association (dated April 6, 2001); and the American Council of Life Insurers (dated April 10, 2001). See discussion below in Section III.A.2(b) regarding the importance of public comment to the SRO proposed rule change process.

¹⁵ See, e.g., Comment letters from Credit Suisse First Boston (dated March 26, 2001); the Council of Institutional Investors (dated March 26, 2001); the Investment Company Institute (dated April 6, 2001); and the Consumer Federation of America (dated April 6, 2001). See discussion below in Section IV regarding abrogation of immediately effective proposals.

¹⁶ See, e.g., Comment letters from the Securities Industry Association (dated April 6, 2001) and Brunelle & Hadjickow (dated April 4, 2001). These commenters believed that entities that are familiar with the technology and operation of SRO trading systems should be given an opportunity to comment on proposed changes to such systems. See Section III.A.2(b), below ("Opportunity for Public Comment With Regard to Immediately Effective Rule Filings").

¹⁷ A proposed rule change designated immediately effective normally becomes operative upon filing with the Commission, except for a proposal submitted pursuant to Rule 19b-4(f)(6), which becomes operative 30 days after the date of filing with the Commission or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. 17 CFR 240.19b-4(f)(6)(iii)

¹⁸ See, e.g., Comment letters from the Investment Company Institute (dated April 6, 2001); the State of Wisconsin Investment Board (dated March 28, 2001); Brunelle & Hadjickow (dated April 4, 2001); the Consumer Federation of America (dated April 6, 2001); the Securities Industry Association (dated April 6, 2001); and the American Council of Life Insurers (dated April 10, 2001). One commenter suggested that a delay between the effective and operative date would allow the Commission to abrogate a rule with a minimum of disruption to an SRO's operations. See Comment letter from the State of Wisconsin Investment Board (dated March 28, 2001).

¹⁹ See Comment letters from Credit Suisse First Boston (dated March 26, 2001); the Chicago Stock Exchange (dated April 5, 2001); the Philadelphia Stock Exchange (dated April 6, 2001); Nasdaq (dated April 6, 2001); the Securities Industry Association (dated April 6, 2001); the Pacific Exchange (dated April 24, 2001); the Government Securities Clearing Corporation (dated March 20, 2001); NASD Dispute Resolution and NASD Regulation (dated May 3, 2001). One

The Commission has considered thoroughly all of these comments. The Commission is not taking action today on proposed Rule 19b-6 nor with regard to any of the other related changes,²⁰ but the Commission's action in this release is consistent with the objectives underlying the Rule 19b-6 proposal and takes into account the varying views expressed in the comments.

The Commission notes that the guidance and rule adopted herein do not alter the existing legal obligations for SROs filing proposed rule changes. The Commission today is not modifying or replacing Rule 19b-4, nor is it imposing related obligations on SROs with regard to the rule filing process and, therefore, the Commission believes that the additional requirements proposed in the Rule 19b-6 Proposing Release are not necessary at this time. As discussed below, the guidance in this release addresses a much narrower part of the SRO rule filing process and imposes no new obligations on SROs.

The Commission believes that it is now appropriate to issue guidance related to the filing of certain immediately effective proposed rule changes by SROs and to adopt a rule amendment designed to streamline further the SRO proposed rule change process. Specifically, the Commission today is (1) providing an interpretation of the Commission's views as to which SRO rule filings could be filed as immediately effective and (2) modifying only its own internal processes.

commenter suggested that the Commission publish notice of a proposed rule change within ten calendar days, not business days, and recommended that there be a mechanism to ensure compliance with the requirement. See Comment letter from the Chicago Board Options Exchange (dated April 11, 2001).

²⁰ For example, the Commission is taking no further action at this time on the Rule 19b-6 proposal to require certifications or to remove the pre-filing or operative delay from Rule 19b-4(f)(6) under the Exchange Act.

II. Background on the Current Rule Filing Process

Section 19(b)(1) of the Exchange Act requires an SRO to file with the Commission any proposed rule change,²¹ which must be “accompanied by a concise general statement of the basis and purpose of such proposed rule change” and be submitted electronically on Form 19b-4, in accordance with the General Instructions thereto.²² Exhibit 1 of Form 19b-4 requires an SRO to prepare the notice of its proposed rule change for publication in the Federal Register.²³ A proposed rule change may not take effect unless it is approved by the Commission²⁴ or becomes immediately effective upon filing pursuant to Section 19(b)(3)(A) of the Exchange Act.²⁵

²¹ Section 19(b)(1) of the Exchange Act defines a “proposed rule change” as “any proposed rule, or any proposed change in, addition to, or deletion from the rules of” an SRO. 15 U.S.C. 78s(b)(1). Section 3(a)(27) of the Exchange Act defines “rules” to include “the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing... and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, association, or clearing agency.” 15 U.S.C. 78c(a)(27).

²² 17 CFR 249.819. Among other things, the General Instructions to Form 19b-4 specify that an SRO’s proposal must be clear and complete before it will be accepted as filed by the Commission. See General Instruction B to Form 19b-4 (“This form, including the exhibits, is intended to elicit information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether the proposed rule change is consistent with the requirements of the [Exchange] Act and the rules and regulations thereunder... The [SRO] must provide all the information called for by the form, including the exhibits, and must present the information in a clear and comprehensible manner... Any filing that does not comply with the requirements of this form may be returned to the [SRO] at any time before the issuance of the notice of filing. Any filing so returned shall for all purposes be deemed not to have been filed with the Commission”). See also Rule 0-3 under the Exchange Act, 17 CFR 240.0-3 (“The date on which papers are actually received by the Commission shall be the date of filing thereof if all of the requirements with respect to the filing have been complied with....”).

²³ If the conditions of Rule 19b-4 and Form 19b-4 are satisfied, a proposed rule change submitted electronically via the Commission’s Electronic Form Filing System on or before 5:30 p.m. Eastern Time on a business day is deemed “filed” on that business day, and all filings submitted after 5:30 p.m. Eastern Time are deemed filed on the next business day. See Rule 19b-4(k), 17 CFR 240.19b-4(k).

²⁴ See 15 U.S.C. 78s(b)(2).

²⁵ 15 U.S.C. 78s(b)(3)(A).

A. Proposals Subject to Commission Approval

For those proposals that are subject to Commission approval, Section 19(b)(2) of the Exchange Act specifies the standards and time periods for Commission action either to approve a proposed rule change or to institute proceedings to determine whether a proposed rule change should be disapproved.²⁶ After expiration of the applicable comment period and due consideration of any comment letters received, the Commission shall approve a proposed rule change if it finds such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.²⁷ The Commission shall disapprove a proposed rule change if it cannot make such a finding.²⁸

B. Immediately Effective Proposals

Section 19(b)(3)(A) of the Exchange Act provides that, notwithstanding the provisions of Section 19(b)(2), a proposed rule change may take effect upon filing with the Commission if designated by the SRO as:

- (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization;
- (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization; or
- (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule...may specify....²⁹

²⁶ See 15 U.S.C. 78s(b)(2). The Commission must either approve or institute disapproval proceedings within thirty-five days of the date of publication of notice of the filing in the Federal Register, or within such longer period as the Commission may designate (up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding) or as to which the SRO consents. See id.

²⁷ The Commission may approve a proposed rule change on an accelerated basis prior to the 30th day after publication of the notice in the Federal Register if it finds good cause and publishes its reasons for so doing. See id.

²⁸ See id.

²⁹ 15 U.S.C. 78s(b)(3)(A).

Section 19(b)(3)(A)(iii) of the Exchange Act grants the Commission authority to expand the scope of proposed rule changes entitled to qualify for immediate effectiveness to other matters which the Commission, by rule, consistent with the public interest and the purposes of Section 19(b) of the Exchange Act, may specify. Rule 19b-4(f) under the Exchange Act³⁰ specifies the following types of proposed rule changes that may take effect upon filing with the Commission pursuant to Section 19(b)(3)(A) if properly designated by an SRO as:

- (1) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule;
- (2) establishing or changing a due, fee, or other charge applicable to a member;
- (3) concerned solely with the administration of the self-regulatory organization;
- (4) effecting a change in an existing service of a registered clearing agency that: (i) does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible; and (ii) does not significantly affect the respective rights or obligations of the clearing agency or persons using the service;
- (5) effecting a change in an existing order-entry or trading system of a self-regulatory organization that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not have the effect of limiting the access to or availability of the system; or
- (6) effecting a change that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition;

³⁰

17 CFR 240.19b-4(f).

and (iii) by its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change (the “pre-filing”), or such shorter time as designated by the Commission.³¹

As with a proposed rule change filed pursuant to Section 19(b)(2) of the Exchange Act, the Commission publishes notice in the Federal Register of a proposed rule change designated for immediate effectiveness under Section 19(b)(3)(A).³² An immediately effective filing becomes operative upon filing with the Commission, except for a proposal submitted pursuant to Rule 19b-4(f)(6), which becomes operative 30 days after the date of filing with the Commission

³¹ The five-day period commences from the date the Commission receives the SRO’s pre-filing. The pre-filing requirement was designed to serve as an opportunity for Commission staff to “discuss with the SRO whether there exists an adequate basis upon which the proposed rule change may properly qualify” for immediate effectiveness under Rule 19b-4(f)(6), and allows the SRO to “elicit guidance from Commission staff to help the SRO identify those aspects of a proposed rule change that the Commission deems important” in order to “help the SRO articulate in its subsequent filing the purpose and effects of the proposed rule change, which in turn should further facilitate and expedite the filing process.” Securities Exchange Act Release No. 34140 (June 1, 1994), 59 FR 29393, 29395 (June 7, 1994) (S7-17-94) (“Non-Controversial Rule Proposing Release”). The Commission also notes that it has enhanced its electronic system through which SROs file proposed rule changes to allow the electronic submission of pre-filings.

³² An SRO must designate the basis for immediate effectiveness of the proposed rule change in Item 7 of Form 19b-4. See Item 7 of Form 19b-4 (“Basis for Summary Effectiveness Pursuant to Section 19(b)(3)(A) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)”).

or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest.³³

Further, the Exchange Act provides that at any time within 60 days of the date of filing of a proposed rule change designated for immediate effectiveness under Section 19(b)(3)(A) of the Exchange Act and Rule 19b-4(f) thereunder, the Commission summarily may abrogate the proposed rule change and require that the SRO re-file the proposal under Section 19(b)(2) of the Exchange Act “if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].”³⁴

III. Interpretive Guidance on the Rule Filing Process

The Commission today takes several actions, discussed in greater detail below, intended to facilitate more expeditious handling of proposed rule changes submitted by SROs. The Commission is providing interpretive guidance regarding the range of proposed changes to exchange trading rules that qualify for immediate effectiveness pursuant to Exchange Act Rule 19b-4(f)(6) as not significantly affecting the protection of investors or the public interest and not imposing any significant burden on competition.³⁵ The Commission anticipates that the guidance will result in exchanges filing a broader range of proposed changes to trading rules for immediate effectiveness under Rule 19b-4(f)(6). Additionally, the Commission is providing

³³ With respect to amendments to filings designated for immediate effectiveness pursuant to Rule 19b-4(f)(6), the Commission has stated that “any substantive amendment would trigger a new 30-day period, assuming the changes do not render the filing ineligible for this category.” Non-Controversial Rule Adopting Release, *supra* note 8, 59 FR at 66695. The Commission staff, however, has “discretion to accept editorial changes without triggering a new 30-day period.” *Id.* Such proposals should not require extensive amendments, since “[a] filing requiring further substantive amendments may indicate that it is not appropriate for the expedited treatment afforded by the noncontroversial category.” *Id.*

³⁴ 15 U.S.C. 78s(b)(3)(C).

³⁵ See Rule 19b-4(f)(6), 17 CFR 240.19b-4(f)(6).

guidance on proposed rule changes relating to an SRO's minor rule violation plan ("MRVP") and "copycat" filings relating to SRO rules other than trading rules. The guidance provided herein as it relates to proposed changes to trading rules is directed at SROs that operate trading systems (i.e., the national securities exchanges). The additional guidance is applicable to all SROs, including exchanges, national securities associations, clearing agencies, and the MSRB.

Further, as discussed in Section V below, the Commission is adopting an amendment to Rule 200.30-3(a)(12) relating to the delegation of authority to the Director of the Division of Trading and Markets regarding the publication of proposed rule changes.³⁶ Amended Rule 200.30-3(a)(12) applies with regard to all SRO rule filings.

A. Interpretive Guidance on Immediately Effective Proposed Rule Changes

The national securities exchanges' need to implement quickly new trading rules has become increasingly critical, particularly given the evolving role of securities exchanges, innovations in U.S. and cross-border trading, and the increasingly competitive financial marketplace. Specifically, the Commission recognizes that the national securities exchanges registered under Section 6(a) of the Exchange Act³⁷ face increased competitive pressures from entities that trade the same or similar financial instruments – such as foreign exchanges, futures exchanges, ECNs, and ATSS. These competitors can change their trading rules or trade new products with greater ease, and without filing them with the Commission.

³⁶ To assist the Commission in processing proposed rule changes expeditiously, the Commission emphasizes the obligation of each SRO to prepare proposed rule changes that are clear and complete. See *supra* note 22 and accompanying text. The Commission encourages SROs to devote sufficient resources to the rule filing process to assure quality work product to enable the Commission to evaluate efficiently whether the proposed rule change is consistent with the Exchange Act and applicable rules and regulations thereunder as well as the SRO's own rules.

³⁷ 15 U.S.C. 78f(a).

Accordingly, to inform exchanges' understanding of the range of exchange trading rules eligible for immediate effectiveness and to encourage exchanges to consider filing a broader range of proposed changes to trading rules that do not "significantly affect the protection of investors or the public interest"³⁸ or do not "impose any significant burden on competition,"³⁹ and thus qualify for immediate effectiveness under Rule 19b-4(f)(6), the Commission is providing the interpretive guidance set forth in this release.

1. Previous Commission Guidance on Immediately Effective Proposals

As discussed above, Rule 19b-4(f)(6) permits a proposed rule change to become immediately effective if, among other things, it is properly designated by an SRO as effecting a change that does not significantly affect the protection of investors or the public interest, and does not impose any significant burden on competition. Further, an immediately effective rule pursuant to Rule 19b-4(f)(6), by its terms, may not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, provided that the SRO has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

When adding paragraph (f)(6) to Rule 19b-4 in 1994, the Commission referred to it as the "noncontroversial category" and noted that it was intended to accommodate proposed rule changes that were generally "less likely to engender adverse comments or require the degree of review attendant with more controversial filings."⁴⁰ Accordingly, the Commission contemplated

³⁸ 17 CFR 240.19b-4(f)(6)(i).

³⁹ 17 CFR 240.19b-4(f)(6)(ii).

⁴⁰ Non-Controversial Rule Adopting Release, supra note 8, 59 FR at 66696.

that proposals eligible for filing under paragraph (f)(6) of Rule 19b-4 would generally be “inherently simple and concise” and “otherwise require little in the way of extended review or analysis by the Commission.”⁴¹

2. Interpretation of Rule 19b-4(f)(6) for Rule Proposals Involving Exchange Trading Rules

The rule filing process, by which national securities exchanges are required to file their proposed rule changes with the Commission, currently allows the exchanges to implement many of their proposed rule changes relating to trading rules on an expedited basis. The Commission believes that more rule filings pertaining to the operation of an SRO’s trading systems qualify for immediate effectiveness than are currently filed as such. A number of proposed rule changes that could qualify for immediate effectiveness under Section 19(b)(3)(A) of the Exchange Act are filed, instead, “regular way” under Section 19(b)(2), thus requiring the Commission to issue a notice and an approval order.⁴²

The Commission believes that a proposed trading rule change appropriately may be filed as an immediately effective rule so long as each policy issue raised by the proposed trading rule (i) has been considered previously by the Commission when the Commission approved another exchange’s trading rule (that was subject to notice and comment) pursuant to Section 19(b)(2) of the Exchange Act, and (ii) the rule change resolves such policy issue in a manner consistent with such prior approval. The Commission believes that filing such proposed rule changes for immediate effectiveness not only will reduce the time before which an exchange could

⁴¹ Id. at 66695.

⁴² The Commission understands, however, that there may be a variety of reasons why an SRO may file a proposed rule change under Section 19(b)(2), even though the rule change would have been appropriately filed as an immediately effective rule filing.

implement its new rule or modify an existing one, but also will eliminate the need for the Commission to issue both a notice and an approval order for each such filing.

The Commission notes that certain types of proposals remain ineligible for immediate effectiveness under Rule 19b-4(f)(6). For example, proposals that introduce potentially anti-competitive or unfairly discriminatory aspects to an SRO's operation, or otherwise conflict with stated Commission policy, would not be eligible for immediate effectiveness since they would not meet the standard of Rule 19b-4(f)(6) and the interpretation. Similarly, proposals that would substantially alter an exchange's market structure would continue to be ineligible for immediate effectiveness.

(a) Examples of Trading Rules Eligible for Immediate Effectiveness

Below is a partial list of the types of trading rules that the Commission believes are appropriate for filing as immediately effective rule changes under this interpretation. The Commission emphasizes that this is a partial – not exhaustive – list, designed to assist exchanges in determining the types of proposed trading rule changes that are appropriately filed as immediately effective.

- Protection of Limit Orders. In approving exchange trading rules, the Commission carefully reviews whether they protect limit orders that are displayed on an exchange's book, since limit orders contribute to price discovery, provide liquidity to the market, and may narrow the quoted spread.⁴³ A proposed trading rule change is eligible for immediate effectiveness if the proposal facilitates trading of public customer orders, or

⁴³ See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (S7-30-95) (adopting Rule 11Ac1-4) ("The Commission believes that limit orders are a valuable component of price discovery. The uniform display of such orders will encourage tighter, deeper, and more efficient markets.").

otherwise enables them to interact with order flow on the exchange on an equitable basis (such as price/time priority).

- Market Maker Obligations. The Commission carefully reviews special advantages provided to market makers when it considers exchange trading rule proposals. Market makers can play an important role in providing liquidity to the market, and an exchange can appropriately reward them for that as well as the services they provide to the exchange's market, so long as the rewards are not disproportionate to the services provided.⁴⁴ For example, a proposed trading rule change that strengthens the market while providing benefits to market makers is eligible for immediate effectiveness if the benefits conferred are offset by corresponding responsibilities to the market that provide customer trading interest a net benefit.
- Preferred Order Flow. The Commission recognizes that exchanges compete for preferred order flow. A proposal to allow broker-dealers to execute preferred orders on an exchange is eligible for immediate effectiveness if the rule change provides other market participants a reasonable opportunity to interact with preferred orders and the

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See, e.g., Securities Exchange Act Release Nos. 54580 (October 6, 2006), 71 FR 60781, 60782 (October 16, 2006) (SR-ISE-2006-40) (order approving the establishment of ISE's Second Market); 54238 (July 28, 2006), 71 FR 44758, 44761 (August 7, 2006) (SR-NYSE Arca-2006-13) ("Market Makers receive certain benefits for carrying out their duties.... The Commission believes that a Market Maker must have an affirmative obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis to justify this favorable treatment."); 53652 (April 13, 2006), 71 FR 20422 (April 20, 2006) (SR-Amex-2005-100) (order approving the establishment of a new class of registered options trader called a Remote Registered Options Trader); 52094 (July 21, 2005), 70 FR 43913, 43915 (July 29, 2005) (SR-CHX-2004-11) (order approving a fully-automated electronic book for the display and execution of orders in securities that are not assigned to a specialist) ("Because market makers receive certain benefits for carrying out their duties, the Commission believes that they should have an affirmative obligation to hold themselves out as willing to buy and sell securities for their own account on a regular or continuous basis to justify this favorable treatment."); and 51366 (March 14, 2005), 70 FR 13217, 13221 (March 18, 2005) (order approving the introduction of Remote Market Makers) ("In particular, the Commission believes that RMMs' affirmative obligations are sufficient to justify the benefits they receive as market makers.").

proposal does not impinge upon the incentive for market participants to post competitive quotes.⁴⁵

- Trading Hours. With respect to trading hours, the Commission believes that proposals to modify the trading hours of an exchange, provided there is a sufficient degree of quotation and last-sale transparency during any extended hours, also are eligible for immediate effectiveness under Rule 19b-4(f)(6).⁴⁶
- Conforming Rules to Approved Changes to NMS Plan or Commission Rule. The Commission believes that proposed rule changes to implement provisions of an approved national market system plan (such as the Options Linkage Plan⁴⁷) or a Commission rule are eligible for immediate effectiveness under Rule 19b-4(f)(6).

⁴⁵ See, e.g., Securities Exchange Act Release No. 37406 (March 29, 1996), 61 FR 15322 (April 5, 1996) (SR-CSE-95-03) (“The Commission has concluded that preferencing, as supplemented by the order handling policies, is not necessarily inconsistent with the attainment of best execution of customer orders, the maintenance of fair and orderly markets, or the protection of investors and the public interest under Section 6(b) (5) of the Act.”). See also, e.g., Securities Exchange Act Release Nos. 50819 (December 8, 2004), 69 FR 75093, 75097 (December 15, 2004) (SR-ISE-2003-06) (order approving the establishment of rules to implement a price improvement mechanism) (“The Commission... has expressed its concern that proposals by options exchanges that guarantee a significant portion of orders to any market participant could erode the incentive to display aggressively priced quotes. Thus, the Commission must weigh whether the proposed participation right would so substantially reduce the ability of other market participants to trade with an order that it would reduce price competition.”).

⁴⁶ The Commission notes, however, that an exchange proposal to modify the “regular trading hours,” as defined in Rule 600(b)(64) of Regulation NMS (17 CFR 242.600(a)(64) (defining “regular trading hours” as the time between 9:30 a.m. and 4:00 p.m., Eastern Time)) for any NMS stocks that it lists – which thereby has the effect of extending the time during which all trading centers must protect quotations pursuant to Rule 611 of Regulation NMS (17 CFR 242.611) – must be filed under Section 19(b)(2) of the Exchange Act. The Commission believes that, because such a proposal could potentially raise significant competitive issues and could affect existing SRO surveillance and oversight programs, it must be considered by the Commission after prior notice and comment before it becomes operative. See Non-Controversial Rule Proposing Release, supra note 31, 59 FR at 29394 (noting that a proposal that would affect the surveillance or oversight capabilities of an SRO could directly impair the protection of investors and should be filed under Section 19(b)(2) of the Exchange Act).

⁴⁷ The Options Linkage Plan is a national market system plan for the purpose of creating and operating an intermarket linkage among the various participant exchanges.

(b) Opportunity for Public Comment With Regard to Immediately Effective Rule Filings

Although the Commission is encouraging the exchanges to designate additional proposed changes in the category of trading rules as immediately effective, the Commission is not minimizing the importance of receiving public comments on proposed rule changes relating to trading rules. The Commission emphasizes that it continues to believe that the public interest is served by offering the public, investors, SRO members, and other market participants the opportunity to comment on SRO rule proposals. The Commission considers all comments it receives on each proposed rule change, and makes available all comments to the applicable SRO for its consideration as well.

Comments on an immediately effective filing help the Commission analyze the impact of the filing and evaluate whether to abrogate it.⁴⁸ Comments also help the exchange address legitimate concerns, in a manner that does not delay implementation of the proposed rule change, while still preserving the Commission's ability to act to abrogate when appropriate. For example, in response to a comment letter that raises significant concerns with an immediately effective rule change, an exchange could consider revising its rule (by submitting either another immediately effective proposal or a proposed rule change that requires notice and comment) in a manner that reasonably addresses the issues raised by the commenter.⁴⁹ As described below,⁵⁰ an exchange will decrease the likelihood of abrogation of an immediately effective filing by clearly describing the significance of the rule change and how the proposal is consistent with the

⁴⁸ The Commission notes that no inference should be made regarding whether an SRO's proposed rule change "impose[s] a significant burden on competition" merely because an SRO's competitor objects to the rule filing.

⁴⁹ If the second proposal were filed under Rule 19b-4(f)(6), the Commission could consider waiving the five-day pre-filing period and the 30-day pre-operative period to permit the revision to the new rule to be operative as quickly as possible. See Rule 19b-4(f)(6)(iii).

⁵⁰ See infra Section IV.

standards applicable to exchange rules, such as the provisions set forth in Section 6 and Section 11A of the Exchange Act.⁵¹

B. Other Types of Immediately Effective Proposed Rule Changes

1. Filings Based on the Rules of Another SRO, Other than Trading Rules

The Commission also is issuing interpretive guidance for all SROs with respect to “copycat” filings relating to SRO rules other than trading rules that are eligible for immediate effectiveness. The Commission previously had stated that filings that are “virtually identical” to an SRO filing already approved by the Commission are eligible for immediate effectiveness under Rule 19b-4(f)(6).⁵² The Commission now clarifies that an SRO may designate a proposed rule change for immediate effectiveness even if not “virtually identical” to another SRO’s rules.⁵³

In particular, the Commission recognizes that, while each SRO is unique and has modified its rulebook over time to reflect its particular structure and terminology, all share basic similarities such that a proposed rule change need not be “virtually identical” to the precise text of another SRO’s rules in order for the prescribed conduct and scope of the rule change to be consistent with the other SRO’s rule on which it is based. The Commission believes that a proposed rule change appropriately may be filed as an immediately effective rule so long as it is based on and similar to another SRO’s rule and each policy issue raised by the proposed rule (i) has been considered previously by the Commission when the Commission approved another

⁵¹ 15 U.S.C. 78f and 15 U.S.C. 78k-1, respectively.

⁵² See Non-Controversial Rule Adopting Release, supra note 8, 59 FR at 66697.

⁵³ The Commission guidance contained herein applicable to “copycat” and MRVP filings that are based on SRO rule changes previously approved by the Commission is not intended to limit the ability of SROs to continue to file proposals under Section 19(b)(3)(A) of the Exchange Act where such proposals are based on another SRO’s rules that also were effective pursuant to Section 19(b)(3)(A) of the Act.

exchange's rule (that was subject to notice and comment), and (ii) the rule change resolves such policy issue in a manner consistent with such prior approval. For this class of proposed rule changes, in support of its designation for immediate effectiveness, the SRO is required under Item 8 of Form 19b-4 to identify the original SRO rule(s) on which its proposed rule change is based and explain any differences between its proposed rule change and the rule(s) upon which it is based.⁵⁴

2. Changes to an SRO's Minor Rule Violation Plan

The Commission also believes that more filings relating to an SRO's MRVP could be appropriately filed as immediately effective upon filing under paragraph (f)(6) of Rule 19b-4. Based on its experience with MRVP proposals and various changes to those MRVPs over the years, the Commission believes that MRVPs have been useful elements of SROs' disciplinary function. The MRVP allows an SRO to impose a limited sanction on a member using an abbreviated process when a full disciplinary proceeding may not be warranted. Proposed rule changes that enable SROs to bring new rules into the MRVP sanctioning process rarely raise significant issues and promote compliance by the SRO's members with the SRO's rules and the rules of the Commission.

The Commission previously has stated that certain changes to an SRO's MRVP can be filed for immediate effectiveness pursuant to Rule 19b-4(f)(6) and reiterates that guidance here.⁵⁵

⁵⁴ In identifying a rule on which its proposal is based, the SRO should cite to the Commission's approval order for that rule. See Item 8 of Form 19b-4.

⁵⁵ See Non-Controversial Rule Proposing Release, supra note 31, 59 FR at 29395 (noting that a proposed change that adds an existing rule to an SRO's MRVP, that is objective in nature, such as a reporting obligation, and does not involve a violation of the federal securities laws or the rules thereunder, could be eligible for filing as a "non-controversial" proposed rule change). See also Non-Controversial Rule Adopting Release, supra note 8, 59 FR at 66696 (noting that an NYSE proposal to add violations of an NYSE rule would have been eligible for immediate effectiveness under Rule 19b-4(f)(6)).

Moreover, consistent with “copycat” filings, the Commission believes that a change to an SRO’s MRVP appropriately may be filed as an immediately effective rule so long as each policy issue raised (i) has been considered previously by the Commission when the Commission approved another exchange’s MRVP rule change, and (ii) the rule change resolves such policy issue in a manner consistent with such prior approval.⁵⁶ Immediate effectiveness of such proposals reduces the administrative burdens on SROs that seek to expand the use of their MRVPs.

IV. Abrogation of Immediately Effective Proposals

We have designed the guidance to be principles-based because we cannot anticipate the content and nature of every proposed rule change that might be filed. By its nature, therefore, applying the guidance will involve an element of judgment. We encourage SROs to file immediately-effective proposed rule changes when in the judgment of the SRO that approach is appropriate and consistent with the statute, rules, and this guidance.⁵⁷

We acknowledge that the Commission ultimately may determine to abrogate the immediately-effective proposed rule change. As described in greater detail above, pursuant to

⁵⁶ As with any immediately effective filing, the Commission could abrogate an MRVP-related immediately effective proposed rule change that raises significant issues. For example, an MRVP filing that has the effect of excusing certain rule violations (by, for example, aggregating several instances of violative behavior as a single offense under the SRO’s MRVP) would not be eligible for filing under Rule 19b-4(f)(6). In addition, when proposing a change to its MRVP, it would be helpful for the SRO to specify which violations trigger sanctions, and to cite the rules of conduct that may be enforced using the MRVP. If one of the rules of conduct is lengthy, to facilitate ease of reference, the SRO could consider including citations to the necessary sub-paragraphs in the MRVP rule. Providing a sufficient level of detail as to the rules and violations covered by the MRVP would help affected entities better understand the operation of the plan and would provide specificity useful to assist the SRO in administering its MRVP.

⁵⁷ An SRO that files an immediately effective proposed rule change with the Commission should try to anticipate and address concerns relating to the protection of investors, the public interest, and the burdens on competition. See generally Items 3 and 4 of Form 19b-4. The Commission further notes that conclusory statements made in Item 7 of Form 19b-4 could make it more difficult for the Commission to confirm that the proposed rule change has been properly designated. See Item 7 of Form 19b-4 (“Basis for Summary Effectiveness Pursuant to Section 19(b)(3)(A) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)”).

Section 19(b)(3)(C), at any time within 60 days of the date of filing of an immediately effective proposed rule change, the Exchange Act permits the Commission summarily to abrogate the rule change “if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].”⁵⁸

In connection with the interpretation, the Commission also is removing its delegation of authority the Director of the Division of Trading and Markets to abrogate SRO rule filings. We emphasize that abrogation does not necessarily imply that a proposed rule change is inconsistent with the Exchange Act.⁵⁹ If the Commission abrogates an SRO’s proposed rule change filed for immediate effectiveness after it became effective but before it becomes operative (*i.e.*, 30 days after filing or such shorter period as the Commission may designate), the SRO would not have to revert to its previous rules, because they never ceased being operative.⁶⁰ A Commission determination to abrogate a proposed rule change does not affect the validity or force of the rule change during the period it was in effect.⁶¹

V. Amendment to Rule 200.30-3(a)(12)

The Commission believes that explicitly outlining the mechanism for issuance of notices of proposed SRO rule changes will further enhance the efficiency of the rule filing process. As such, the Commission is modifying its delegation of authority to the Director of the Division of

⁵⁸ 15 U.S.C. 78s(b)(3)(C).

⁵⁹ By its terms, Section 19(b)(3)(C) states that the Commission may abrogate a proposal and “require that the proposed rule change be refiled...” pursuant to Exchange Act Section 19(b)(1) to be reviewed by the Commission pursuant to Section 19(b)(2).

⁶⁰ See 15 U.S.C. 78s(b)(3)(C). A proposed rule change filed pursuant to Rule 19b-4(f)(6) becomes effective upon filing, but may not become operative until 30 days after the date of filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. See 17 CFR 240.19b-4(f)(6)(iii).

⁶¹ See 15 U.S.C. 78s(b)(3)(C).

Trading and Markets. The amended rule specifies that the Division shall issue notices of all proposed rule changes within 15 business days of filing thereof by the self-regulatory organization unless the Director of the Division personally directs otherwise, and, if the Director has so directed, he shall promptly notify the Commission and either the Commission or the Director may order publication of the notice thereafter.⁶²

The Commission believes that this requirement will enhance transparency with respect to the rule filing process, which also will provide additional certainty to SROs with respect to the issuance of notices of proposed rule changes. The Commission also expects this requirement to significantly improve the efficiency of the processing of SRO proposed rule changes and the issuance of notices of proposed rule changes, particularly with respect to filings subject to notice and comment pursuant to Section 19(b)(2) of the Exchange Act. The Commission believes that requiring the Division to issue notice of all proposed rule changes that are properly filed and comply with all applicable requirements within 15 business days of filing thereof will help SROs plan accordingly as well as assist the Commission staff in managing their work flow.

The Commission notes that SRO rule change proposals will continue to be required to be drafted with precision if they are to provide information necessary to elicit meaningful public comment on the proposed rule change. As is currently the case, a proposal that does not comply with the requirements of Form 19b-4 and Rule 19b-4 under the Exchange Act will not be accepted as filed.⁶³

⁶² Nevertheless, the Division may continue to submit proposed rule changes and related matters to the Commission for its consideration as it considers appropriate.

The Commission notes that Commission rules require an SRO to post its proposed rule change on its Web site when the proposed rule change is submitted to the Commission. Further, the proposed rule change will be posted on the Commission's Web site shortly after the Commission issues notice thereof.

⁶³ See supra note 22.

In order to provide for the possibility that there may be unusual and infrequent circumstances in which the 15 business day requirement is impractical, the rule permits the Director of the Division of Trading and Markets in such circumstances to direct otherwise. The rule provides that this function cannot be subdelegated.

VI. Administrative Procedure Act, Regulatory Flexibility Act, and Paperwork Reduction Act

The Commission finds, in accordance with Section 553(b)(3)(A) of the Administrative Procedure Act,⁶⁴ that the interpretive guidance issued today and amended Commission Rule 200.30-3(a)(12) relate solely to interpretations and agency organization, procedure, or practice. Accordingly, the guidance and Rule 200.30-3(a)(12) are not subject to the provisions of the Administrative Procedure Act requiring notice, opportunity for public comment, and publication prior to their adoption.⁶⁵

Further, publication of a substantive rule not less than 30 days before its effective date is required by the Administrative Procedure Act except as otherwise provided for in Section 553(d). However, interpretive rules may take effect less than 30 days after publication.⁶⁶ In addition, because the amended rule relates solely to the internal processes of the Commission with regard to the publication of proposed rule changes filed by SROs, the Commission finds

⁶⁴ 5 U.S.C. 553(b)(3)(A).

⁶⁵ For similar reasons, the amendments do not require analysis under the Regulatory Flexibility Act or analysis of major rule status under the Small Business Regulatory Enforcement Fairness Act. See 5 U.S.C. 601(2) (for purposes of Regulatory Flexibility Act analyses, the term "rule" means any rule for which the agency publishes a general notice of proposed rulemaking); 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).

⁶⁶ See 5 U.S.C. 553(d)(2).

that there is good cause for making amended Rule 200.30-3(a)(12) effective upon publication in the Federal Register.⁶⁷

Finally, the rule and the Commission's interpretation do not contain any new or additional collections of information as defined by the Paperwork Reduction Act of 1995, as amended.⁶⁸

VII. Costs and Benefits of the Proposed Amendments

The Commission is sensitive to the costs and benefits of its rules, and has considered carefully the costs and the benefits of the interpretive guidance and the rule amendment. To the extent that SROs decide to avail themselves of the guidance contained in this release, the Commission believes that more rule changes will be filed as immediately effective rule filings and more proposed rule changes relating to trading rules, MRVPs, and "copycat" proposals that currently are filed under Section 19(b)(2) will take effect upon filing with the Commission. As SROs increase their use of Section 19(b)(3)(A) to file more proposed rule changes for immediate effectiveness, SROs will be able to modify their trading systems and rules more quickly in response to competitive pressures, while still being subject to the protections provided by Exchange Act Section 19(b). Further, as more proposed rule changes become effective upon filing, the burdens on the SROs, as well as on the Commission and its staff, are expected to be reduced since such proposals will be processed and take effect more quickly, as those rule changes would not be subject to the issuance of a Commission order before they may take effect. Also, to the extent that the guidance increases the percentage of SRO proposed rule changes that may take effect upon filing with the Commission, there will be efficiencies as the processing of

⁶⁷ See 5 U.S.C. 553(d)(3).

⁶⁸ 44 U.S.C. 3501.

such proposed rule changes requires fewer staff resources since the Commission is not required to issue an order approving such proposed rule changes.

In addition, the revised rule regarding the issuance of a notice of a proposed rule change within 15 business days of filing with the Commission will benefit SROs by providing additional certainty to them regarding the process, thereby enabling them to plan according, and improving the efficiency and the speed with which the Commission processes SRO rule filings. The Commission believes that this rule will increase the speed with which the Commission handles SRO proposed rule changes. The Commission does not expect its guidance and the rule amendment to increase the costs on SROs of filing proposed rule changes with the Commission.

Certain costs associated with the Commission's action today may potentially result from the change in the amount of time that interested persons will have to comment on proposed changes to trading rules before they become operative. In particular, to the extent that SROs designate a greater number of proposed rule changes for immediate effectiveness pursuant to Section 19(b)(3)(A) where they previously would have submitted them pursuant to Section 19(b)(2), then the opportunity for interested persons to comment on such proposals will now occur after the proposal has taken effect upon filing with the Commission, since such proposals are not be subject to Commission approval before they become effective.

The Commission believes that this potential cost is limited by a number of factors. First, interested persons will continue to have an opportunity to submit written data, views, and arguments concerning such proposed rule changes before market participants must comply with the new rules because proposals that take effect upon filing with the Commission pursuant to Rule 19b-4(f)(6) ordinarily will not become operative until 30 days after filing with the Commission unless the SRO demonstrates to the Commission that waiver of the operative delay

would be consistent with the protection of investors and the public interest. In addition, the Commission summarily may abrogate a proposed rule change. If an SRO were to re-file the proposed rule change pursuant to Section 19(b)(2), the proposed rule change will be published for notice and comment.⁶⁹ The Commission's action or inaction with regard to abrogation will be informed by its own views, as well as the views expressed by commenters.

Finally, as currently is the case, a proposed rule change may take effect upon filing with the Commission only if it satisfies the standards set forth in Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. Additionally, the Commission guidance outlined above specifies that an immediately-effective proposed rule change involving a trading rule, MRVP, or copycat proposal may not raise policy issues that the Commission previously has not considered in a proposed rule change filed by another exchange that was approved by the Commission after notice and comment. Accordingly, since the rule on which the new proposal is modeled will have been previously subject to notice and comment, the interested persons will have had the opportunity to comment before the prior proposal (or proposals) became effective and on the immediately-effective rule filing, as well.

In addition, amended Rule 200.30-3(a)(12) relates to internal agency management. The Commission's rule amendment is intended to increase the efficiency of the Commission's review of SRO proposed rule changes by outlining the Commission's expectations with respect to Commission review of and the timing of issuance of a notice of an SRO's proposed rule change. Any increase in the costs of this amended rule fall on the Commission and its staff. In particular, the Commission will have to concentrate staff resources on reviewing and noticing within 15 days the proposed rule changes submitted by SROs. However, the ability of SROs to devote

⁶⁹ See 15 U.S.C. 78s(b)(3)(C).

sufficient resources to preparing clear and complete proposals should enable the staff to review expeditiously a proposed rule change and issue the notice substantially in the form provided by the SRO when both are clear, complete, and consistent with all applicable requirements.

VIII. Effect on Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act⁷⁰ 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. Rule 200.30-3(a)(12) applies to the Commission's delegation of authority with regard to the publication of notice of proposed rule changes filed by SROs pursuant to Section 19(b)(1) of the Exchange Act.⁷¹ Specifically, the modifications to the rule, which require the Division of Trading and Markets to issue notice of a proposed rule change within 15 business days of filing with the Commission; do not impose any burdens or costs on SROs. Further, the interpretation likely will facilitate the ability of SROs to modify their trading systems and rules more quickly in response to competitive pressures, while still preserving the protections provided by Exchange Act Section 19(b).

The Commission expects the interpretive guidance and amended Rule 200.30-3(a)(12) to have a positive effect on efficiency, competition, and capital formation in that the exchanges that utilize the guidance are expected to find themselves in a better position to compete with entities that operate trading systems that are not subject to the rule filing processes of Section 19(b) of the Exchange Act.

Furthermore, any increase in the number of proposed rule changes that may become effective upon filing with the Commission should improve the ability of SROs to amend their rules efficiently, particularly with respect to rules relating to trading systems and "copycat".

⁷⁰ 15 U.S.C. 78w(a)(2).

⁷¹ 15 U.S.C. 78s(b)(1).

proposals, which will enhance their ability to respond to competitive pressures by allowing them to file changes to their systems on an immediately-effective basis. In addition, to the extent that SROs file an increasing number of their proposed rule changes for immediate effectiveness pursuant to Section 19(b)(3)(A) of the Exchange Act rather than for Commission approval pursuant to Section 19(b)(2) of the Exchange Act, this guidance should allow the Commission to focus on those filings that raise significant issues and that are required to be submitted under Section 19(b)(2) of the Exchange Act for Commission approval.⁷²

IX. Statutory Basis and Text of Amendments

This amendment to 17 CFR Part 200.30-3(a)(12) is being adopted pursuant to statutory authority granted to the Commission, including Sections 4A, 6, 11A, 15A, 15B, 17A, 19, and 23 of the Exchange Act.⁷³

List of Subjects

17 CFR Part 200

Administrative practice and procedures, Authority delegations (Government agencies).

17 CFR 241

Securities.

Text of the Adopted Rules

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

⁷² 15 U.S.C. 78s(b)(2). The Commission notes that the majority of rule proposals filed by SROs are currently designated for immediate effectiveness. For example, in 2006, SROs filed 1,018 proposed rule changes with the Commission. Of those filings, 478 (47%) were filed pursuant to Section 19(b)(2) and 540 (53%) were filed pursuant to Section 19(b)(3)(A).

⁷³ 15 U.S.C. 78d-1, 78f, 78k-1, 78o-3, 78o-4, 78q-1, 78s, and 78w, respectively.

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

Subpart A – Organization and Program Management

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.

* * * * *

2. Section 200.19a is amended by:

- a. Revising the section heading as set forth below;
- b. In the first sentence of the introductory text of the section, revise the phrase “Division of Market Regulation” to read “Division of Trading and Markets”; and
- c. Remove the authority citation following the section.

§ 200.19a Director of the Division of Trading and Markets.

* * * * *

3. Section 200.30-1, paragraph (i), first sentence is amended by revising the phrase “Division of Market Regulation” to read “Division of Trading and Markets”.

4. Section 200.30-3 is amended by:

- a. Revising the section heading as set forth below;
- b. In the introductory text to the section, revising the phrase “Division of Market Regulation” to read “Division of Trading and Markets”;
- c. Adding two sentences to the end of paragraph (a)(12); and
- d. removing and reserving paragraph (a)(58).

The revision and addition reads as follows:

§ 200.30-3 Delegation of authority to Director of Division of Trading and Markets.

* * * * *

(a) * * *

(12) * * * The Division shall issue such notices of proposed rule changes within 15 business days of filing by the self-regulatory organization unless the Director of the Division personally otherwise directs. If the Director has so directed, the Division Director shall promptly notify the Commission and either the Commission or the Director may order publication of the notice thereafter.

* * * * *

5. Section 200.30-4, paragraph (a)(12), first sentence is amended by

Revising the phrase "Division of Market Regulation" to read "Division of Trading and Markets".

6. Section 200.30-11, paragraph (c)(2), is amended by revising the phrase "Division of Market Regulation" to read "Division of Trading and Markets".

7. Section 200.30-18, introductory text of paragraph (h), is amended by revising the phrase "Division of Market Regulation" to read "Division of Trading and Markets".

PART 241 – INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

8. Part 241 is amended by adding Release No. 34-58024 and the release date of June 25, 2008 to the list of interpretive releases.

By the Commission.



Florence E. Harmon
Acting Secretary

July 3, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58105 / July 7, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13087

In the Matter of

PHILLIP W. OFFILL, JR., Esq.

Respondent.

**ORDER OF FORTHWITH SUSPENSION
PURSUANT TO RULE 102(e)(2) OF THE
COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Phillip Offill, Jr. pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. 200.102(e)(2)].¹

II.

The Commission finds that:

1. Offill is an attorney admitted to practice law in Texas.
2. On March 13, 2008, an evidentiary panel of the District 06A Grievance Committee of the Texas State Bar ("Texas State Bar") concluded that Offill had, among other things: (i) failed to return client documents to a former client after the attorney-client relationship had ended and the client had requested that the documents be returned; (ii) intended to destroy or conceal client documents when a dispute was pending between Offill and his law firm, on the one hand, and his former client, on the other; (iii) intended to destroy or conceal client documents when Offill knew that his former client was about to commence litigation against him; (iv) failed to counsel certain individuals and entities about various potential conflicts of interest; (v) failed to obtain waivers of conflict from certain individuals and entities when he

¹Rule 102(e)(2) provides in pertinent part: "Any attorney who has been suspended or disbarred by a court of the United States or of any State; or any person whose license to practice as a[] . . . professional or expert has been revoked or suspended in any State . . . shall be forthwith suspended from appearing or practicing before the Commission."

sought to represent them simultaneously in the same transaction; (vi) failed to counsel certain individuals and entities about the potential legal and ethical implications of representing multiple parties to a single transaction; (viii) made misrepresentations to a federal judge in Florida; (ix) misrepresented his and his client's relationship to certain individuals in litigation pleadings; (x) failed intentionally to respond completely to discovery requests in litigation; and (xi) failed intentionally to put in writing advice he had given to his clients to make it easier for them to deny that such advice had ever been tendered.

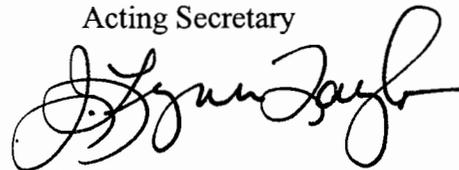
3. The Texas State Bar accordingly issued a Judgment of Partially Probated Suspension ("Judgment") against Offill on March 13, ordering that he: (i) be suspended from practicing law for a period of 36 months, beginning May 1, 2008, and (ii) be placed on a period of probated suspension for 24 months, beginning May 1, 2011. The Judgment further ordered Offill to pay \$70,000 in attorneys' fees and \$17,200 in direct expenses to the Texas State Bar on or before April 30, 2008.

III.

In view of the foregoing, the Commission finds that Offill is an attorney who has been suspended from practicing law within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice. Accordingly, it is ORDERED, that Phillip W. Offill is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58106 / July 7, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11769

In the Matter of

**Franklin Advisers, Inc. and Franklin/
Templeton Distributors, Inc.**

Respondents.

**ORDER APPROVING FINAL
ACCOUNTING, DIRECTING
PAYMENT OF REMAINDER OF
FAIR FUND TO UNITED STATES
TREASURY, AND DISCHARGING
ADMINISTRATOR**

On May 19, 2006, the Commission published a notice of the Plan of Distribution proposed by the Division of Enforcement in connection with this proceeding (Securities Exchange Act Release No. 53844). The Plan of Distribution proposed that a Fair Fund consisting of \$20,000,001 in disgorgement, civil penalties, and any accrued interest, be distributed *pro rata* to each Franklin Templeton mutual fund ("FT Fund") based on the amount of brokerage commissions attributed to that FT Fund during the calendar years 2001, 2002, and 2003. The Plan of Distribution also provided that the Commission arrange for direct payment, by electronic transfer in immediately available funds, to each FT Fund its share of the Fair Fund.

On June 23, 2006, the Commission approved the Plan of Distribution and the appointment of Marc J. Fagel, Esq., Associate District Administrator of the Commission's San Francisco Regional Office, as Plan Administrator (Securities Exchange Act Release No. 54037). On August 21, 2006, the Commission issued an order directing Franklin Templeton to distribute the funds pursuant to the Plan of Distribution. On September 28, 2006, \$20,701,898.26 was distributed to the FT Funds affected by the use of brokerage commissions to pay for shelf space.

Between December 9, 2004 and December 18, 2006, income tax payments totaling \$467,580 were made from the Fair Fund. Pursuant to the Plan Administrator's final accounting,

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submitted pursuant to Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans, \$166,093.65 remains in the Fair Fund.

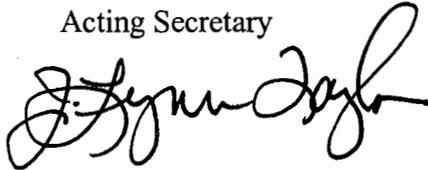
Accordingly, IT IS ORDERED that the Commission approves the final accounting of the Fair Fund established in this matter.

IT IS FURTHER ORDERED THAT the residual amount of \$166,094.98* shall be transferred to the United States Treasury by the Commission's Office of Financial Management.

IT IS FURTHER ORDERED THAT the Plan Administrator is discharged.

By the Commission.

Florence E. Harmon
Acting Secretary



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

* This amount includes an additional \$1.33 refund from the IRS for an overpayment of taxes that was received after the action memorandum circulated.

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release No. 34-58107; File No. S7-19-07]

RIN 3235-AJ57

Amendment to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; notice of re-opening of comment period.

SUMMARY: The Securities and Exchange Commission is re-opening the comment period on the "Amendments to Regulation SHO" it re-proposed in Securities Exchange Act Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007), (the "Proposal"). In view of the continuing public interest in the Proposal we believe that it is appropriate to re-open the comment period to provide the public with additional information before we take action on the Proposal.

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
- 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.

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Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7-19-07. 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 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: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief and Christina M. Adams, Staff Attorney, 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.

SUPPLEMENTARY INFORMATION: The Commission is requesting additional public comment on proposed amendments to Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Securities Exchange Act of 1934 ("Exchange Act"). In the Proposal, the Commission re-proposed amendments to Regulation SHO under the Exchange Act intended to further reduce the number of persistent fails to

deliver¹ in certain equity securities by eliminating the options market maker exception to the close-out requirement of Regulation SHO. The Commission also sought comment on two alternatives to elimination that would limit the scope of the options market maker exception. The Commission is re-opening the comment period, which ended on September 13, 2007, to provide additional information with respect to the Proposal to the public.

At the same time that the Commission re-proposed amendments to Regulation SHO to eliminate the options market maker exception to Regulation SHO's close-out requirement, the Commission approved amendments to Regulation SHO to eliminate the rule's "grandfather" provision.² The "grandfather" provision had provided that fails to deliver established prior to a security becoming a threshold security did not have to be closed out in accordance with Regulation SHO's thirteen consecutive settlement day close-out requirement. The amendment to eliminate the "grandfather" exception became effective on October 15, 2007. The amendment also contained a one-time phase-in period that provided that previously-grandfathered fails to deliver in a security that was a threshold security on the effective date of the amendment must be closed out within 35 consecutive settlement days from the effective date of the amendment. The phase-in period ended on December 5, 2007.³

¹ A "fail to deliver" occurs when the seller of a security fails to deliver the security by settlement date. 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 generally 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 generally must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale.

² Securities Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007).

³ See id.

In response to the Proposal, commenters urged the Commission to obtain empirical data to demonstrate the relationship between fails to deliver and the options market maker exception before it determines whether additional rulemaking is necessary. In particular, commenters urged the Commission to obtain data relating to the impact of the elimination of the grandfather provision and connecting fails to deliver to the options market maker exception.⁴ The Commission has obtained additional data on fails to deliver since the Proposal was published. Accordingly, in response to commenters and because the Commission believes the additional data will aid the public in commenting on the Proposal, the Commission is re-opening the comment period to share with the public data obtained by the Commission regarding fails to deliver and the options market maker exception, and to provide the public with an opportunity to comment on the data.

To ascertain whether fails to deliver are not being closed out due to the options market maker exception to the close-out requirement since the elimination of the “grandfather” provision, Commission staff obtained data on securities with extended fails to deliver from a National Securities Clearing Corporation (“NSCC”) participant which settles and clears for a large segment of the options market for January and February 2008. A review of this data reveals that a high number of fails to deliver were not closed out as a result of the options market maker exception.⁵ Specifically, the data indicated that as of January 31, 2008, the options market maker exception was claimed in 16 threshold securities for a total of 6,365,158 fails to deliver. As of February 29, 2008, the

⁴ See e.g., Comments of Keith F. Higgins, Committee on Federal Regulation of Securities, American Bar Association, Section of Business Law (Oct. 5, 2007); comments of John Gilmartin and Ben Londergan, Group One Trading, LP (Sept. 28, 2007); see also comments of Gerald D. O’Connell, Susquehanna Investment Group (Oct. 11, 2007).

⁵ We note that the data reflects only those extended fails to deliver not closed out due to the options market maker exception and, therefore, does not reflect all fails to deliver in the securities included in the data.

data indicated that the options market maker exception was claimed in 20 threshold securities for a total of 6,963,949 fails to deliver.

In addition, the Commission is releasing the results of a recent analysis by the Commissions' Office of Economic Analysis ("OEA") of fails to deliver before and after the elimination of Regulation SHO's "grandfather" provision.⁶ As set forth below, these results show that extended fails to deliver in non-optionable threshold securities declined significantly after the elimination of the "grandfather" provision while extended fails to deliver in optionable threshold securities increased significantly. Specifically, changes for optionable threshold securities include:

- The average daily number of optionable threshold list securities increased by 25.0%.
- The average daily number of new fail to deliver positions in optionable threshold securities increased by 45.3%.
- For fails aged more than 17 days in optionable threshold securities, the average daily dollar value of fails to deliver increased by 73.4%.
- For fails aged more than 17 days in optionable threshold securities, the average daily number of fail to deliver positions increased by 30.7%.
- The average daily number of optionable threshold list securities with fails aged more than 17 days increased by 40.9%.

Further, changes for non-optionable threshold securities include:

- The average daily number of non-optionable threshold list securities decreased by 3.5%.
- The average daily number of new fail to deliver positions in non-optionable threshold securities increased by 7.4%.
- For fails aged more than 17 days in non-optionable threshold securities, the average daily dollar value of fails to deliver decreased by 34.5%.
- For fails aged more than 17 days in non-optionable threshold securities, the average daily number of fail to deliver positions decreased by 38.8%.

⁶ See Memorandum from the Commission's Office of Economic Analysis (dated June 9, 2008), which is available on the Commission's internet website at <http://www.sec.gov/comments/s7-19-07/s71907.shtml> (the "OEA Memorandum"). As discussed above, the "grandfather" provision was eliminated as of October 15, 2007 with a one-time phase in period which expired on December 5, 2007. The sample data used in the OEA Memorandum compares two time periods: April 9, 2007 – October 14, 2007, which is defined as the "pre-amendment period" and December 10, 2007 – March 31, 2008, which is defined as the "post-amendment period."

- The average daily number of non-optionable threshold list securities with fails aged more than 17 days decreased by 32.6%.⁷

To ascertain the extent to which fails to deliver were not being closed out due to the options market maker exception to the close-out requirement prior to the elimination of the “grandfather” provision, Commission staff obtained data from certain self-regulatory organizations for 2006 and 2007 regarding use of the options market maker exception. This data is explained in more detail below.

In 2007, as part of its regular Regulation SHO surveillance, the Financial Industry Regulatory Authority (“FINRA”) conducted a review of securities with extended fails to deliver at the NSCC to ascertain the continuing cause of fails to deliver, and to also assess compliance with NYSE Rule 440/SEA⁸ and Regulation SHO. As set forth below, according to data provided by one NSCC participant that settles and clears for a large segment of the options market, a number of fails to deliver at that participant were not closed out due to claims that the fails were excepted from the close-out requirement as a result of the options market maker exception.

A review of the FINRA data for 2007 shows the following:

Month	Fails to Deliver ⁹	No. of Securities
February	35,665	1
March	900,276	5
April	3,433,639	8
May	228,878	2
June	2,441,122	14
July	462,414	6
August	3,065,710	12

⁷ See *id.*

⁸ NYSE Rule 440 requires that “[e]very member not associated with a member organization and every member organization shall make and preserve books and records as the Exchange may prescribe and as prescribed by Rule 17a-3.”

⁹ These numbers represent fails to deliver which, as explained in footnote 1 above, are shares of a security that are not delivered by settlement date. According to the data provided to FINRA, these fails to deliver were not closed out due to the options market maker exception.

October	4,456,340	13
November	1,841,063	2
December	5,621,982	15

As indicated in the table above, the options market maker exception to the close-out requirement was claimed for a large number of fails to deliver for the entire year, including both before and after October 15, 2007, the effective date of the elimination of Regulation SHO's "grandfather" provision.

On December 11, 2006 the Chicago Board of Options Exchange ("CBOE") along with the American Stock Exchange, NYSE Arca, Inc., and the Philadelphia Stock Exchange initiated a Regulation SHO review of options market makers covering the time period from May through July 2006. The focus of these reviews was the options market maker exception to the close-out requirement for aged fails to deliver in threshold securities that were open for thirteen consecutive settlement days.¹⁰

According to CBOE, the reviews revealed that there were 598 exceptions claimed, covering 58 threshold securities for a total of 11,759,799 fails to deliver. For the 58 threshold securities identified, the number of fails to deliver for which an exemption was claimed from the close-out requirement ranged from 207 to 1,950,655. The following is a distribution of the number of fails to deliver:

<u># of Fails to Deliver for which Exception Was Claimed</u>	<u># of Threshold Securities</u>
0 - 100,000	35
100,001 - 200,000	4
200,001 - 300,000	4
300,001 - 400,000	5
400,001 - 500,000	4
500,001 - 600,000	2

¹⁰ The "grandfather" provision was also in effect during this period but was not the subject of these reviews.

600,001 - 700,000	-
700,001 - 800,000	1
800,001 - 900,000	-
900,001 - 1,000,000	1
> 1,000,000	2

Therefore, the Commission is re-opening the comment period for Exchange Act Release No. 56213 from the date of this release through [insert date 30 days after publication in the Federal Register].

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 7, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 8, 2008

IN THE MATTER OF :

VMT Scientific, Inc. :

File No. 500-1 :

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of VMT Scientific, Inc. ("VMT Scientific") because of questions regarding the accuracy of assertions in press releases concerning, among other things: (1) the legal status of VMT Scientific; (2) VMT Scientific's business combinations; (3) VMT Scientific's current financial condition; and (4) VMT Scientific's assets.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above listed company is suspended for the period from 9:30 a.m. EDT, July 8, 2008 through 11:59 p.m. EDT, on July 21, 2008.

By the Commission.



Florence E. Harmon
Acting Secretary

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SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 28329; 812-13074]

ING Clarion Real Estate Income Fund, et al.; Notice of Application

July 8, 2008

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

Action: Notice of application under section 6(c) of the Investment Company Act of 1940 ("Act") for an exemption from section 19(b) of the Act and rule 19b-1 under the Act.

Summary of Application: Applicants request an order to permit certain closed-end investment companies to make periodic distributions of long-term capital gains with respect to their outstanding common stock as frequently as twelve times each year, and as frequently as distributions are specified by or in accordance with the terms of any outstanding preferred stock that such investment companies may issue.

Applicants: ING Clarion Real Estate Income Fund ("IIA"), ING Clarion Global Real Estate Income Fund ("IGR"), and ING Clarion Real Estate Securities, L.P. (the "Adviser").

Filing Dates: March 26, 2004, February 1, 2007, June 12, 2008, and July 8, 2008.

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 August 4, 2008, and should be accompanied by proof of service on applicants, in the form of an affidavit or, for lawyers, a certificate of service. Hearing

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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, Securities and Exchange Commission, 100 F Street, NE, Washington, 20549-1090; Applicants, 201 King of Prussia Road, Suite 600, Radnor, PA 19087, Attention: T. Ritson Ferguson.

For Further Information Contact: Wendy Friedlander, Senior Counsel, at (202) 551-6837, or James M. Curtis, Branch Chief, at (202) 551-6825 (Division of Investment Management, Office of Chief Counsel).

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 Room, 100 F Street, NE Washington 20549-1520 (telephone (202) 551-5850).

Applicants' Representations:

1. Each of IIA and IGR is a registered closed-end management investment company organized as a Delaware statutory trust, and each has high current income as its primary objective and capital appreciation as its secondary objective.¹ The common shares issued by IIA and IGR are listed on the New York Stock Exchange, and the preferred shares issued by each are not listed on any exchange. Applicants believe that the shareholders

¹ Applicants request that any order issued granting the relief requested in the application also apply to any closed-end investment company ("fund") that in the future: (a) is advised by the Adviser (including any successor in interest) or by any entity controlling, controlled by, or under common control (within the meaning of section 2(a)(9) of the Act) with the Adviser; and (b) complies with the terms and conditions of the requested order. A successor in interest is limited to entities that result from a reorganization into another jurisdiction or a change in the type of business organization.

of IIA and IGR are generally conservative, dividend-sensitive investors who desire current income periodically and may favor a fixed distribution policy.

2. The Adviser is registered under the Investment Advisers Act of 1940 and is responsible for the overall management of IIA and IGR. The Adviser is a subsidiary of ING Group, N.V., a financial services organization based in The Netherlands.

3. Applicants represent that on November 16, 2006, the Boards of Trustees (the "Boards") of each of IIA and IGR, including a majority of the members of each of the Boards who are not "interested persons" of each fund (the "Independent Trustees") as defined in section 2(a)(19) of the Act, reviewed information regarding the purpose and terms of a proposed distribution policy, the likely effects of such policy on the respective fund's long-term total return (in relation to market price and net asset value ("NAV") per common share) and the relationship between the fund's distribution rate on its common shares under the policy and the fund's total return on NAV per share. Applicants state that the Independent Trustees of each of IIA and IGR also considered what conflicts of interest the Adviser and the affiliated persons of the Adviser and each fund might have with respect to the adoption or implementation of such policy. Applicants further state that after considering such information the Board, including the Independent Trustees, of each of IIA and IGR approved a distribution policy and related plan with respect to each of the respective fund's common shares (a "Plan") and determined that such policy and Plan are consistent with the relevant fund's investment objectives and in the best interests of such fund's common shareholders.

4. Applicants state that the purpose of each of the proposed Plans would be to permit each fund to distribute over the course of each year, through periodic distributions as

nearly equal as practicable and any required special distributions, an amount closely approximating the total taxable income of the fund during such year and, if so determined by its Board, all or a portion of the returns of capital paid by portfolio companies to the fund during such year. Applicants represent that each of the funds would distribute to its respective common shareholders a fixed monthly percentage or amount under its proposed Plan, which percentage or amount may be adjusted from time to time.

Applicants state that the minimum annual distribution rate with respect to a fund's common shares under each Plan would be independent of the fund's performance during any particular period but would be expected to correlate with the fund's performance over time. Applicants explain that each distribution on the common shares would be at the stated rate then in effect, except for extraordinary distributions and potential increases or decreases in the final dividend periods in light of the fund's performance for the entire calendar year and to enable the fund to comply with the distribution requirements of subchapter M of the Internal Revenue Code of 1986 (the "Code") for the calendar year. Applicants expect that over time the NAV distribution rate with respect to a fund's common shares will approximately equal that fund's total return on NAV.

5. Applicants state that at the November 16, 2006 meeting, the Boards of IIA and IGR each also adopted policies and procedures under rule 38a-1 under the Act that are reasonably designed to ensure that all notices sent to IIA or IGR shareholders with distributions under the Plan ("Notices") comply with condition II below, and that all other written communications by IIA or IGR or its agents regarding distributions under the Plan include the disclosure required by condition III below. Applicants state that the Boards of IIA and IGR each also adopted policies and procedures at that meeting that

require IIA and IGR to keep records that demonstrate each fund's compliance with all of the conditions of the requested order and that are necessary for each fund to form the basis for, or demonstrate the calculation of, the amounts disclosed in its Notices.

Applicants' Legal Analysis:

1. Section 19(b) generally makes it unlawful for any registered investment company to make long-term capital gains distributions more than once each year. Rule 19b-1 limits the number of capital gains dividends, as defined in section 852(b)(3)(C) of the Code ("distributions"), that a fund may make with respect to any one taxable year to one, plus a supplemental "clean up" distribution made pursuant to section 855 of the Code not exceeding 10% of the total amount distributed for the year, plus one additional capital gain dividend made in whole or in part to avoid the excise tax under section 4982 of the Code.

2. Section 6(c) provides that the Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision of the Act, if and to the extent that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

3. Applicants state that the one of the concerns underlying section 19(b) and rule 19b-1 is that shareholders might be unable to differentiate between regular distributions of capital gains and distributions of investment income. Applicants state, however, that rule 19a-1 effectively addresses this concern by requiring that a separate statement showing the sources of a distribution (e.g., estimated net income, net short-term capital

gains, net long-term capital gains and/or return of capital) accompany any distributions (or the confirmation of the reinvestment of distributions) estimated to be sourced in part from capital gains or capital. Applicants state that the same information also is included in IIA's and IGR's annual reports to shareholders and on its IRS Form 1099-DIV, which is sent to each common and preferred shareholder who received distributions during the year.

4. Applicants further state that each of IIA and IGR will make the additional disclosures required by the conditions set forth below, and each of them has adopted compliance policies and procedures in accordance with rule 38a-1 to ensure that all required Notices and disclosures are sent to shareholders. Applicants argue that by providing the information required by section 19(a) and rule 19a-1, and by complying with the procedures adopted under each Plan and the conditions listed below, the funds would ensure that each fund's shareholders are provided sufficient information to understand that their periodic distributions are not tied to the fund's net investment income (which for this purpose is the fund's taxable income other than from capital gains) and realized capital gains to date, and may not represent yield or investment return. Applicants also state that compliance with each fund's compliance procedures and condition III set forth below will ensure that prospective shareholders and third parties are provided with the same information. Accordingly, applicants assert that continuing to subject the funds to section 19(b) and rule 19b-1 would afford shareholders no extra protection.

5. Applicants note that section 19(b) and rule 19b-1 also were intended to prevent certain improper sales practices, including, in particular, the practice of urging an

investor to purchase shares of a fund on the basis of an upcoming capital gains dividend (“selling the dividend”), where the dividend would result in an immediate corresponding reduction in NAV and would be in effect a taxable return of the investor’s capital.

Applicants assert that the “selling the dividend” concern should not apply to closed-end investment companies, such as IIA and IGR, which do not continuously distribute shares.

According to Applicants, if the underlying concern extends to secondary market purchases of shares of closed-end funds that are subject to a large upcoming capital gains dividend, adoption of a Plan actually helps minimize the concern by avoiding, through periodic distributions, any buildup of large end-of-the-year distributions.

6. Applicants also note that common shares of closed-end funds that invest primarily in equity securities often trade in the marketplace at a discount to their NAV. Applicants believe that this discount may be reduced for closed-end funds that pay relatively frequent dividends on their common shares at a consistent rate, whether or not those dividends contain an element of long-term capital gain.

7. Applicants assert that the application of rule 19b-1 to a Plan actually could have an undesirable influence on portfolio management decisions. Applicants state that, in the absence of an exemption from rule 19b-1, the implementation of a Plan imposes pressure on management (i) not to realize any net long-term capital gains until the point in the year that the fund can pay all of its remaining distributions in accordance with rule 19b-1, and (ii) not to realize any long-term capital gains during any particular year in excess of the amount of the aggregate pay-out for the year (since as a practical matter excess gains must be distributed and accordingly would not be available to satisfy pay-out requirements in following years), notwithstanding that purely investment considerations

might favor realization of long-term gains at different times or in different amounts.

Applicants thus assert that the limitation on the number of capital gain distributions that a fund may make with respect to any one year imposed by rule 19b-1, may prevent the efficient operation of a Plan whenever that fund's realized net long-term capital gains in any year exceed the total of the periodic distributions that may include such capital gains under the rule.

8. In addition, Applicants assert that rule 19b-1 may cause fixed regular periodic distributions under a Plan to be funded with returns of capital² (to the extent net investment income and realized short-term capital gains are insufficient to fund the distribution), even though realized net long-term capital gains otherwise could be available. To distribute all of a fund's long-term capital gains within the limits in rule 19b-1, a fund may be required to make total distributions in excess of the annual amount called for by its Plan, or to retain and pay taxes on the excess amount. Applicants thus assert that the requested order would minimize these effects of rule 19b-1 by enabling the funds to realize long-term capital gains as often as investment considerations dictate without fear of violating rule 19b-1.

9. Applicants state that Revenue Ruling 89-81 under the Code requires that a fund that has both common stock and preferred stock outstanding designate the types of income, e.g., investment income and capital gains, in the same proportion as the total distributions distributed to each class for the tax year. To satisfy the proportionate designation requirements of Revenue Ruling 89-81, whenever a fund has realized a long-

² Returns of capital as used in the application means return of capital for financial accounting purposes and not for tax accounting purposes.

term capital gain with respect to a given tax year, the fund must designate the required proportionate share of such capital gain to be included in common and preferred stock dividends. Applicants state that although rule 19b-1 allows a fund some flexibility with respect to the frequency of capital gains distributions, a fund might use all of the exceptions available under the rule for a tax year and still need to distribute additional capital gains allocated to the preferred stock to comply with Revenue Ruling 89-81.

10. Applicants assert that the potential abuses addressed by section 19(b) and rule 19b-1 do not arise with respect to preferred stock issued by a closed-end fund.

Applicants assert that such distributions are fixed or determined in periodic auctions by reference to short-term interest rates rather than by reference to performance of the issuer and *Revenue Ruling 89-81* determines the proportion of such distributions that are comprised of the long-term capital gains.

11. Applicants also submit that the "selling the dividend" concern is not applicable to preferred stock, which entitles a holder to no more than a periodic dividend at a fixed rate or the rate determined by the market, and, like a debt security, is priced based upon its liquidation value, credit quality, and frequency of payment. Applicants state that investors buy preferred shares for the purpose of receiving payments at the frequency bargained for, and do not expect the liquidation value of their shares to change.

12. Applicants request an order under section 6(c) granting an exemption from the provisions of section 19(b) and rule 19b-1 to permit each fund's common stock to distribute periodic capital gains dividends (as defined in section 852(b)(3)(C) of the Code) as often as monthly in any one taxable year in respect of its common shares and as

often as specified by or determined in accordance with the terms thereof in respect of its preferred shares.³

Applicants' Conditions:

Applicants agree that, with respect to each fund seeking to rely on the order, the order will be subject to the following conditions:

I. Compliance Review and Reporting. The fund's chief compliance officer will: (a) report to the fund Board, no less frequently than once every three months or at the next regularly scheduled quarterly board meeting, whether (i) the fund and the fund adviser have complied with the conditions to the requested order, and (ii) a Material Compliance Matter, as defined in rule 38a-1(e)(2), has occurred with respect to compliance with such conditions; and (b) review the adequacy of the policies and procedures adopted by the fund no less frequently than annually.

II. Disclosures to Fund Shareholders:

A. Each Notice to the holders of the fund's common shares, in addition to the information required by section 19(a) and rule 19a-1:

1. will provide, in a tabular or graphical format:

(a) the amount of the distribution, on a per common share basis, together with the amounts of such distribution amount, on a per common share basis and as a percentage of such distribution amount, from estimated: (A) net investment income; (B) net realized short-term capital gains; (C) net realized long-term capital gains; and (D) return of capital or other capital source;

³ Applicants state that a future fund that relies on the requested order will satisfy each of the representations in the application except that such representations will be made in respect of actions by the board of directors of such future fund and will be made at a future time.

(b) the fiscal year-to-date cumulative amount of distributions, on a per common share basis, together with the amounts of such cumulative amount, on a per common share basis and as a percentage of such cumulative amount of distributions, from estimated: (A) net investment income; (B) net realized short-term capital gains; (C) net realized long-term capital gains; and (D) return of capital or other capital source;

(c) the average annual total return in relation to the change in NAV for the 5-year period (or, if the fund's history of operations is less than five years, the time period commencing immediately following the fund's first public offering) ending on the last day of the month prior to the most recent distribution declaration date compared to the current fiscal period's annualized distribution rate expressed as a percentage of NAV as of the last day of the month prior to the most recent distribution declaration date; and

(d) the cumulative total return in relation to the change in NAV from the last completed fiscal year to the last day of the month prior to the most recent distribution declaration date compared to the fiscal year-to-date cumulative distribution rate expressed as a percentage of NAV as of the last day of the month prior to the most recent distribution declaration date.

Such disclosure shall be made in a type size at least as large and as prominent as the estimate of the sources of the current distribution; and

2. will include the following disclosure:

(a) "You should not draw any conclusions about the fund's investment performance from the amount of this distribution or from the terms of the fund's Plan";

(b) “The fund estimates that it has distributed more than its income and net realized capital gains; therefore, a portion of your distribution may be a return of capital. A return of capital may occur for example, when some or all of the money that you invested in the fund is paid back to you. A return of capital distribution does not necessarily reflect the fund’s investment performance and should not be confused with ‘yield’ or ‘income’”; and

(c) “The amounts and sources of distributions reported in this Notice are only estimates and are not being provided for tax reporting purposes. The actual amounts and sources of the amounts for [accounting and] tax reporting purposes will depend upon the fund’s investment experience during the remainder of its fiscal year and may be subject to changes based on tax regulations. The fund will send you a Form 1099-DIV for the calendar year that will tell you how to report these distributions for federal income tax purposes.”

Such disclosure shall be made in a type size at least as large as and as prominent as any other information in the Notice and placed on the same page in close proximity to the amount and the sources of the distribution.

B. On the inside front cover of each report to shareholders under rule 30e-1 under the Act, the fund will:

1. describe the terms of the Plan (including the fixed amount or fixed percentage of the distributions and the frequency of the distributions);
2. include the disclosure required by condition II.A.2.a above;
3. state, if applicable, that the Plan provides that the Board may amend or terminate the Plan at any time without prior notice to fund shareholders; and

4. describe any reasonably foreseeable circumstances that might cause the fund to terminate the Plan and any reasonably foreseeable consequences of such termination.

C. Each report provided to shareholders under rule 30e-1 and in each prospectus filed with the Commission on Form N-2 under the Act, will provide the fund's total return in relation to changes in NAV in the financial highlights table and in any discussion about the fund's total return.

III. Disclosure to Shareholders, Prospective Shareholders and Third Parties:

A. The fund will include the information contained in the relevant Notice, including the disclosure required by condition II.A.2 above, in any written communication (other than a Form 1099) about the Plan or distributions under the Plan by the fund, or agents that the fund has authorized to make such communication on the fund's behalf, to any fund common shareholder, prospective common shareholder or third-party information provider;

B. The fund will issue, contemporaneously with the issuance of any Notice, a press release containing the information in the Notice and will file with the Commission the information contained in such Notice, including the disclosure required by condition II.A.2 above, as an exhibit to its next filed Form N-CSR; and

C. The fund will post prominently a statement on its (or its adviser's) Web site containing the information in each Notice, including the disclosure required by condition II.A.2 above, and will maintain such information on such Web site for at least 24 months.

IV. Delivery of 19(a) Notices to Beneficial Owners: If a broker, dealer, bank or other person ("financial intermediary") holds common stock issued by the fund in nominee

name, or otherwise, on behalf of a beneficial owner, the fund: (a) will request that the financial intermediary, or its agent, forward the Notice to all beneficial owners of the fund's shares held through such financial intermediary; (b) will provide, in a timely manner, to the financial intermediary, or its agent, enough copies of the Notice assembled in the form and at the place that the financial intermediary, or its agent, reasonably requests to facilitate the financial intermediary's sending of the Notice to each beneficial owner of the fund's shares; and (c) upon the request of any financial intermediary, or its agent, that receives copies of the Notice, will pay the financial intermediary, or its agent, the reasonable expenses of sending the Notice to such beneficial owners.

V. Additional Board Determinations for Funds Whose Shares Trade at a Premium: If:

A. The fund's common shares have traded on the exchange that they primarily trade on at the time in question at an average premium to NAV equal to or greater than 10%, as determined on the basis of the average of the discount or premium to NAV of the fund's common shares as of the close of each trading day over a 12-week rolling period (each such 12-week rolling period ending on the last trading day of each week); and

B. The fund's annualized distribution rate for such 12-week rolling period, expressed as a percentage of NAV as of the ending date of such 12-week rolling period, is greater than the fund's average annual total return in relation to the change in NAV over the 2-year period ending on the last day of such 12-week rolling period; then:

1. At the earlier of the next regularly scheduled meeting or within four months of the last day of such 12-week rolling period, the Board including a majority of the Independent Trustees:

(a) will request and evaluate, and the fund's adviser will furnish, such information as may be reasonably necessary to make an informed determination of whether the Plan should be continued or continued after amendment;

(b) will determine whether continuation, or continuation after amendment, of the Plan is consistent with the fund's investment objective(s) and policies and in the best interests of the fund and its shareholders, after considering the information in condition V.B.1.a above; including, without limitation:

(1) whether the Plan is accomplishing its purpose(s);

(2) the reasonably foreseeable effects of the Plan on the fund's long-term total return in relation to the market price and NAV of the fund's common shares; and

(3) the fund's current distribution rate, as described in condition V.B above, compared to with the fund's average annual total return over the 2-year period, as described in condition V.B, or such longer period as the board deems appropriate; and

(c) based upon that determination, will approve or disapprove the continuation, or continuation after amendment, of the Plan; and

2. The Board will record the information considered by it and the basis for its approval or disapproval of the continuation, or continuation after amendment, of the Plan in its meeting minutes, which must be made and preserved for a period of not less than six years from the date of such meeting, the first two years in an easily accessible place.

VI. Public Offerings: The fund will not make a public offering of the fund's common shares other than:

A. a rights offering below net asset value to holders of the fund's common stock;
B. an offering in connection with a dividend reinvestment plan, merger, consolidation, acquisition, spin-off or reorganization of the fund; or

C. an offering other than an offering described in conditions VI.A and VI.B above, unless, with respect to such other offering:

1. the fund's average annual distribution rate for the six months ending on the last day of the month ended immediately prior to the most recent distribution declaration date,⁴ expressed as a percentage of NAV per share as of such date, is no more than 1 percentage point greater than the fund's average annual total return for the 5-year period ending on such date;⁵ and

2. the transmittal letter accompanying any registration statement filed with the Commission in connection with such offering discloses that the fund has received an order under section 19(b) to permit it to make periodic distributions of long-term capital gains with respect to its common stock as frequently as twelve times each year, and as frequently as distributions are specified in accordance with the terms of any outstanding preferred stock that such fund may issue.

VII. Amendments to Rule 19b-1: The requested relief will expire on the effective date of any amendment to rule 19b-1 that provides relief permitting certain closed-end

⁴ If the fund has been in operation fewer than two years, the measured period will be immediately following the fund's first public offering.

⁵ If the fund has been in operation fewer than five years, the measured period will be immediately following the fund's first public offering.

investment companies to make periodic distributions of long-term capital gains with respect to their outstanding common stock as frequently as twelve times each year.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58121; File No. PCAOB-2008-03)

July 9, 2008

Public Company Accounting Oversight Board; Notice of Filing of Proposed Changes Regarding Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence, Amendment to Interim Independence Standards, and Amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on April 24, 2008, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rule changes described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule Change

On April 22, 2008, the Board adopted Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence, an amendment to the Board's Interim Independence Standards, and an amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles. The proposed rule change text is set out below. Language deleted by the amendment to Rule 3523 is in brackets. Language that is added by the amendment to Rule 3523 is italicized.

RULES OF THE BOARD

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SECTION 3. PROFESSIONAL STANDARDS

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Part 5 – Ethics

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Subpart I – Independence

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Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the [audit and] professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless –

(a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

(b) the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited –

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

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Rule 3526. Communication with Audit Committees Concerning Independence

A registered public accounting firm must –

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and

(3) document the substance of its discussion with the audit committee of the issuer.

(b) at least annually with respect to each of its issuer audit clients –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and

(4) document the substance of its discussion with the audit committee of the issuer.

Amendment to PCAOB Interim Independence Standards

Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB Standard No. 1"), ISB Interpretation 00-1, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, and ISB Interpretation 00-2, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1, are superseded by Rule 3526.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish "ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Moreover, Section 103(b) of the Act directs the Board to establish such rules on auditor independence "as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, Title II of th[e] Act."

The Board adopted Rule 3526, Communication with Audit Committees Concerning Independence, because it believed that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any relationships the accounting firm has with the issuer that may reasonably be thought to bear on its independence. The rule is intended to build on the communication requirements in Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB No. 1") and provide the audit committee with information – including information about the firm's relationships with persons in financial reporting oversight roles ("FROR") at the company – that may be important to its determination about whether to hire the firm as the company's auditor. The rule also requires a registered firm on at least an annual basis after becoming the issuer's auditor to make a similar communication and also affirm to the audit committee of the issuer, in writing, that the firm is independent. The Board intends for these communications to provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion

between the firm and the audit committee. The rule also includes a new requirement for the firm to document the substance of its discussion with the audit committee.

The Board adopted amendments to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles, to exclude the portion of the audit period that precedes the beginning of the professional engagement period. The Board believes that it is not necessary for the rule to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period. The Board also added a note to Rule 3523 that states that in an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to persons covered by Rule 3523 before the earlier of the date that the firm (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

The proposed rule changes also amend the PCAOB interim independence standards because Rule 3526 will supersede the Board's interim independence requirement, ISB No. 1, and two related interpretations.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms.

C. Board's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2007-008 (July 24, 2007). The Board received 16 written comments. A copy of PCAOB Release No. 2007-008 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rule change, as discussed below.

Rule 3526. Communication with Audit Committees Concerning Independence

Under Section 301 of the Act, "[t]he audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer... for the purpose of preparing or issuing an audit report or related work..."^{1/} PCAOB interim independence standards require the auditor to provide certain information to the audit committee about independence that could assist

^{1/} The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

the audit committee in fulfilling these oversight responsibilities. Specifically, ISB No. 1 requires, among other things, firms to disclose at least annually to the audit committee all relationships between the auditor and its related entities and the company and its related entities that, in the auditor's professional judgment, may reasonably be thought to bear on the auditor's independence. ISB No. 1 does not, however, require the firm to provide information to the audit committee about the firm's independence in connection with becoming the issuer's auditor (i.e., before the person or firm becomes the issuer's auditor).

As discussed in the proposing release, the Board proposed Rule 3526 because it believed that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any relationships the accounting firm has with the issuer that may reasonably be thought to bear on its independence. The proposed rule was intended to build on the communication requirements in ISB No. 1 and provide the audit committee with information – including information about the firm's relationships with persons in FRORs at the company – that may be important to its determination about whether to hire the firm as the company's auditor. The Board also proposed to include in the rule a new requirement for the firm to document the substance of its discussion with the audit committee.

All commenters were generally in favor of the Board adopting the proposed rule, and, as discussed more fully below, some recommended modifications. Commenters stated that Rule 3526 would assist audit committees in fulfilling their responsibilities and would aid them in their decision-making process. After carefully considering the comments, the Board is adopting Rule 3526 with one modification, as described below. If

approved by the SEC, Rule 3526 will supersede ISB No. 1 and two related interpretations.^{2/}

Scope of the Required Communication

The Board proposed in Rule 3526(a) to require the registered firm, prior to accepting an initial engagement pursuant to the standards of the PCAOB, to describe in writing to the audit committee^{3/} all relationships between the accounting firm or any

^{2/} ISB Interpretation 00-1, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, and ISB Interpretation 00-2, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1. The interpretations state that the responsibility to comply with ISB No. 1 rests solely with the primary auditor, but that the primary auditor should include in its report to the audit committee all of its relationships and those of its domestic and foreign associated firms that could reasonably bear on the independence of the primary auditor. Under these interpretations, if the primary auditor is relying on the work of secondary auditors not associated with the primary auditor's firm, the report of the primary auditor should either describe any such secondary auditors' relationships, or it should state that it does not do so. The treatment of secondary auditors under Rule 3526 will be similar to the treatment of secondary auditors under ISB No. 1 and the two interpretations. Secondary auditors will not need to comply with Rule 3526, but the primary auditor will need to disclose to the audit committee any relationships of the firm's affiliates that could reasonably be thought to bear on the independence of the primary auditor. As under ISB No. 1 and the related interpretations, the scope of any communications about secondary auditors under Rule 3526 should be clear to the audit committee. Accordingly, the Board expects the primary auditor's report to either include any covered relationships of any secondary auditors not affiliated with the firm or state that it does not do so. One commenter recommended that the Board consider providing an exemption for secondary auditors. Because the rule does not require communications by secondary auditors, an exemption is not necessary.

^{3/} One commenter recommended the Board provide guidance in situations in which an issuer does not have an audit committee. Under Section 2(a)(3) of the Act, "[t]he term 'audit committee' means – (A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Accordingly, under Rule 3526, if an audit client does not have an audit committee, the auditor would be required to make the communications to the entire board of directors.

affiliates of the firm^{4/} and the potential audit client or persons in FRORs at the potential audit client that may reasonably be thought to bear on independence. The Board also proposed to require the firm to discuss with the audit committee the potential effects of those relationships on the firm's independence. In Rule 3526(b), the Board proposed to require a registered firm on at least an annual basis after becoming the issuer's auditor to provide the same information described above and also affirm to the audit committee of the issuer, in writing, that the firm is independent in compliance with Rule 3520, Auditor Independence.^{5/} As described in the proposing release, the Board intended for these communications to provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion between the firm and the audit committee.

Commenters generally believed that the scope of the required communications was appropriate. Several commenters noted that, to a large extent, firms are already making the kinds of communications that would be required by proposed Rule 3526. One commenter acknowledged, however, that existing communications between the firm and a potential new audit client do not include the disclosure of tax services to a person in a

Additionally, one commenter recommended that audit committees provide better disclosure, through the proxy, when approving non-audit services performed by the auditor. The commenter stated that providing this type of transparency will permit investors a greater ability to evaluate audit committee's fiduciary performance of shareholders. The Board does not have statutory authority to require disclosure by audit committees.

^{4/} One commenter recommended that the Board adopt a definition of affiliate of the firm. This term is already defined in Rule 3501.

^{5/} Rule 3520 states that a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

FROR or his or her immediate family member. Additionally, some registered firms noted that communications regarding the auditor's independence currently vary in content and timing and may, in some instances, occur only orally.

Most commenters did not believe that it was necessary for the Board to expand the scope of the required communication to include any additional matters. One commenter, however, recommended requiring the firm to confirm its independence in writing to the audit committee prior to accepting an initial engagement. Another commenter recommended revising Rule 3526(a) to require the firm to make the communications in its initial proposal to the company's audit committee.

As discussed above, the Board proposed to require firms to affirm their independence annually but did not propose a similar requirement that would apply before the firm is initially engaged as the company's auditor. Rule 3526(a) requires registered firms to make certain communications about relationships that may reasonably be thought to bear on independence before accepting an initial engagement pursuant to the standards of the PCAOB. Rather than prescribing a particular time before that point when the communications must occur, however, the rule allows registered firms and audit committees the flexibility to make that determination. The Board understands that, in some cases, firms need time before a new engagement begins to resolve any matters that could impair their independence. If a firm were required to affirm its independence prior to accepting a new engagement, it would need to wait until it has resolved any independence issues to make the required communications. These communications are intended to assist the audit committee in fulfilling its responsibility to hire the auditor – their usefulness for that purpose may diminish if they are left until immediately before

the engagement begins. Accordingly, the Board does not believe a requirement for auditors to affirm that they are independent before accepting a new engagement is appropriate.

Other commenters recommended certain exclusions from the scope of the required communications. For example, one commenter asserted that the auditor cannot be expected to know about all relationships that may reasonably be thought to bear on its independence, and recommended that the written communication to the audit committee state that the auditor's assessment is based on information provided to the auditor by the issuer. The Board does not believe that allowing auditors to include such a limitation in the communication would be appropriate. Complying with the Board's independence requirements is the responsibility of the auditor.^{6/} To fulfill this responsibility, as well as their related responsibility under the SEC's independence rules, auditors need to ascertain what relationships with the issuer and persons in FRORs at the issuer may reasonably be thought to bear on their independence. Moreover, some of the information the auditor must assess in order to assure its independence and that may need to be communicated under Rule 3526 – such as the firm's or its associated persons' financial interests in the audit client – can be more readily obtained by the auditor than its audit client.

^{6/} Another commenter suggested that the audit committee should be able to rely on the firm to determine and resolve any independence issues, and that a requirement for the auditor to discuss these matters with the audit committee would increase the responsibilities of the audit committee with respect to independence. This commenter recommended that the Board not adopt these requirements. As discussed above, the rule is intended to provide audit committees with information to assist them in carrying out their responsibilities to oversee the audit engagement, but auditors remain responsible for complying with the independence requirements. Nothing in the rule adds to, or otherwise modifies, the responsibilities of the audit committee.

Another commenter recommended that the Board exclude tax services to a person in a FROR from the required communications because the commenter believed that compliance with Rule 3523, as amended, should adequately address any independence concerns regarding such services. As discussed in the proposing release, Rule 3526 is intended to require disclosure of not only whether the firm provided any specifically prohibited services or maintained any specifically prohibited relationships, but also whether any of the firm's relationships or services may reasonably be thought to bear on independence under the SEC's general standard of auditor independence^{7/} and AU sec. 220, Independence.^{8/} Because auditors will need to consider the relevant facts and circumstances in order to make such a determination, the Board does not believe that per se exemptions are appropriate.

Some commenters suggested that, in certain circumstances, firms would be restricted in the information they could provide to the audit committee about relationships

^{7/} 17 CFR 210.2-01(b). Under that standard, an accountant is not independent if "the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." In considering this general standard, the SEC "looks in the first instance to whether a relationship or the provision of service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client." 17 CFR 210.2-01, preliminary note.

^{8/} AU sec. 220, Independence, requires that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor..." AU sec. 220 notes that "[i]t is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors" and that public confidence in the auditor's independence "would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence."

with persons in FRORs due to legal limitations imposed by confidentiality and privacy laws. Specifically, one commenter was concerned that the auditor would not be able to disclose to the audit committee information about tax services rendered to a person in a FROR prior to obtaining a consent from that person. Another commenter recommended that the Board address the need for obtaining such a consent in its final release, while another recommended that the Board provide an exemption in circumstances where applicable legal restrictions impede an auditor's ability to comply fully with the disclosure requirement.

Under ISB No. 1, auditors have been required to disclose to the audit committee relationships with the company and its related entities and to discuss the auditor's independence with the audit committee. Accordingly, the required communications could include discussion of tax or other services provided to an entity or person other than the company itself. The Board understands that firms are subject to certain confidentiality requirements in the tax context^{2/} and that other restrictions could arise outside of that context, depending on the facts and circumstances that a particular relationship presents. The Board is not, however, aware that firms have encountered difficulty in communicating with audit committees, as required by ISB No. 1 or any other professional practice standard, as a result of such privacy requirements.

As described above, Rule 3526 is a general requirement that, like ISB No. 1, requires disclosure of certain relationships that may be relevant to the audit committee's

^{2/} See 26 U.S.C. 7216; 26 CFR 301.7216-3 (prohibiting disclosure or use of tax return information without written consent of taxpayer that meets specified requirements); 26 CFR 301.7216-1 (defining "tax return information" to mean "any information, including, but not limited to a taxpayer's name, address, or identifying number, which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer").

oversight of the engagement. It does not set forth a list of relationships that must always be disclosed or mandate specific information that must be communicated when disclosure is required. Rather, Rule 3526 allows firms significant flexibility to determine how to comply with the requirements to describe a covered relationship and discuss the potential effects of that relationship on the firm's independence. Accordingly, while the Board will monitor the application of the rule in this regard, it does not believe that the recommended exception is necessary or appropriate at this time.

The Board also received several comments on its proposal not to include the words "in the auditor's professional judgment" in the rule's description of the scope of the required communications. ISB No. 1 requires disclosure of certain relationships that "in the auditor's professional judgment may reasonably be thought to bear on independence." In the proposing release, the Board explained that it believed that omitting the reference to the auditor's professional judgment would clarify the requirement by reminding auditors of the need to focus on the perceptions of reasonable third parties when making independence determinations.

Some commenters supported the proposed exclusion of the words "in the auditor's professional judgment" from Rule 3526. Other commenters, however, believed that the absence of the reference to judgment could confuse, rather than clarify, the requirement and noted that it is reasonable and appropriate for audit committees to rely on the accounting firm's judgment as to what matters should be disclosed. One of these commenters contended that this aspect of the Board's proposal is inconsistent with the Board's recent focus on the importance of the use of auditor judgment. Conversely, one commenter did not object to the absence of a reference to judgment, provided that the

adopting release contain an acknowledgement that the auditor must apply judgment in determining which matters are required to be communicated to the audit committee.^{10/}

As the Board explained in the proposing release, auditors will need to apply judgment to determine whether a relationship may reasonably be thought to bear on independence. After considering commenters' views, the Board continues to believe that adding specific reference to the auditor's professional judgment is unnecessary and inappropriate in this instance. While the Board agrees that auditors must exercise sound judgment in carrying out their responsibilities, it does not believe that specific reference to judgment in this rule is necessary to encourage auditors to do so. Judgment is called for in applying any reasonableness standard to particular facts and circumstances, and Rule 3526 is no different. Determining what relationships may reasonably be thought to bear on independence requires consideration of how a third party – not the auditor – would view the relationship, which is consistent with the SEC's general standard of auditor independence and AU sec. 220. A reference to "in the auditor's professional judgment" could suggest otherwise, however, and therefore could discourage the necessary analysis. Accordingly, the Board has determined not to add the phrase to Rule 3526.

Time Period Covered by Rule 3526(a)

In the proposing release, the Board solicited comment on whether the initial communication in Rule 3526(a) should be limited to relationships that existed during a

^{10/} Additionally, one commenter recommended including the reference to judgment and also referring to the SEC's general standard of auditor independence and the preliminary note to the SEC's independence rules in the proposed rule or the adopting release. Footnote 9 of the Board's adopting release refers to the general standard and the preliminary note.

particular period, and, if so, how long that period should be. Commenters provided a wide variety of recommendations in this area. Some commenters stated that the initial communication should not be limited to relationships that existed during a particular period. Some of these commenters noted that establishing a specific period could result in arbitrary exclusion of certain relationships and recommended that the audit committee and auditor be responsible for determining the relevant time frame.

Other commenters recommended that the time period be limited to the audit and professional engagement period because, according to these commenters, the relevant relationships are those that exist currently or will continue to exist. One of these commenters stated that requiring communication of relationships that existed prior to this period would cause an unnecessary burden on the firm to identify and communicate these matters and on the audit committee to consider such information, because the firm was not subject to the auditor independence rules with respect to the audit client before the beginning of the audit and professional engagement period. One commenter recommended that the required time period should, at a minimum, be the audit period and that the rule should require auditors to consider communicating relationships that existed before that time. Finally, one commenter recommended that the time period should be no longer than two years prior to the commencement of the audit period, and two commenters recommended that the proposed rule should cover a time period of at least three years.

After considering these comments, the Board has determined that the initial communication required by Rule 3526(a) should not be limited to relationships that existed during a particular time period. While the Board agrees that a relationship that

existed during the audit and professional engagement period may be more likely to bear on independence than a relationship that ended substantially before that time, it does not believe that the passage of time is the only factor relevant to a determination of whether a relationship may reasonably be thought to bear on independence. The nature of the relationship must also be considered. For example, if the firm customized and implemented the company's financial reporting system, that relationship, depending on the circumstances, might reasonably be thought to bear on independence even if the engagement to design the system was concluded before the beginning of the audit and professional engagement period. Determining whether a particular relationship is covered by Rule 3526(a) will, therefore, depend on the relevant facts and circumstances.

The Board is making one modification to the rule in response to a comment recommending that Rule 3526 make clear that the relationships required to be disclosed are those that may reasonably be thought to bear on independence as of the date of the communication. Because the relevant relationships are those that continue to bear on independence at the time of the communication, the Board has modified the rule by adding the words "as of the date of the communication" where appropriate. This clarification should help firms distinguish relationships that are covered by the rule from those that are not.

This modification should also clarify that, if a relationship may reasonably be thought to bear on independence as of the date of the communication, it must be disclosed regardless of whether it was disclosed in a prior year. Some commenters suggested that auditors should not be required to repeat a previously made disclosure. The Board believes that an earlier disclosure may reduce the amount of information that

needs to be disclosed, but it does not obviate the need for disclosure altogether. If the nature of the relationship and the potential effects of the relationship on independence remain substantially unchanged, a reference to the earlier disclosure will generally be sufficient when disclosure is required. Moreover, as discussed above, after some amount of time, the length of which depends on the nature of the relationship, a relationship may no longer reasonably be thought to bear on independence and, therefore, would no longer need to be disclosed.

Timing of the Communications

As discussed above, the Board proposed Rule 3526(a) because it believed that auditors should communicate relevant information about independence before becoming the issuer's auditor. A few commenters expressed concern that the proposed rule could cause undue burden on private companies pursuing an initial public offering if the communication were required before the auditor accepts an engagement to assist an existing private company client in going public. According to commenters, a requirement to complete the independence assessment before the auditor could commence work related to the initial public offering might disadvantage the audit client by causing delay. One commenter stated that auditors generally begin work on the initial public offering based upon an initial review of relationships between the accounting firm and the company and complete their independence assessment before the company's registration statement is filed. This commenter suggested that the Board reconsider the required timing of the communications in the context of an initial public offering.

After considering these comments, the Board has determined that relieving a firm whose private company audit client is pursuing an initial public offering from compliance

with Rule 3526 is not necessary or appropriate. As discussed above, the rule is intended to provide audit committees with the information they need to effectively oversee the audit engagement. When a private company undertakes an initial public offering, it must, for the first time, have its financial statements audited by an auditor that is independent within the meaning of the rules of the SEC and PCAOB. Among other decisions an audit committee must make is whether to engage its existing auditor for the initial public offering or whether to retain a new auditor for that purpose. In this context, the Board believes that the communication about an existing auditor's independence – which is relevant to the existing auditor's ability to continue as the company's auditor through, and after, the initial public offering – should not be delayed until just before the registration statement is filed. Moreover, the Board believes that this evaluation will not cause an unnecessary burden because the private company is already a client of the accounting firm and therefore should already be aware of most of the relationships that would need to be communicated.

The Board also received comment on the timing of the annual communication requirement that the Board proposed in Rule 3526(b). Like ISB No. 1, proposed Rule 3526 did not specify when during the year the firm would be required to make the annual communication.^{11/} One commenter recommended that the Board specify in Rule 3526(b) when the annual communication should take place to make sure that these critical discussions do not take place at the end of the audit engagement. The commenter recommended that the proposed rule be changed to state that firms should apply Rule

^{11/} The Board understands that, under ISB No. 1, the communication typically occurs at the end of the audit when the financial statements are issued.

3526 as early in the audit process as practicable, preferably during the planning stage of the audit. One commenter recommended that the communication occur before substantial planning procedures commence, while another recommended that the annual communication should take place at the time the engagement letter is signed and then again near the end of the audit. Finally, one commenter recommended adding a section to Rule 3526 requiring an auditor to update the communications when he or she becomes aware of a covered, previously unknown or new relationship.

After considering these comments, the Board does not believe it is appropriate to mandate specifically when the Rule 3526(b) annual communication take place. In most cases, the communications will be more useful if they take place near the beginning of the audit process. However, by not prescribing the timing of the communication, Rule 3526(b) will allow the auditor and audit committee to determine the timing that is most appropriate in the circumstances of the particular engagement. Similarly, the Board does not believe that it is necessary for the rule to explicitly address how a firm should correct an incomplete communication.

Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

Amendment to Rule 3523 to Exclude the Portion of the Audit Period That Precedes the Professional Engagement Period

Rule 3523, as adopted by the Board, prohibits a registered public accounting firm, or an affiliate of the firm, from providing tax services during the "audit and professional engagement period" to a person in, or an immediate family member of a person in, a FROR at the audit client. Consistent with the SEC's independence rules,^{12/} the phrase

^{12/} 17 CFR 210.2-01(f)(5).

"audit and professional engagement period" is defined to include two discrete periods of time. The "audit period" is the period covered by any financial statements being audited or reviewed.^{13/} The "professional engagement period" is the period beginning when the firm either signs the initial engagement letter or begins audit procedures, whichever is earlier, and ends when either the company or the firm notifies the SEC that the company is no longer that firm's audit client.^{14/}

In circumstances in which a registered firm has been the auditor for an audit client for more than a year, the "audit period" is a subset of the "professional engagement period." However, when a registered firm accepts a new audit client, the audit period may cover a period of time before the commencement of the professional engagement period. In such circumstances, Rule 3523, as adopted, provides that the firm is not independent of its audit client if the firm, or an affiliate of the firm, provided tax services to a person covered by Rule 3523 during the audit period but before the beginning of the professional engagement period. This aspect of the rule therefore effectively prevents a firm from accepting a new audit client if the firm, or an affiliate of the firm, provided tax services to such a person during the period covered by any financial statements to be audited or reviewed.

In preparing for implementation of the Board's tax services and independence rules, the Board decided to revisit the application of Rule 3523 to tax services provided during the audit period. As discussed above, on April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a firm's independence of

^{13/} Rule 3501(a)(iii)(1).

^{14/} Rule 3501(a)(iii)(2).

providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period, and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period. After careful consideration of comments received in response to the concept release, the Board, on July 24, 2007, proposed to amend the rule to exclude the portion of the audit period that precedes the beginning of the professional engagement period.^{15/}

The Board received 13 comments on the proposed amendment to Rule 3523. Almost all of the commenters supported the Board's recommendation to amend Rule 3523.^{16/} Many of these commenters reiterated their belief that the firm's independence would not be affected by the provision of tax services to a person in a FROR during the portion of the audit period that precedes the beginning of the professional engagement period. Commenters also reaffirmed their belief that, if Rule 3523 is not amended, it

^{15/} See PCAOB Release No. 2007-008, which includes a discussion of the comments the Board received on the concept release.

^{16/} Only one commenter on the proposed rule objected to the amendment of Rule 3523. This commenter's objection stemmed from the contention that the terms "professional engagement period" and "a person in a financial reporting role" were not defined. Definitions for "professional engagement period" and "financial reporting oversight role" are provided under Rules 3501(a)(iii)(2) and 3501(f)(i), respectively. The same commenter, while not specifically addressing the proposed amendment, also expressed concern with Rule 3523(a), which provides an exception for tax services to a person who is in a FROR only because he or she serves as a member of the Board of Directors, and, referring to the responsibilities of directors, recommended deleting this section in its entirety. This commenter also recommended that the Board eliminate Rule 3523(b), which provides an exception, under certain circumstances, for tax services to a person who is in a FROR only because of the person's relationship to an affiliate of the entity being audited. The Board does not believe that eliminating these exceptions is warranted.

could adversely affect companies' ability to change auditors by limiting the companies' choice of auditors.

The Board has carefully considered these comments, as well as the comments on the concept release,^{17/} and determined to adopt the amendment to Rule 3523. The Board continues to believe that it is not necessary for the rule to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period. Rule 3523 relates to services provided to individuals and not the audit client that issues the financial statements subject to audit. Additionally, registered firms would remain responsible for considering the relevant facts and circumstances of a specific tax engagement and determining whether their independence is impaired under the SEC's general standard of auditor independence.^{18/}

One commenter objected to the discussion in the proposing release (and included here in the paragraph above) describing the firm's obligation to consider whether the firm's independence is impaired under the SEC's general standard of auditor independence. This commenter stated that the discussion sends a contradictory message by calling for firms to assess whether their independence is impaired despite the Board's conclusion that restrictions are unnecessary to preserve independence. The Board disagrees. As a result of the Board's amendment, firms will not be specifically prohibited by Rule 3523 from providing tax services to persons in a FROR during the portion of the

^{17/} In response to the concept release, two commenters stated that Rule 3523 should not be amended to exclude the portion of the audit period that precedes the professional engagement period. These commenters believed that providing tax services to a person in a FROR during the audit period impairs independence, and suggested that audit firms may plan for a change of auditors sufficiently in advance to avoid or minimize any problems resulting from the application of the rule to the audit period.

^{18/} 17 CFR 210.2-01(b); see footnote 7.

audit period that precedes the professional engagement period. That does not mean, however, that such services are categorically permitted. Rather, as discussed in the proposing release, the amendment reflects the Board's belief that a more tailored approach, based on facts and circumstances and measured against the general standard of auditor independence, is preferable to a per se prohibition. Accordingly, as with any other service or relationship that is not specifically prohibited by the independence rules, firms must determine whether the service or relationship impairs independence under the SEC's general standard of auditor independence.

Application of Rule 3523 to New Issuers

The Board proposed adding a note to Rule 3523 concerning the application of Rule 3523 in the context of an initial public offering in light of comments received on the concept release. The proposed note stated that, in the context of an initial public offering, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that a registered firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a firm's independence under Rule 3523. Commenters generally recommended that the Board adopt the note and encouraged the Board to consider expanding it to include other corporate life events, noting that corporate life events other than an initial public offering may also result in the need for an audit client's financial statements to be audited pursuant to the standards of the PCAOB for the first time.^{19/}

^{19/} Commenters suggested the following as examples of when an audit client's financial statements would, for the first time, need to be audited pursuant to the standards of the PCAOB – mergers, reverse mergers in which a privately-held entity merges with a public company and succeeds to the public company's reporting obligations under the Securities Exchange Act of 1934, issuance of publicly traded debt,

In response to these comments, the Board determined to revise the note to Rule 3523 to describe events, other than just initial public offerings, pursuant to which a company's financial statements must be audited in accordance with the standards of the PCAOB for the first time. Specifically, the Board replaced the words "[i]n the context of an initial public offering" with "[i]n an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB." This situation may occur when a company decides to conduct an initial public offering of its securities,^{20/} which would require the company to file, for the first time, a registration statement under the Securities Act of 1933. Additionally this situation may occur when a foreign private issuer decides to list its securities on a national securities exchange, which would require the company to register its securities, for the first time, under the Securities Exchange Act of 1934. In both cases, the company's audited financial statements would be required, for the first time, to be audited pursuant to the standards of the PCAOB.^{21/}

issuance of partnership or other units, inclusion of a public company's securities in an employee benefit plan, decision by a foreign private issuer to list its securities in the United States, and companies that have greater than 500 U.S. shareholders and total assets exceeding \$10 million as of the latest fiscal year-end.

^{20/} The company may offer equity securities, debt securities, limited partnership interests, trust interests, or another type of securities in the initial public offering.

^{21/} The Board intends the note to Rule 3523 to describe all circumstances in which a company that was not an "issuer," as defined by the Act, becomes an issuer as a result of a corporate life event or otherwise. These circumstances include those in which a private company that was once an issuer becomes an issuer again. As long as the company was not required to have its financial statements audited pursuant to the standards of the PCAOB prior to being required to do so, the Board will consider the requirement to be a "first-time" requirement for purposes of the note.

The Board does not believe it is appropriate to list in the note the various corporate life events identified by commenters, such as mergers or acquisitions, reverse mergers or other similar transactions. The relevant factor is not the name given to a transaction or event but whether the transaction or event triggers the initial requirement for an audit pursuant to the standards of the PCAOB. For example, the surviving company in a merger or acquisition transaction may be an issuer that is already filing with the SEC financial statements required to be audited pursuant to the standards of the PCAOB. The Board did not intend the note to Rule 3523 to describe such a scenario.^{22/} By focusing on the need for a first-time audit pursuant to the standards of the PCAOB, the company and its auditors are better able to determine whether a proposed transaction or corporate life event is described by the note.

One commenter stated that, while it is easy to identify the date on which the initial engagement letter to perform an audit pursuant to the standards of the PCAOB is signed, it would be very difficult to apply the second prong of the note, which requires identification of the date that the auditor began procedures to perform an audit pursuant to the standards of the PCAOB, especially if the registered firm audited the company's prior years' financial statements.^{23/} Another commenter similarly questioned whether this

^{22/} Another example is a private operating company becoming a reporting company through a reverse merger with a reporting shell company. In this scenario, even though the operating company assumes the reporting obligations of the former shell company, the surviving reporting company is the former shell company whose financial statements already were required to be audited pursuant to the standards of the PCAOB. Therefore, the note to Rule 3523 does not describe this situation.

^{23/} The commenter noted that, when a company undertakes an initial public offering, it is required to include in the registration statement audited financial statements for its past three completed fiscal years. These financial statements may have previously been audited pursuant to generally accepted auditing standards ("GAAS"). The

period begins when the auditor begins planning for the audit. The Board recognizes that, in certain circumstances, it may be difficult to identify when a continuing auditor began procedures pursuant to the standards of the PCAOB. An auditor begins procedures for purposes of Rule 3523 when he or she begins procedures, including required audit planning procedures, to update its earlier audits to conform them to the standards of the PCAOB or begins procedures on a new audit pursuant to those standards. This point in time will depend on the facts and circumstances of the particular engagement and corporate life event, rather than on any more specific triggering event that the Board could establish by rule.

Transition Periods

Rule 3523 prohibits the provision of tax services to covered persons once the professional engagement period begins. Some commenters on the concept release recommended that the Board amend Rule 3523 to allow a transition period after a company changes auditors so that the new auditor may complete any tax services in progress to any persons in FRORs affected by the issuer's change of auditors.^{24/} Other commenters stated that tax services to persons in FRORs should, as is currently required, cease before the professional engagement period begins. The Board decided to seek

commenter was concerned that if the company does not retain a new auditor for its initial public offering, there may be a question as to whether the auditor should consider its audits of the prior years in assessing when it "began procedures" as provided under the note to Rule 3523. An auditor should not consider work already performed on previously completed GAAS audits for determining when the auditor "began procedures" because those audits were not performed pursuant to the standards of the PCAOB.

^{24/} Rule 3523(c) provides a time-limited transition period for an auditor to complete in-progress tax services to a person that becomes a FROR at the audit client through a hiring, promotion, or other change in employment event. That transition period is unaffected by the proposed rules changes.

further feedback on this topic in the proposing release. Specifically, the Board asked commenters to specify why they believed any transition period was necessary and how long any such transition period should be.^{25/}

The majority of commenters on this topic recommended that the Board provide for a 180-day transition period to allow an accounting firm to complete covered tax services once the professional engagement period begins. Most of these commenters stated that, since the Board has previously determined that a 180-day transition is appropriate when a person is hired or promoted into a FROR,^{26/} the Board should provide the same transition when an issuer changes its auditor. The commenters stated that, without a transition period, the person in a FROR could experience undue hardship because he or she may have to switch tax preparers in the middle of the personal tax services engagement. Additionally, some commenters stated that some accounting firms may not be able to terminate the in-process personal tax services engagements within a timeframe that would also allow them to submit their proposal for the new audit engagement. Conversely, some commenters stated that they believed that the Board should not provide a transition period and that it is appropriate for the firm to cease the personal tax services before the professional engagement period begins or that a transition period should only be available on a case-by-case basis where cessation of services would cause significant hardship.^{27/}

^{25/} See PCAOB Release 2007-008 (July 24, 2007), at 12.

^{26/} See Rule 3523(c).

^{27/} Another commenter stated that Rule 3523 should be effective immediately for issuers with fiscal years ending on or after December 15, 2007, that all personal tax services in process should be allowed to continue until the filing of the applicable tax

After considering these comments, the Board does not believe that a transition period is necessary when a company changes its auditor and has determined not to amend Rule 3523 to include one. The Board adopted Rule 3523 because the provision of tax services to a person in a FROR after the accounting firm is hired as the auditor creates an unacceptable appearance that the firm lacks independence. While the Board believed a time-limited exception was warranted to accommodate persons who, through a hiring or promotion event, abruptly become covered by the rule, it does not believe that such a transition period is similarly necessary after an auditor change. In the former situation, the firm already is the issuer's auditor and has no control over whether or when the person is promoted or otherwise moved into a FROR. In contrast, the firm controls whether and when it begins a new engagement. The Board therefore believes that the firm is able to conclude, or transition to another provider, any tax services to persons in FRORs at a new audit client before beginning the engagement.^{28/}

Some commenters also encouraged the Board to consider providing a transition period for firms to complete tax services to persons who become covered by Rule 3523 as a result of a corporate life event, such as a merger, acquisition, or initial public offering. Commenters suggested that such corporate life events present conceptually similar transition issues to those related to the hiring or promotion of a person into a

return, and that such services, along with the related fees, should be disclosed in the issuer's filings with the SEC and documented in the minutes of meetings of the audit committee.

^{28/} Nothing in Rule 3523 requires a firm to complete or terminate tax services to persons in FRORs at a potential audit client before submitting a proposal for a new audit engagement. Rather, the rule requires the accounting firm to complete or terminate those services by the beginning of the professional engagement period.

FROR and that Rule 3523(c) should therefore be expanded to accommodate them.

Commenters also stated that the absence of transitional relief may cause unnecessary hardship for persons in FRORs whose tax return preparation work was well underway at the point of the initial public offering, merger, or acquisition.^{29/}

As discussed above, in the context of an initial public offering, the rule, as amended, makes clear that tax services provided to a person in a FROR do not impair independence as long as those tax services are concluded before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so. Auditors should have sufficient time before that date to conclude any tax services to persons that would be covered by the rule. Accordingly, the Board does not believe that the recommended transition period is necessary in the context of an initial public offering.

The Board also considered whether a transition period is necessary to allow a firm to conclude tax services to persons who become covered by the rule after a merger or acquisition. As discussed above, Rule 3523(c) already provides a transition period for a firm to conclude tax services to a person who was not in a FROR before a hiring, promotion, or other change in employment event. If a business combination results in a change of employer for a person in a FROR – from, for example, the acquired company

^{29/} The commenters further stated that, because persons in FRORs may receive tax services from a number of accounting firms, the application of the rule to the audit period may unreasonably restrict a company's ability to either continue or change auditors after a corporate life event. As discussed above, the Board has amended the rule to exclude the portion of the audit period that precedes the professional engagement period.

to the acquiring company – the existing transition period in Rule 3523 would apply.^{30/} For example, if Company A acquires Company B, a person who was in a FROR at Company B would experience an "other change in employment event" if he or she became an employee of Company A in a FROR as a result of the acquisition. If such a person had been receiving tax services from Company A's registered public accounting firm pursuant to an engagement in process before the acquisition, the time-limited exception in Rule 3523(c) would apply.^{31/}

In the example above, persons in FRORs at Company A would not experience a change in employment event because they were employed by Company A both before and after the acquisition, and Rule 3523(c) would, therefore, not apply. If Company B's auditor became Company A's auditor after the acquisition (replacing Company A's auditor), Company B's auditor would have to conclude any tax services to persons in FRORs (and their immediate family members) at Company A before the start of the professional engagement period. The Board believes this is appropriate because, as discussed above, the Board does not believe that a transition period is necessary to allow a newly engaged auditor to conclude in-progress tax services to persons in FRORs at the new audit client. Accordingly, the Board has determined not to expand the existing transition period in Rule 3523(c).

^{30/} See also Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees (April 3, 2007), Question and Answer No. 6, at 4-5.

^{31/} Id.

Effective Date

Rule 3526 establishes new requirements for registered public accounting firms. The Board believes it is appropriate to allow a reasonable period of time for such firms to prepare internal policies and procedures and train their employees to ensure compliance with these new requirements. Accordingly, Rule 3526 will become effective, and ISB No. 1 and the related interpretations superseded, on the later of September 30, 2008, or 30 days after the date that the SEC approves the rule.

The amendment to Rule 3523 would have the effect of making permanent the Board's delay in implementing the rule as it applies to tax services provided during the period subject to audit but before the professional engagement period. Accordingly, no transition period is necessary, and the amended rule will become effective immediately upon approval by the SEC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rule change; or
- (b) institute proceedings to determine whether the proposed rule change should

be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with

the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB 2008-03 on the subject line.

Paper comments:

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

All submissions should refer to File Number PCAOB 2008-03. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change;

we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2008-03 and should be submitted on or before **[insert date 21 days from publication in the Federal Register]**.

By the Commission.

A handwritten signature in cursive script, appearing to read "Florence E. Harmon".

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58133 / July 10, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13079

In the Matter of

**Benguet Corp.,
Clean Systems Technology Group, Ltd.,
Lumenon Innovative Lightwave Technology, Inc.,
Symbiat, Inc.,
Uniroyal Technology Corp., and
Value Holdings, Inc.
(n/k/a Galea Life Sciences, Inc.),**

Respondents.

**ORDER MAKING FINDINGS AND
REVOKING REGISTRATION OF
SECURITIES PURSUANT TO
SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT OF
1934 AS TO UNIROYAL
TECHNOLOGY CORP.**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors to accept the Offer of Settlement submitted by Uniroyal Technology Corp. ("Uniroyal" or "Respondent") pursuant to Rule 240(a) of the Rules of Practice of the Commission, 17 C.F.R. § 201.240(a), for the purpose of settlement of these proceedings initiated against Respondent on June 23, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 as to Uniroyal Technology Corp. ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that¹:

1. Uniroyal (CIK No. 890096) is a forfeited Delaware corporation located in Tampa, Florida with a class of equity securities registered with the Commission under Exchange Act Section 12. As of June 17, 2008, the common stock of Uniroyal (symbol "UTICQ") was quoted on the Pink Sheets. The Respondent filed a Chapter 11 bankruptcy petition August 25, 2002, which was later converted to a Chapter 7 proceeding, and was still pending as of June 30, 2008.

2. Uniroyal has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 29, 2002.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 12(j) of the Exchange Act, the registration of each class of Uniroyal's securities registered pursuant to Exchange Act Section 12 be, and hereby is, revoked.

For the Commission, by its Secretary, pursuant to delegated authority.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

¹The 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.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58132 / July 10, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13065

In the Matter of

American Ship Building Co., and
Harbour Intermodal, Ltd.,

Respondents.

ORDER MAKING FINDINGS AND
REVOKING REGISTRATION OF
SECURITIES PURSUANT TO
SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT OF
1934 AS TO HARBOUR
INTERMODAL, LTD.

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors to accept the Offer of Settlement submitted by Harbour Intermodal, Ltd. ("Harbour" or "Respondent") pursuant to Rule 240(a) of the Rules of Practice of the Commission, 17 C.F.R. § 201.240(a), for the purpose of settlement of these proceedings initiated against Respondent on June 12, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 as to Harbour Intermodal, Ltd. ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that¹:

1. Harbour (CIK No. 933649) is a Delaware corporation located in Newark, New Jersey with a class of equity securities registered with the Commission under Exchange Act Section 12. As of June 2, 2008, the common stock of Harbour (symbol "HICC") was quoted on the Pink Sheets.

2. Harbour has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2002.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 12(j) of the Exchange Act, the registration of each class of Harbour's securities registered pursuant to Exchange Act Section 12 be, and hereby is, revoked.

For the Commission, by its Secretary, pursuant to delegated authority.

Florence E. Harmon
Acting Secretary

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

¹The 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.

F.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58141 / July 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13080

In the Matter of

**National Fruit and Vegetable Technology Corp.,
National Properties Investment Trust,
National Record Mart, Inc.,
National Sorbents, Inc.,
Nations Flooring, Inc.,
Netcare Health Group, Inc., and
Netgain Development, Inc.,**

Respondents.

**ORDER MAKING FINDINGS AND
REVOKING REGISTRATION OF
SECURITIES PURSUANT TO SECTION
12(j) OF THE SECURITIES
EXCHANGE ACT OF 1934 AS TO
NATIONAL FRUIT AND VEGETABLE
TECHNOLOGY CORP.**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors to accept the Offer of Settlement submitted by National Fruit and Vegetable Technology Corp. ("National Fruit" or "Respondent") pursuant to Rule 240(a) of the Rules of Practice of the Commission, 17 C.F.R. § 201.240(a), for the purpose of settlement of these proceedings initiated against Respondent on June 24, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 as to by National Fruit and Vegetable Technology Corp. ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that¹:

1. National Fruit (CIK No. 815747) is a defaulted Nevada corporation located in Baltimore, Ohio. At all times relevant to this proceeding, the securities of National Fruit have been registered under Exchange Act Section 12(g).

2. National Fruit has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended December 31, 2000.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanctions specified in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Exchange Act Section 12(j), registration of each class of Respondent's securities registered pursuant to Exchange Act Section 12 be, and hereby is, revoked.

For the Commission, by its Secretary, pursuant to delegated authority.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

¹The 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.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8943 / July 11, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 58150 / July 11, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2753 / July 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28330 / July 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12554

In the Matter of

**MICHAEL SASSANO,
DOGAN BARUH, ROBERT
OKIN, AND R. SCOTT
ABRY,**

Respondents.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933, SECTIONS
15(b) AND 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTION
203(f) OF THE INVESTMENT ADVISERS
ACT OF 1940, AND SECTION 9(b) OF
THE INVESTMENT COMPANY ACT OF
1940 AS TO DOGAN BARUH**

I.

On January 31, 2007, 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"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Dogan Baruh ("Baruh" or "Respondent").

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II.

In connection with 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 Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Respondent

1. Dogan Baruh, 31, resides in New York, New York. From June 1998 until January 2003, Baruh was employed as a registered representative ("RR") by CIBC World Markets, Inc. ("CIBC" or "World Markets") in its Private Client Division ("PCD") as part of a group of RRs working in a market timing unit headed by Broker Doe. Baruh was an RR of World Markets until January 2003, at which time he became an RR of Fahnestock & Co., Inc. ("Fahnestock"). He holds a Series 7 license. In March 2004, Oppenheimer and Co., Inc. ("Oppenheimer") indefinitely suspended Baruh and, in July 2004, Baruh resigned from Oppenheimer.

Other Relevant Entities

2. CIBC is a New York-based broker-dealer subsidiary of Canadian Imperial Bank of Commerce, a Canadian financial and bank holding company. During the relevant time period, CIBC was registered with the Commission as both a broker-dealer and an investment adviser. CIBC, through its CIBC Oppenheimer retail division, serviced high-net-worth individuals, money managers, and other customers, including hedge funds. In January 2003, CIBC sold its Oppenheimer retail division to Fahnestock. On July 20, 2005, the Commission instituted settled administrative and cease-and-desist proceedings against CIBC, in which CIBC settled to charges that it violated Section 17(a) of the Securities Act, Sections 7(c), 10(b), 11(d), 15(c) and 17(a) of the Exchange Act and Rules 10b-3, 10b-5 and 17a-3 thereunder, as well as Rule 22c-1 as adopted under Section 22(c) of the Investment Company Act and Regulation T promulgated by the Federal Reserve Board regarding the extension of margin credit.

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.

3. Fahnestock was a New York-based broker-dealer which, in January 2003, through its parent holding company Fahnestock Viner Holdings, Inc., acquired CIBC's retail division. After the purchase, Baruh became a Fahnestock employee. In September 2003, Fahnestock changed its name to Oppenheimer and Co., Inc. Oppenheimer is registered with the Commission as both a broker-dealer and an investment adviser.

Summary

4. This matter involves Baruh's deceptive market timing and late trading while an RR at CIBC and Fahnestock. Together with other RRs at CIBC and Fahnestock (the "Brokers"), Baruh and the Brokers engaged in a scheme to defraud mutual fund companies.

5. Between 1998 and September 2003, Baruh and the Brokers actively assisted market timing customers in deceiving mutual funds. CIBC, Fahnestock and the Brokers received hundreds of letters and emails from mutual funds regarding their market timing trading activities. Baruh and the Brokers repeatedly ignored these communications, and continued to work with their market timing customers to implement their market timing strategies up until the point when mutual funds threatened to terminate their dealer agreements with CIBC or Fahnestock. Even then, Baruh and the Brokers did not always stop market timing, resulting in a number of mutual funds terminating their dealer agreement with CIBC or Fahnestock, or refusing to accept any trades from the Brokers' branch office. CIBC supported the market timing business of Baruh and the Brokers, including giving them the exclusive right to engage in market timing at CIBC. In addition, CIBC created the Mutual Fund Exchange System ("MFES") exclusively for the market timing business. The MFES allowed customers to submit their mutual fund trades via electronic spreadsheet, which Baruh and the Brokers could then electronically convert into orders within CIBC's systems. The MFES system had the added benefit of allowing customers to submit multiple smaller trades within one account as a means to stay "under the radar" of mutual funds' internal timing monitors.

6. Among the deceptive practices that Baruh and the Brokers engaged in on behalf of their customers were the following: (a) using new account numbers for blocked customer accounts; (b) creating new RR numbers to disguise themselves and their customers from the mutual funds; (c) trading in smaller amounts in order to avoid detection by the mutual funds, including using an in-house electronic trading platform to break up trades into small dollar volumes; (d) using annuities to avoid restrictions on market timing; (e) using the investment adviser trading platforms of two broker-dealers, Charles Schwab & Co., Inc. ("Schwab") and FMR Corp. ("Fidelity"), to continue market timing mutual funds that had previously blocked their customers' trading; and (f) on one instance, sending trades from a different branch to deceive the mutual funds about the origins of the trade. Baruh also engaged in late trading by accepting trade orders from a hedge fund customer with the understanding that those trades would be entered after 4:00 p.m.

Deceptive Market Timing

7. Baruh started at CIBC in 1998 and became part of a market timing group headed by Broker Doe. Baruh and the Brokers opened multiple accounts for their customers in order to

disguise the identity of account holders and continue market timing on behalf of customers that mutual funds had previously blocked. Creating new accounts enabled a market timer to evade blocks mutual funds had placed on their previous timing accounts.

8. Some mutual funds discerned that Baruh and the Brokers enabled their customers to clone accounts to evade blocks and notified CIBC and Fahnestock that they disapproved of the practice. Dozens of mutual fund companies, through letters, e-mails and other communications, told Baruh and the Brokers of the harm suffered by long-term shareholders as a result of their deceptive market timing. Time and time again, Baruh and the Brokers continued to enter trades in violation of the instructions of the mutual fund companies to stop. As an internal CIBC e-mail to Baruh in January 2003 stated, one mutual fund company was "frustrated by the fact that you stop timing in current accounts when they ask only to show up later in others."

9. Baruh and the Brokers used multiple RR numbers to deceive mutual funds about the source of market timing trades. Using alternative RR numbers allowed the Brokers and their customers to "disguise" their identity and fool the mutual funds into believing that they had not been previously blocked from trading. This became increasingly important as mutual funds began to identify RR numbers associated with Baruh as the source of the abusive trading. Baruh and the Brokers had at least 85 RR numbers at CIBC.

10. Another method used to disguise their timing from mutual funds was to stay "under the radar" of the funds by trading in small dollar amounts. Baruh and the Brokers opened multiple accounts for their timing customers in order to spread timing money across multiple accounts, instead of trading one large lump sum, which would have been a "red flag" to mutual funds. For example, one market timing customer of Baruh's had 195 accounts at CIBC and Fahnestock; another had 246 accounts.

11. Baruh and the Brokers also used platforms at other broker-dealers as a way to deceive mutual funds. Specifically, utilizing CIBC's status as an investment adviser, accounts were opened at Fidelity and Schwab on behalf of the market timing customers of Baruh and the Brokers as another means of evading mutual fund blocks.

12. The market timing of Baruh and the Brokers occurred on a large scale. From June 1998 through September 2003, Baruh and the Brokers market timed more than 80 mutual funds. Their customers purchased more than \$90 billion of mutual fund shares through more than 217,000 trades. During this period, the trades placed by Baruh and the Brokers on behalf of their customers had a median holding period of only two days. Baruh benefited from the conduct described above.

Late Trading

13. From at least August 2001 to November 2002, Baruh accepted numerous trade orders from one of his market timing hedge fund customers before 4:00 p.m. with the understanding that he would not receive final instructions on executing the proposed trades until after 4:00 p.m. Further, despite the fact that the trading decision was made after 4:00 p.m., the understanding was that the proposed trades would be priced as of 4:00 p.m., the time as of which

the relevant mutual funds determined their net asset value. Typically, the customer would fax its proposed trades to Baruh before the market closed. Thereafter, the customer would call and instruct him whether to execute the proposed trades. While these calls occasionally occurred before 4:00 p.m., they very often occurred after 4:00 p.m., allowing the customer to observe the after-hours markets. Baruh also cancelled trades after 4:00 p.m. at the customer's request.

Violations

14. As a result of the conduct described above, Baruh willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities, and in connection with the purchase or sale of securities. Among other things, Baruh participated in a scheme with his market timing customers to defraud mutual funds and their shareholders by engaging in deceptive market timing. Baruh defrauded mutual funds and their shareholders when he and the Brokers misrepresented and concealed the identities of CIBC's RRs and customers, as well as the nature of their customers' market timing activity, from the mutual funds. Baruh acted knowingly and/or recklessly in engaging in these activities.

15. As a result of the conduct described above, Baruh willfully aided and abetted and caused his customers' violations 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 and sale of securities, and in connection with the purchase or sale of securities. Among other things, the market timing customers of Baruh and the Brokers engaged in a fraudulent scheme to conceal their identities from mutual fund companies' internal monitors and by late trading. Customers consulted with Baruh and authorized deceptive market timing and late trading. Baruh acted knowingly and/or recklessly in engaging in these activities.

16. As a result of the conduct described above, Baruh willfully aided and abetted and caused CIBC's violations of Section 15(c) of the Exchange Act, which prohibits a broker or a dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security by means of any manipulative, deceptive, or other fraudulent device or contrivance, and Rule 10b-3, which prohibits a broker or dealer from using or employing any act, practice or course of business that is a manipulative, deceptive, or other fraudulent device or contrivance in connection with the purchase or sale of any security otherwise than on a national security exchange.

17. As a result of the conduct described above, Baruh willfully aided and abetted and caused CIBC's violations of Rule 22c-1, as adopted under Section 22(c) of the Investment Company Act, which provides that "[n]o registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."

Undertakings

18. Ongoing Cooperation by Baruh. Baruh undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, Baruh has undertaken:

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

b. To be interviewed by the Commission's staff at such times as the staff reasonably may request and 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

c. That in connection with any testimony of Baruh to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Baruh:

- i. Agrees that any such notice or subpoena for his appearance and testimony may be served by regular mail on his counsel, Andrew Lawler, 641 Lexington Avenue, 27th floor, New York, NY 10022; and
- ii. Agrees that any such notice or subpoena for his 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 or the Commission's Rules of Practice.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, it is hereby ORDERED that:

A. Respondent Baruh shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

B. Respondent Baruh shall cease and desist from causing any violations and any future violations of Section 15(c) of the Exchange Act and Rule 10b-3 thereunder, and Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act;

C. Respondent Baruh shall be, and hereby is, barred from association with any broker, dealer or investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

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;

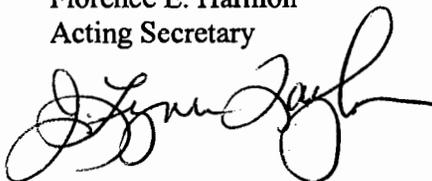
E. IT IS FURTHERED ORDERED that Respondent shall pay disgorgement of \$1 and a civil money penalty in the amount of \$325,000 to the Securities and Exchange Commission. Baruh shall satisfy this obligation by paying \$162,500 within ten (10) days of entry of this Order and the remaining \$162,500 within 180 days of entry of this Order. Such payments shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Baruh as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Stoelting, Senior Trial Counsel, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, NY 10281;

F. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 ("Fair Fund distribution") by the Fair Fund established in In the Matter of Canadian Imperial Holdings, Inc. and CIBC World Markets Corp., AP File No. 3-11987. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall

not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Florence E. Harmon
Acting Secretary

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

By: J. Lynn Taylor
Assistant Secretary

I.

On April 12, 2005, the Securities and Exchange Commission (“Commission”) entered an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 11b-1 Thereunder (“OIP”) against respondent Warren E. Turk (“Turk”).

II.

Turk has submitted an Offer of Settlement (“Offer”) in these administrative proceedings, 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, Turk consents to the entry of this Order Making Findings, Imposing Remedial Sanctions, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934 and Rule 11b-1 Thereunder as to Warren E. Turk (“Turk”), as set forth below.

III.

On the basis of this Order and Turk’s Offer, the Commission finds¹ that:

FACTS

1. Turk is one of several respondents in pending administrative and cease-and-desist proceedings, file number 3-11893, who have been charged with improper trading during the period from at least 1999 through June 30, 2003, while they were acting as specialists on the New York Stock Exchange (“NYSE”).
2. Turk, age 39, of New York, New York, acted as a specialist on the NYSE at Van der Moolen Specialists USA, LLC (“Van der Moolen”) and a Van der Moolen predecessor firm from at least January 1, 1999 to approximately November 2004 (the “Relevant Period”).
3. During the Relevant Period, Turk acted as a specialist in Pfizer, Inc. (“PFE”) (from approximately January 1999 to approximately July 1999), Abercrombie & Fitch Co. (“ANF”) (from approximately October 1999 to approximately July 2000), and Cypress Semiconductor Corp. (“CY”) (from approximately April 2000 to approximately May 2003).

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

4. As a specialist, Turk had an obligation to serve public customer orders over the proprietary interests of the firm with whom he was formerly employed, Van der Moolen. In his role as a specialist, Turk had a general duty to match executable public customer or “agency” buy and sell orders and not to fill customer orders through trades from Van der Moolen’s own account when those customer orders could be matched with other customer orders. Turk violated this obligation by filling orders through proprietary trades rather than through other customer orders, through two types of improper trading referred to herein as “interpositioning” and “trading ahead.”
5. Interpositioning involves a two-step process that allows the specialist to generate a profit for the specialist firm from the spread between two opposite trades. Interpositioning can take various forms. In one form, the specialist purchases stock for the specialist firm’s proprietary account from the customer sell order, and then fills the customer buy order by selling from the specialist firm’s proprietary account at a higher price – thus locking in a riskless profit for the specialist firm’s proprietary account. A second form of interpositioning involves the specialist selling stock into the customer buy order, and then filling the customer sell order by buying for the specialist firm’s proprietary account at a lower price – again, locking in a riskless profit for the specialist firm’s proprietary account. In both forms of interpositioning, the specialist participates on both sides of the trade, thereby capturing the spread between the purchase and sale prices, disadvantaging at least one of the parties to the transaction.
6. Trading ahead involves a practice whereby the specialist fills an agency order through a proprietary trade for the specialist firm’s proprietary account – and thereby improperly ‘steps in front’ of, or ‘trades ahead’ of, another agency order – simply to allow the specialist firm to take advantage of market conditions promptly. Unlike interpositioning, the practice of “trading ahead” does not necessarily involve a second specialist trade for the specialist firm’s proprietary account into the opposite, disadvantaged agency order. For example, in a declining market, a specialist may “trade ahead” by filling a market buy order by selling stock from the specialist firm’s proprietary account in front of an agency market sell order. In so doing, the specialist would lock in a higher price for the proprietary trade, then fill the agency sell order *after* the proprietary trade, and thereby force the agency market sell order to accept a slightly lower price as the price of the stock fell.
7. During the Relevant Period, in PFE, ANF and CY, Turk engaged in approximately 697 instances of interpositioning, locking in a riskless profit of approximately \$83,049 for his firm’s proprietary account at the expense of customer orders, and approximately 4,199 instances of trading ahead, causing approximately \$896,542 in customer harm.

APPLICABLE LAW

Section 11(b) of the Exchange Act and Rule 11b-1 Thereunder

8. Section 11(b) of the Exchange Act and Rule 11b-1 thereunder require various limitations on the operations of specialists, including limiting a specialist's dealer transactions to those "reasonably necessary to permit him to maintain a fair and orderly market." Exchange Act Section 11(b) and Rule 11b-1 thereunder permit a national securities exchange to promulgate rules that allow a member to register as a specialist and to act as a dealer. Under Exchange Act Rule 11b-1 if the Commission finds, after appropriate notice and opportunity for hearing, that a specialist has for any account in which he has an interest "effected transactions ... which were not part of a course of dealings reasonably necessary to permit such specialist to maintain a fair and orderly market," and were "not effected in a manner consistent with the rules adopted by such exchange," the Commission may order the exchange to suspend or cancel the specialist's registration. If, however, the exchange itself has suspended or canceled the specialist's registration, no further sanction shall be imposed unless the Commission finds "substantial or continued misconduct."
9. Where specialists make trades for their firm's proprietary accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly market," they have violated Exchange Act Section 11(b) and Rule 11b-1 thereunder. The Commission has brought settled actions for sanctions under Exchange Act Section 15(b) against specialists under Section 11(b) and Rule 11b-1 thereunder. See In the Matter of Albert Fried & Co. and Albert Fried, Jr., 1978 WL 196046, S.E.C. Release No. 34-15293 (Nov. 3, 1978).
10. Several NYSE rules prohibit a specialist from trading ahead of a customer order, as well as from engaging in interpositioning, and require agency orders to be matched whenever possible, consistent with a specialist's duty to maintain a fair and orderly market.
11. NYSE Rule 104 (Dealings by Specialists), which sets forth specialists' obligations, prohibits specialists from trading for their own accounts unless it is reasonably necessary to maintain a fair and orderly market. This is known as the negative obligation. Rule 104 states in relevant part: "No specialist shall effect . . . purchases or sales of any security in which such specialist is registered . . . , unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market."²

² Rule 104.10(3), which describes specialists' affirmative obligations, also expands on the negative obligation:

12. NYSE Rule 92 (Limitations on Members' Trading Because of Customers Orders) generally prohibits a member from entering a proprietary order to buy (or sell) a security while in possession of an executable buy (or sell) agency order that could be executed at the same price. During the Relevant Period, Rule 92 stated in relevant part:

No member shall personally buy . . . any security . . . for his own account or for any account in which he is . . . interested . . . while such member personally holds or has knowledge that his member organization holds an unexecuted market order to buy such security . . . for a customer.³

13. Similarly, NYSE Rule 92 also applies to the specialist buying or selling a security while holding an unexecuted market buy or sell order, as well as to circumstances where the specialist holds unexecuted customer limit orders at a price that could be satisfied by the proprietary transaction effected by the specialist.
14. NYSE Rule 123B (Exchange Automated Order Routing Systems) requires specialists to cross orders received over the DOT system. Rule 123B(d) states in relevant part: "a specialist shall execute System orders in accordance with Exchange auction market rules and procedures, including requirements to expose orders to buying and selling interest in the trading crowd and *to cross orders before buying or selling from his own account.*" (Emphasis added).
15. NYSE Rule 401 requires NYSE members to "adhere to the principles of good business practice in the conduct of his or its business affairs." Similarly, NYSE

Transactions on the Exchange for his own account effected by a member acting as a specialist must constitute a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable depth, and to the minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated. Transactions not part of such a course of dealings . . . are not to be effected.

³ Rule 92 was amended on January 7, 2002 to read in relevant part:

[n]o member or member organization shall cause the entry of an order to buy (sell) any Exchange-listed security for any account in which such member or member organization or any approved person thereof is directly or indirectly interested (a "proprietary order"), if the person responsible for the entry of such order has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price.

Rule 476(a)(6) provides sanctions if NYSE members are adjudged guilty of “conduct or proceeding inconsistent with just and equitable principles of trade.”

16. As a result of the conduct described above, Turk violated all of the aforementioned NYSE rules and willfully⁴ violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

IV.

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

Accordingly, it is hereby ORDERED that:

1. Turk be, and hereby is, censured pursuant to Section 15(b)(6) of the Exchange Act.
2. Pursuant to Section 21C of the Exchange Act, Turk shall cease and desist from committing or causing any violations and any future violations of Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

⁴ A willful violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

3. It is further ordered that Turk shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$75,000 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 Turk 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 Scott L. Black, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

By the Commission.



Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Act of 1933
Release No. 8944 / July 16, 2008

Securities Exchange Act of 1934
Release No. 58170 / July 16, 2008

Administrative Proceeding
File Number 3-11893

In the Matter of	:	ORDER MAKING FINDINGS,
	:	IMPOSING REMEDIAL SANCTIONS,
	:	AND IMPOSING A CEASE-AND-DESIST
	:	ORDER PURSUANT TO SECTION 8A OF
	:	THE SECURITIES ACT OF 1933 AND
	:	SECTIONS 15(b)(6), 21C AND 11(b) OF THE
	:	SECURITIES EXCHANGE ACT OF 1934 AND
	:	RULE 11b-1 THEREUNDER AS TO
	:	GERARD T. HAYES
David A. Finnerty,	:	
Donald R. Foley II,	:	
Scott G. Hunt,	:	
Thomas J. Murphy, Jr.,	:	
Kevin M. Fee,	:	
Frank A. Delaney IV,	:	
Freddy DeBoer,	:	
Todd J. Christie,	:	
James V. Parolisi,	:	
Robert W. Luckow,	:	
Patrick E. Murphy,	:	
Robert A. Johnson, Jr.,	:	
Patrick J. McGagh, Jr.,	:	
Joseph Bongiorno,	:	
Michael J. Hayward,	:	
Richard P. Volpe,	:	
Michael F. Stern,	:	
Warren E. Turk,	:	
Gerard T. Hayes, and	:	
Robert A. Scavone, Jr.	:	
	:	
Respondents.	:	
	:	

I.

On April 12, 2005, the Securities and Exchange Commission ("Commission") entered an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 11b-1 Thereunder ("OIP") against respondent Gerard T. Hayes ("Hayes").

II.

Hayes has submitted an Offer of Settlement ("Offer") in these administrative proceedings, 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, Hayes consents to the entry of this Order Making Findings, Imposing Remedial Sanctions, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934 and Rule 11b-1 Thereunder as to Gerard T. Hayes ("Order"), as set forth below.

III.

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

FACTS

1. Hayes is one of several respondents in pending administrative and cease-and-desist proceedings, file number 3-11893, who have been charged with fraudulent and other improper trading during the period from at least 1999 through June 30, 2003, while they were acting as specialists on the New York Stock Exchange ("NYSE").
2. Hayes, age 47, of Easton, Connecticut, acted as a specialist on the NYSE at Van der Moolen Specialists USA, LLC ("Van der Moolen") from at least January 1, 1999 to approximately November 2004 (the "Relevant Period").
3. During the Relevant Period, Hayes acted as a specialist in International Paper Co. ("IP") (from approximately January 1999 to approximately June 2000, and from approximately April 2001 to approximately May 2003), and The Walt Disney Co. ("DIS") (from approximately August 2000 to approximately February 2001).

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

4. As a specialist, Hayes had an obligation to serve public customer orders over the proprietary interests of the firm with whom he was formerly employed, Van der Moolen. In his role as a specialist, Hayes had a general duty to match executable public customer or “agency” buy and sell orders and not to fill customer orders through trades from Van der Moolen’s own account when those customer orders could be matched with other customer orders. Hayes violated this obligation by filling orders through proprietary trades rather than through other customer orders, through two types of improper trading referred to herein as “interpositioning” and “trading ahead.”
5. Interpositioning involves a two-step process that allows the specialist to generate a profit for the specialist firm from the spread between two opposite trades. Interpositioning can take various forms. In one form, the specialist purchases stock for the specialist firm’s proprietary account from the customer sell order, and then fills the customer buy order by selling from the specialist firm’s proprietary account at a higher price – thus locking in a riskless profit for the specialist firm’s proprietary account. A second form of interpositioning involves the specialist selling stock into the customer buy order, and then filling the customer sell order by buying for the specialist firm’s proprietary account at a lower price – again, locking in a riskless profit for the specialist firm’s proprietary account. In both forms of interpositioning, the specialist participates on both sides of the trade, thereby capturing the spread between the purchase and sale prices, disadvantaging at least one of the parties to the transaction.
6. Trading ahead involves a practice whereby the specialist fills an agency order through a proprietary trade for the specialist firm’s proprietary account – and thereby improperly ‘steps in front’ of, or ‘trades ahead’ of, another agency order – simply to allow the specialist firm to take advantage of market conditions promptly. Unlike interpositioning, the practice of “trading ahead” does not necessarily involve a second specialist trade for the specialist firm’s proprietary account into the opposite, disadvantaged agency order. For example, in a declining market, a specialist may “trade ahead” by filling a market buy order by selling stock from the specialist firm’s proprietary account in front of an agency market sell order. In so doing, the specialist would lock in a higher price for the proprietary trade, then fill the agency sell order *after* the proprietary trade, and thereby force the agency market sell order to accept a slightly lower price as the price of the stock fell.
7. During the Relevant Period, in IP and DIS, Hayes knowingly or recklessly engaged in approximately 2,145 instances of interpositioning, locking in a riskless profit of approximately \$143,454 for his firm’s proprietary account at the expense of customer orders, and approximately 5,350 instances of trading ahead, causing approximately \$528,103 in customer harm.

APPLICABLE LAW

Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

8. The antifraud provisions of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder prohibit, among other things, any schemes to defraud or fraudulent or deceptive acts and practices in the offer or sale (Section 17(a)) or in connection with the purchase or sale (Section 10(b) and Rule 10b-5) of securities. Basic, Inc. v. Levinson, 485 US 224, 235 n.13 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (en banc)). To prove a violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the Commission must prove that the respondent acted with scienter. Aaron v. SEC, 446 U.S. 680, 691 (1980). Scienter may be established by proof of conscious behavior or recklessness on the part of the respondent. In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 74 (2d Cir. 2001); SEC v. U.S. Environmental, Inc., 155 F.3d 107, 111 (2d Cir. 1998), cert. denied, 526 U.S. 1111 (1999). Scienter need not be shown in order to establish violations of Sections 17(a)(2) and (3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 696-97 (1980).
9. As a result of the described conduct above, Hayes willfully violated Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Section 11(b) of the Exchange Act and Rule 11b-1 Thereunder

10. Section 11(b) of the Exchange Act and Rule 11b-1 thereunder require various limitations on the operations of specialists, including limiting a specialist's dealer transactions to those "reasonably necessary to permit him to maintain a fair and orderly market." Section 11(b) of the Exchange Act and Rule 11b-1 thereunder permit a national securities exchange to promulgate rules that allow a member to register as a specialist and to act as a dealer. Under Rule 11b-1 of the Exchange Act if the Commission finds, after appropriate notice and opportunity for hearing, that a specialist has for any account in which he has an interest "effected transactions ... which were not part of a course of dealings reasonably necessary to permit such specialist to maintain a fair and orderly market," and were "not effected in a manner consistent with the rules adopted by such exchange," the Commission may order the exchange to suspend or cancel the specialist's registration. If, however, the exchange itself has suspended or canceled the specialist's registration, no further sanction shall be imposed unless the Commission finds "substantial or continued misconduct."
11. Where specialists make trades for their firm's proprietary accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly

market,” they have violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder. The Commission has brought settled actions for sanctions under Exchange Act Section 15(b) against specialists under Section 11(b) of the Exchange Act and Rule 11b-1 thereunder. See In the Matter of Albert Fried & Co. and Albert Fried, Jr., 1978 WL 196046, S.E.C. Release No. 34-15293 (Nov. 3, 1978).

12. Several NYSE rules prohibit a specialist from trading ahead of a customer order, as well as from engaging in interpositioning, and require agency orders to be matched whenever possible, consistent with a specialist’s duty to maintain a fair and orderly market.
13. NYSE Rule 104 (Dealings by Specialists), which sets forth specialists’ obligations, prohibits specialists from trading for their own accounts unless it is reasonably necessary to maintain a fair and orderly market. This is known as the negative obligation. Rule 104 states in relevant part: “No specialist shall effect . . . purchases or sales of any security in which such specialist is registered . . . , unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market.”²
14. NYSE Rule 92 (Limitations on Members’ Trading Because of Customers Orders) generally prohibits a member from entering a proprietary order to buy (or sell) a security while in possession of an executable buy (or sell) agency order that could be executed at the same price. During the Relevant Period, Rule 92 stated in relevant part:

No member shall personally buy . . . any security . . . for his own account or for any account in which he is . . . interested . . . while such member personally holds or has knowledge that his member organization holds an unexecuted market order to buy such security . . . for a customer.³

² Rule 104.10(3), which describes specialists’ affirmative obligations, also expands on the negative obligation:

Transactions on the Exchange for his own account effected by a member acting as a specialist must constitute a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable depth, and to the minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated. Transactions not part of such a course of dealings . . . are not to be effected.

³ Rule 92 was amended on January 7, 2002 to read in relevant part:

15. Similarly, NYSE Rule 92 also applies to the specialist buying or selling a security while holding an unexecuted market buy or sell order, as well as to circumstances where the specialist holds unexecuted customer limit orders at a price that could be satisfied by the proprietary transaction effected by the specialist.
16. NYSE Rule 123B (Exchange Automated Order Routing Systems) requires specialists to cross orders received over the DOT system. Rule 123B(d) states in relevant part: "a specialist shall execute System orders in accordance with Exchange auction market rules and procedures, including requirements to expose orders to buying and selling interest in the trading crowd and *to cross orders before buying or selling from his own account.*" (Emphasis added).
17. NYSE Rule 401 requires NYSE members to "adhere to the principles of good business practice in the conduct of his or its business affairs." Similarly, NYSE Rule 476(a)(6) provides sanctions if NYSE members are adjudged guilty of "conduct or proceeding inconsistent with just and equitable principles of trade."
18. As a result of the conduct described above, Hayes also violated all of the aforementioned NYSE rules and willfully violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

IV.

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

Accordingly, it is hereby ORDERED that:

1. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Hayes shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, and Sections 10(b) and 11(b) of the Exchange Act and Rules 10b-5 and 11b-1 thereunder.
2. Pursuant to Section 15(b)(6) of the Exchange Act, Hayes be, and hereby is, barred from association with any broker or dealer.

[n]o member or member organization shall cause the entry of an order to buy (sell) any Exchange-listed security for any account in which such member or member organization or any approved person thereof is directly or indirectly interested (a "proprietary order"), if the person responsible for the entry of such order has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price.

Any reapplication for association by Hayes 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 Hayes, 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.

3. It is further ordered that Respondent shall, within 10 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 Hayes 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 Scott L. Black, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

By the Commission.



Florence E. Harmon
Acting Secretary

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, Delargy 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. Delargy, age 44, currently resides in Bangor, Maine. He is a Certified Public Accountant, with an inactive license in California. From July 1999 to May 2001, he was an officer of iGo Corporation ("iGo"). He was the Chief Financial Officer of iGo from July 1999 through December 2000, and Chief Operating Officer from December 2000 to May 2001. From 1999 through the third quarter of 2000, he signed iGo's Forms 10-Q and Forms 10-K. From 1999 through the first quarter of 2001, he signed management representation letters that were provided to iGo's independent auditor, Deloitte & Touche LLP, in connection with their audits of iGo's financial statements.

2. **iGo**, a Delaware corporation with headquarters formerly in Reno, Nevada, manufactured and distributed parts and accessories for mobile technology products such as laptops, cellular phones, and wireless devices. iGo conducted its initial public offering on October 15, 1999. During the relevant period, iGo's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ National Market System. iGo was acquired by Mobility Electronics, Inc. on September 4, 2002 and is no longer a public company.

3. On March 24, 2005, the Commission filed a complaint against Delargy in Securities and Exchange Commission v. Kenneth Hawk, et al., Civil Action Number 3:05-CV-00172-LRH-VPC (D. Nev.). On July 15, 2008, the Court entered a final judgment permanently enjoining Delargy, by consent, from future violations of Sections 10b and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1, and 13b2-2 thereunder, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder. The Court also entered an order barring Delargy from serving as an officer or director of a public company for a period of three years and ordered him to pay a civil penalty of \$50,000.

4. The Commission's complaint alleges that Delargy knowingly and/or recklessly caused iGo to materially overstate its revenues, and understate its losses, in the fourth quarter of 1999, and the third and fourth quarters of 2000, by improperly recording revenue on nine sales transactions, some of which were fraudulent. The complaint also alleges that Delargy misrepresented material facts about the improper sales transactions to iGo's independent auditors in connection with their audits of iGo's financial statements in fiscal years 1999 and 2000, and caused iGo to fail to maintain proper internal controls and accurate books and records. Additionally, the Complaint alleged that Delargy violated, and aided and abetted iGo's violations of, the provisions of the federal securities laws as noted 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 Respondent Delargy's Offer.

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

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

B. After three (3) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

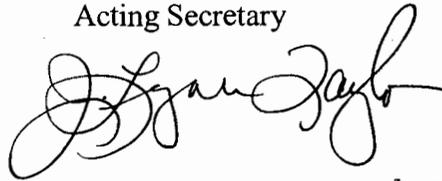
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Florence E. Harmon,
Acting Secretary

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

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8945 / July 18, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 58193 / July 18, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2756 / July 18, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28333 / July 18, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12554

In the Matter of

**Michael Sassano, Dogan
Baruh, Robert Okin, and R.
Scott Abry,**

Respondents.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933, SECTIONS
15(b) AND 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTION
203(f) OF THE INVESTMENT ADVISERS
ACT OF 1940, AND SECTION 9(b) OF
THE INVESTMENT COMPANY ACT OF
1940 AS TO MICHAEL SASSANO**

I.

On January 31, 2007, 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"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Michael Sassano ("Sassano" or "Respondent").

II.

In connection with these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these

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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 the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Respondent

1. Michael Sassano, 37, resides in Monaco. From 1997 until January 2003, Sassano was employed as a registered representative ("RR") by CIBC World Markets Corp. ("CIBC") in its CIBC Oppenheimer retail division, and specifically in its Private Client Division ("PCD"). On April 24, 2002, Sassano was promoted to Managing Director. He was a RR of CIBC until January 2003, at which time he became a RR of Fahnestock & Co., Inc. ("Fahnestock"). In September 2003, Fahnestock changed its name to Oppenheimer and Co., Inc. ("Oppenheimer"). Sassano holds Series 7, 63 and 65 licenses. In March 2004, Oppenheimer indefinitely suspended Sassano, and later in 2004 his employment terminated.

Other Relevant Entities

2. CIBC is a New York-based broker-dealer subsidiary of Canadian Imperial Bank of Commerce, Inc., a Canadian financial and bank holding company. During the relevant time period, CIBC was registered with the Commission as both a broker-dealer and an investment adviser. CIBC, through its CIBC Oppenheimer retail division, serviced high-net-worth individuals, money managers, and other customers, including hedge funds. In January 2003, CIBC sold its Oppenheimer retail division to Fahnestock. On July 20, 2005, the Commission instituted settled administrative and cease-and-desist proceedings against CIBC, in which CIBC, without admitting or denying the findings contained therein, agreed to the entry of an order finding that it violated Section 17(a) of the Securities Act, Sections 7(c), 10(b), 11(d), 15(c) and 17(a) of the Exchange Act and Rules 10b-3, 10b-5 and 17a-3 thereunder, as well as Rule 22c-1 as adopted under Section 22(c) of the Investment Company Act and Regulation T promulgated by the Federal Reserve Board regarding the extension of margin credit.

3. Fahnestock was a New York-based broker-dealer which, in January 2003, through its parent holding company Fahnestock Viner Holdings, Inc., acquired CIBC's retail division. After the purchase, Sassano became a Fahnestock employee. In September 2003, Fahnestock

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.

changed its name to Oppenheimer. Oppenheimer is registered with the Commission as both a broker-dealer and an investment adviser.

Summary

4. This matter involves Sassano's deceptive market timing while a RR at CIBC and Fahnestock. Sassano and other RRs at CIBC and Fahnestock (the "Brokers"), engaged in a scheme to defraud mutual fund companies.

5. Between 1998 and September 2003, Sassano and the Brokers, who acted under his direction, actively assisted market timing customers in deceiving mutual funds. CIBC, Fahnestock and the Brokers received hundreds of letters and emails from mutual funds regarding their market timing trading activities. Sassano and the Brokers repeatedly ignored these communications, and continued to work with their market timing customers to implement their market timing strategies up until the point when mutual funds threatened to terminate their dealer agreements with CIBC or Fahnestock. Even then, Sassano and the Brokers did not always stop market timing, resulting in a number of mutual fund companies terminating their dealer agreements with CIBC or Fahnestock, or refusing to accept any trades from Sassano's branch.

6. Among the deceptive practices that Sassano and the Brokers engaged in on behalf of their customers were the following: (a) using new account numbers for blocked customer accounts; (b) creating new RR numbers to disguise themselves and their customers from the mutual funds; (c) trading in smaller amounts in order to avoid detection by the mutual funds, including using an in-house electronic trading platform to break up trades into small dollar volumes; (d) using annuities to avoid restrictions on market timing; (e) using the investment adviser trading platforms of two broker-dealers, Charles Schwab & Co., Inc. ("Schwab") and FMR Corp. ("Fidelity"), to continue market timing mutual funds that had previously blocked Sassano's customers' trading; and (f) on one instance, sending trades from a different branch to deceive the mutual funds about the origins of the trade. Sassano's supervisors were aware that Sassano and the Brokers used deceptive tactics to evade the mutual fund companies' restrictions.

Deceptive Market Timing

7. Sassano started at CIBC in 1997 and, over the next few years, he created a large market timing business in which he executed mutual fund orders on behalf of his customers – large market timing hedge funds. CIBC supported his market timing business, including giving him the exclusive right to engage in market timing at CIBC. Sassano also requested, and his supervisors approved, the creation of an electronic trading platform at CIBC to facilitate Sassano's market timing business. Thus, CIBC created the Mutual Fund Exchange System ("MFES") exclusively for Sassano. The MFES allowed Sassano's customers to submit their mutual fund trades via electronic spreadsheet, which Sassano and the Brokers could then electronically convert into orders within CIBC's systems. The MFES system had the added benefit of allowing customers to submit multiple smaller trades within one account as a means to stay "under the radar" of mutual funds' internal timing monitors.

8. The Brokers, acting at Sassano's direction, opened multiple accounts for their customers in order to disguise the identity of account holders and continue market timing on behalf of customers that mutual funds had previously blocked. Creating new accounts enabled a market timer to evade blocks mutual funds had placed on their previous timing accounts.

9. Some mutual funds discerned that Sassano and the Brokers enabled their customers to clone accounts to evade blocks and notified CIBC and Fahnestock that they disapproved of the practice. Dozens of mutual fund companies, through letters, e-mails and other communications, told Sassano and the Brokers of the harm suffered by long-term shareholders as a result of their deceptive market timing. Sassano and the Brokers continued to enter trades in violation of the instructions of the mutual fund companies to stop. As an internal CIBC e-mail to Sassano and a Broker in January 2003 stated, one mutual fund company was "frustrated by the fact that you stop timing in current accounts when they ask only to show up later in others."

10. Sassano and the Brokers used multiple RR numbers to deceive mutual funds about the source of market timing trades. Using alternative RR numbers allowed the Brokers and their customers to "disguise" their identity and fool the mutual funds into believing that they had not been previously blocked from trading. This became increasingly important as Sassano's business grew and mutual funds began to identify RR numbers associated with Sassano as the source of the abusive trading. Sassano and the Brokers had at least 85 RR numbers at CIBC.

11. Another method Sassano and the Brokers used to disguise their timing from mutual funds was to stay "under the radar" of the funds by breaking up trades in smaller dollar amounts. The Brokers, acting at Sassano's direction, opened multiple accounts for their timing customers in order to spread timing money across multiple accounts, instead of trading one large lump sum, which would have been a "red flag" to mutual funds. For example, one market timing customer of Sassano's had 195 accounts at CIBC and Fahnestock; another had 246 accounts.

12. Platforms at other broker-dealers were also used as a way to deceive mutual funds. Specifically, utilizing CIBC's status as an investment adviser, Sassano and the Brokers opened accounts at Fidelity and Schwab on behalf of his market timing customers as another means of evading mutual fund blocks.

13. The market timing of Sassano and the Brokers occurred on a large scale. From January 1998 through September 2003, Sassano and the Brokers market timed more than 80 mutual fund companies. Their market timing customers purchased more than \$90 billion of mutual fund shares through more than 217,000 trades. During this period, the trades placed by Sassano and the Brokers on behalf of their market timing customers had a median holding period of only two days. Sassano benefited from the conduct described above.

Violations

14. As a result of the conduct described above, Sassano willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which

prohibit fraudulent conduct in the offer and sale of securities, and in connection with the purchase or sale of securities. Among other things, Sassano participated in a scheme with his market timing customers to defraud mutual funds and their shareholders by engaging in deceptive market timing. Sassano defrauded mutual funds and their shareholders when he and the Brokers misrepresented and concealed the identities of CIBC's RRs and customers, as well as the nature of their customers' market timing activity, from the mutual funds. Sassano acted knowingly and/or recklessly in engaging in these activities.

15. As a result of the conduct described above, Sassano willfully aided and abetted and caused his customers' violations 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 and sale of securities, and in connection with the purchase or sale of securities. Among other things, Sassano's market timing customers engaged in a fraudulent scheme to conceal their identities from mutual fund companies' internal monitors. Customers consulted with Sassano and authorized deceptive market timing. Sassano acted knowingly and/or recklessly in engaging in these activities.

16. As a result of the conduct described above, Sassano willfully aided and abetted and caused CIBC's violations of Section 15(c) of the Exchange Act, which prohibits a broker or a dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security by means of any manipulative, deceptive, or other fraudulent device or contrivance, and Rule 10b-3, which prohibits a broker or dealer from using or employing any act, practice or course of business that is a manipulative, deceptive, or other fraudulent device or contrivance in connection with the purchase or sale of any security otherwise than on a national security exchange.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, it is hereby ORDERED that:

A. Respondent Sassano shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

B. Respondent Sassano shall cease and desist from causing any violations and any future violations of Section 15(c) of the Exchange Act and Rule 10b-3 thereunder.

C. Respondent Sassano shall be, and hereby is, barred from association with any broker, dealer or investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or

principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

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;

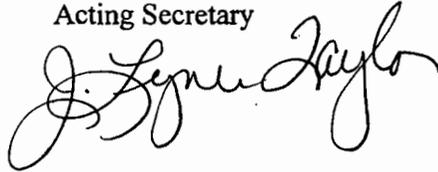
E. IT IS FURTHER ORDERED that Respondent shall pay disgorgement of \$1 and a civil money penalty in the amount of \$1,000,000 to the Securities and Exchange Commission. Sassano shall satisfy this obligation by paying: (1) \$100,001 within 10 days of entry of this Order; (2) \$450,000 within 180 days of entry of this Order; and (3) the remaining \$450,000 within 360 days of entry of this Order. Such payments shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover letter that identifies Sassano as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Stoelting, Senior Trial Counsel, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, NY 10281.

F. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 ("Fair Fund distribution") by the Fair Fund established in In the Matter of Canadian Imperial Holdings, Inc. and CIBC World Markets Corp., AP File No. 3-11987. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought

against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Florence E. Harmon
Acting Secretary

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

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58213 / July 23, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13093

In the Matter of

RICHARD MCGILL,
WILLIAM SANDERS,
MICHAEL TUCHMAN, and
DANNY RAYBURN

Respondents.

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 Richard McGill ("McGill"), William Sanders ("Sanders"), Michael Tuchman ("Tuchman"), and Danny Rayburn ("Rayburn") (collectively the "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondents consent to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b)

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of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions (“Order”), as set forth below.

III.

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

1. Between April 2003 and August 2006, Respondents were salespeople in an Irvine, California office that sold securities of Real Estate Partners, Inc. (“REP”). Respondents were not registered in any capacity with the Commission. McGill, age 58, is a resident of Laguna Niguel, California. Sanders, age 56, is a resident of Norco, California. Tuchman, age 38, is a resident of Irvine, California. Rayburn, age 47, is a resident of Westminster, California.

2. On June 10, 2008, final judgments were entered by consent against Respondents, permanently enjoining each of them from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933 (“Securities Act”), and Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Real Estate Partners, Inc., et al., Civil Action Number SACV 07-1022 AG (RNBx), in the United States District Court for the Central District of California.

3. The Commission’s Complaint alleged that Respondents participated in the unregistered offer and sale of REP’s securities, and acted as unregistered broker-dealers.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondents McGill, Sanders, Tuchman, and Rayburn be, and hereby are barred from association with any broker or dealer, with the right to reapply for association after five years to the appropriate self-regulatory organization, or if there is none, to the Commission;

Any reapplication for association by any of the Respondents 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 Respondents, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58214 / July 23, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13094

In the Matter of

DONALD G. RYAN,

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 Donald G. Ryan ("Ryan" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

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1. Respondent was the sole principal of Principal Management Group, a Nevada corporation formed in 2001. Between April 2003 and August 2006, Respondent was not registered in any capacity with the Commission. Ryan, age 43, is a resident of Irvine, California.

2. On June 10, 2008, a final judgment was entered by consent against Respondent, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Real Estate Partners, Inc., et al., Civil Action Number SACV 07-1022 AG (RNBx), in the United States District Court for the Central District of California.

3. The Commission's Complaint alleged that Respondent made fraudulent misrepresentations in the unregistered offer and sale of Real Estate Partners, Inc.'s securities, and acted as an unregistered broker-dealer.

IV.

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

Accordingly, it is hereby ORDERED:

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

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

By the Commission.

Florence E. Harmon
Acting Secretary

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. 58220 / July 24, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2759 / July 24, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13097

In the Matter of

JENNIFER XUJIA WANG,

Respondent.

**ORDER INSTITUTING
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 proceedings 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 Jennifer Xujia Wang ("Respondent" or "Wang").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2 and III.4 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 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. Wang is a resident of Englishtown, New Jersey. From August 29, 2005 until June 10, 2007, Wang was employed by Morgan Stanley & Co., Inc. ("Morgan Stanley"), a registered broker-dealer and investment adviser, as Vice-President and manager of the Securitized Product Group, in a group referred to as the Valuation Review sub-department, which itself was a sub-department of the Financial Control department in Morgan Stanley's Finance Division. On March 14, 2007, Wang refused to cooperate with Morgan Stanley's internal investigation relating to the matters more fully described in the Amended Complaint, referred to in paragraph III.3 below, filed by the Commission in the civil action it brought against Wang and her husband, Rubin Chen a/k/a Ruben Chen a/k/a Ruopian Chen ("Chen"). That day, Wang, who was then pregnant and on disability leave, also alerted Morgan Stanley that she did not intend to return to work following the birth of her child. Morgan Stanley terminated her employment on June 10, 2007, following her arrest in connection with a criminal proceeding, described below in paragraphs III.4 and III.5, that was based largely on the same conduct as that alleged in the Commission's Amended Complaint. Wang holds both series 7 and 63 securities industry licenses.

2. On July 3, 2008, a Final Judgment was entered by consent against Wang and Chen, permanently enjoining them from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Jennifer Xujia Wang, et al., Civil Action Number 07-CV-3715 (AKH), in the United States District Court for the Southern District of New York. The Final Judgment also ordered Wang and Chen, jointly and severally, to pay disgorgement and prejudgment interest totaling \$784,829; and ordered Wang and Chen each to pay a civil penalty of \$50,000, based on their sworn representations made to the Commission concerning their financial condition.

3. The Commission's Amended Complaint alleged that Wang and Chen obtained illegal profits of \$727,733 by trading on the basis of material nonpublic information concerning various proposed corporate acquisition transactions. The Amended Complaint further alleged that Wang, in her position as a Vice President of Morgan Stanley, was privy to material nonpublic information concerning each of the pending acquisitions, which she unlawfully disclosed to Chen.

4. On September 5, 2007, Wang pled guilty to four felony counts, including one count of conspiracy to commit securities fraud, in violation of Title 18, United States Code, Section 371, and three counts of insider trading, in violation of Title 15, United States Code, Sections 78j(b) and 78ff, Title 17, Code of Federal Regulations, Sections 240.10b-5 and 240.10b5-2, and Title 18, United States Code, Section 2, before the United States District Court for the Southern District of New York, in United States v. Xujia Wang, et al., 07-CR-730.

5. The counts of the criminal information to which Wang pled guilty are based largely on conduct included as part of the allegations in the Commission's Amended Complaint.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Wang'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 Wang 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 to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2760 / July 24, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13098

In the Matter of

RUBIN CHEN a/k/a RUBEN
CHEN a/k/a RUOPIAN
CHEN,

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 Rubin Chen a/k/a Ruben Chen a/k/a Ruopian Chen ("Respondent" or "Chen").

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 and III.4 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

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1. Chen is a resident of Englishtown, New Jersey. From approximately July 18, 2005, until March 14, 2007, Chen was employed by ING Investment Management Services, LLC (“ING”) in New York, New York, as a Vice-President of the Fund of Funds Department and the head of relative value hedge fund strategies. In this role, he was associated with a subsidiary of ING, ING Alternative Asset Management LLC, which is a registered investment adviser. On March 14, 2007, Chen resigned from ING after refusing the company’s request that he cooperate with the firm’s internal investigation of his trading.

2. On July 3, 2008, a Final Judgment was entered by consent against Chen, and his wife Jennifer Xujia Wang (“Wang”), permanently enjoining them 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. Jennifer Xujia Wang, et al., Civil Action Number 07-CV-3715 (AKH), in the United States District Court for the Southern District of New York. The Final Judgment also ordered Chen and Wang, jointly and severally, to pay disgorgement and prejudgment interest totaling \$784,829; and ordered Chen and Wang each to pay a civil penalty of \$50,000, based on their sworn representations made to the Commission concerning their financial condition.

3. The Commission’s Amended Complaint alleged that Wang and Chen obtained illegal profits of \$727,733 by trading on the basis of material nonpublic information concerning various proposed corporate acquisition transactions. The Amended Complaint further alleged that Wang, in her position as a Vice President of Morgan Stanley & Co., Inc., was privy to material nonpublic information concerning each of the pending acquisitions, which she unlawfully disclosed to Chen.

4. On September 5, 2007, Chen pled guilty to four felony counts, including one count of conspiracy to commit securities fraud, in violation of Title 18, United States Code, Section 371, and three counts of insider trading, in violation of Title 15, United States Code, Sections 78j(b) and 78ff, Title 17, Code of Federal Regulations, Sections 240.10b-5 and 240.10b5-2, and Title 18, United States Code, Section 2, before the United States District Court for the Southern District of New York, in United States v. Xujia Wang, et al., 07-CR-730.

5. The counts of the criminal information to which Chen pled guilty are based largely on conduct included as part of the allegations in the Commission’s Amended Complaint.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Chen be, and hereby is barred from association with any investment adviser.

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

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Jewels, age 43, is and has been an attorney licensed to practice in the Commonwealth of Massachusetts, and has been a certified public accountant licensed to practice in the State of New York. She served as Chief Financial Officer, Vice President of Finance and Administration, Secretary and Treasurer of Sycamore Networks, Inc. ("Sycamore") from approximately mid-1999 until October 2004. Thereafter, she served as an adviser to Sycamore until October 2005.

2. Sycamore was, at all relevant times, a Delaware corporation with its principal place of business in Chelmsford, Massachusetts. During the relevant period, Sycamore was engaged in the business of developing and marketing optical networking products for telecommunications service providers and government entities. At all relevant times, Sycamore's common stock was registered pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the Nasdaq National Market System.

3. On July 10, 2008, a final judgment was entered against Jewels, permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(b)(5), 14(a) and 16(a) of the Exchange Act and Rules 10b-5, 13b2-1, 13b2-2, 13a-14, 14a-9 and 16a-3 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder, in the civil action entitled Securities and Exchange Commission v. Sycamore Networks, Inc., et al., Civil Action Number 08-CA-11166(DPW), in the United States District Court for the District of Massachusetts. Jewels was also ordered to pay \$30,000 in disgorgement, together with prejudgment interest thereon in the amount of \$4,980.04; to reimburse Sycamore \$190,000 consisting of cash bonuses she received from 2003 through 2004; to pay a \$230,000 civil money penalty; and was barred from serving as an officer or director of a public company for five years.

4. The Commission's complaint alleged, among other things, that Jewels, in connection with the granting of "in-the-money" stock options and resulting underreporting of

expenses, made materially false and misleading statements in various Form 10-K annual reports, Form 10-Q quarterly reports, Form 8-K current reports, and proxy statements during periods including fiscal years 2000 through 2004. The complaint further alleged that Jewels made "in-the-money" options grants to employees in connection with company-wide grants which were issued on dates on which the market price of Sycamore's stock was at or near the low for the period, but failed to record associated stock-based compensation expenses, and backdated other grants, such as new hire and promotional grants, which had significant options expense implications that she disregarded. The complaint further alleged that Jewels was the recipient of at least two grants of "in-the-money" stock options to Company officers issued as of the same dates as company-wide grants and, although Jewels did not directly authorize the grants to herself and other officers, she knew that the favorable grant dates that she selected for the company wide grants would be applied to her options as well, and failed to record compensation expenses related to the officer grants.

IV.

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

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

A. Jewels is suspended from appearing or practicing before the Commission as an attorney for five years. After five years from the date of this order, Jewels has the right to apply for reinstatement to appear or practice before the Commission as an attorney by submitting an affidavit to the Commission's Office of the General Counsel truthfully stating, under penalty of perjury, that she has complied with this Order, that she is not subject to any suspension or disbarment as an attorney by a court of the United States or of any state territory, district, commonwealth, or possession, and that she has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e) of the Commission's Rules of Practice.

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

C. After five years from the date of this order, Respondent 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:

I. 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;

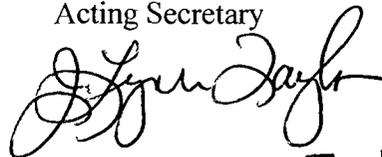
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(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.

D. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission as an accountant 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.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III, paragraph 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. Friedman, age 44, is and has been an attorney licensed to practice in the Commonwealth of Massachusetts. She was employed by Sycamore Networks, Inc. ("Sycamore"), from approximately mid-2000 through approximately December 2003. In or about January and February 2001, she held the position of Senior Director of Employment Affairs.

2. Sycamore was, at all relevant times, a Delaware corporation with its principal place of business in Chelmsford, Massachusetts. At all relevant times, Sycamore was engaged in the business of developing and marketing optical networking products for telecommunications service providers and government entities. At all relevant times, Sycamore's common stock was registered pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the Nasdaq National Market System.

3. On July 9, 2008, the Commission filed a complaint in the United States District Court for the District of Massachusetts against Friedman in Securities and Exchange Commission v. Sycamore Networks, Inc., et al., Civil Action Number 08-CA-111666(DPW) (D. Mass.). On July 10, 2008, the Court entered a final judgment by consent against Friedman, permanently enjoining her from future violations of Section 13(b)(5) of the Exchange Act and Rules 13b2-1 and 13b2-2 thereunder, and aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. Friedman was also ordered to pay a \$40,000 civil money penalty.

4. The Commission's complaint alleged, among other things, that Sycamore, in connection with the underreporting of expenses related to stock option grants, filed materially false and misleading financial statements in various Form 10-K annual reports and Form 10-Q quarterly reports for fiscal years 2000 through 2005. The complaint further alleged that, in or around January 2001, Friedman substantially participated in carrying out a plan, devised by others, to grant in-the-money stock options to a group of approximately five employees at the lowest closing price of the quarter. The complaint further alleged that, in connection with the plan, Friedman altered or created, or caused to be altered or created, personnel and payroll-related documents, all in an effort to create the impression that the employees had started at Sycamore on dates they had not. The complaint further alleged that Friedman knew, or was reckless in not knowing, that the actions she undertook would prevent Sycamore's auditors from detecting the true start dates of the employees and the in-the-money nature of the option grants.

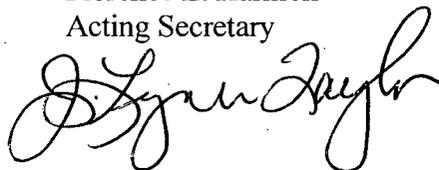
IV.

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

Accordingly, it is hereby ORDERED, effective immediately, that Friedman is suspended from appearing or practicing before the Commission as an attorney for two years. Furthermore, after two years from the date of this order, Friedman has the right to apply for reinstatement by submitting an affidavit to the Commission's Office of the General Counsel truthfully stating, under penalty of perjury, that she has complied with this Order, that she is not subject to any suspension or disbarment as an attorney by a court of the United States or of any state territory, district, commonwealth, or possession, and that she has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 25, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13100

In the Matter of

**The National Capital Companies, Inc.,
National Environmental Controls, Inc.,
National Real Estate Limited Partnership
Income Properties,
National Real Estate Limited Partnership
Income Properties II,
Navarone, Inc.,
NBG Radio Network, Inc., and
Net-Matrix Limited,**

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") against Respondents National Capital Companies, Inc., National Environmental Controls, Inc., National Real Estate Limited Partnership Income Properties, National Real Estate Limited Partnership Income Properties II, Navarone, Inc., NBG Radio Network, Inc., and Net-Matrix Limited.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. The National Capital Companies, Inc. (CIK No. 1086461) is a revoked Nevada corporation located in Irvine, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Capital is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2000, which reported a net loss of

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\$976,000 for the prior nine months. As of July 22, 2008, the company's common stock (symbol "NATC") was traded on the over-the-counter markets.

2. National Environmental Controls, Inc. (CIK No. 70083) is a void Delaware corporation located in Metairie, Louisiana with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Environmental 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 November 30, 1992. The company's Form 10-K for the period ended August 31, 1992 reported no revenues and a net loss of \$843,208 for that fiscal year. As of July 22, 2008, the company's common stock (symbol "NECT") was traded on the over-the-counter markets.

3. National Real Estate Limited Partnership Income Properties (CIK No. 759857) is a cancelled Wisconsin limited partnership located in Pewaukee, Wisconsin with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Real Estate 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, 2002, which reported a net loss of \$3,183 for the prior six months.

4. National Real Estate Limited Partnership Income Properties II (CIK No. 795306) is a cancelled Wisconsin limited partnership located in Pewaukee, Wisconsin with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Real Estate II 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, 2002, which reported a net loss of \$38,228 for the prior six months.

5. Navarone, Inc. (CIK No. 1074958) is a permanently revoked Nevada corporation located in Broken Bow, Oklahoma with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Navarone 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 \$49,808 since inception in 1997.

6. NBG Radio Network, Inc. (CIK No. 1059366) is a defaulted Nevada corporation located in Portland, Oregon with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). NBG 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 August 31, 2002, which reported a net loss of \$3.9 million for the prior nine months. As of July 22, 2008, the company's common stock (symbol "NSBD") was traded on the over-the-counter market.

7. Net-Matrix Limited (CIK No. 1096988) is a British Virgin Islands corporation located in Hong Kong with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Net-Matrix is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended September 30, 2000, which reported a net loss of \$28,339 since its incorporation on September 15, 1999.

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)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

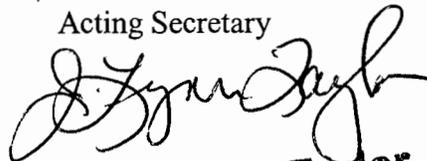
IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Attachment

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

Appendix 1

**Chart of Delinquent Filings
In the Matter of The National Capital Companies, Inc., et al.**

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
The National Capital Companies, Inc.	10-KSB	12/31/00	04/02/01	Not filed	87
	10-QSB	03/31/01	05/15/01	Not filed	86
	10-QSB	06/30/01	08/14/01	Not filed	83
	10-QSB	09/30/01	11/14/01	Not filed	80
	10-KSB	12/31/01	04/01/02	Not filed	75
	10-QSB	03/31/02	05/15/02	Not filed	74
	10-QSB	06/30/02	08/14/02	Not filed	71
	10-QSB	09/30/02	11/14/02	Not filed	68
	10-KSB	12/31/02	03/31/03	Not filed	64
	10-QSB	03/31/03	05/15/03	Not filed	62
	10-QSB	06/30/03	08/14/03	Not filed	59
	10-QSB	09/30/03	11/14/03	Not filed	56
	10-KSB	12/31/03	03/30/04	Not filed	52
	10-QSB	03/31/04	05/17/04	Not filed	50
	10-QSB	06/30/04	08/16/04	Not filed	47
	10-QSB	09/30/04	11/15/04	Not filed	44
	10-KSB	12/31/04	03/31/05	Not filed	40
	10-QSB	03/31/05	05/16/05	Not filed	38
	10-QSB	06/30/05	08/15/05	Not filed	35
	10-QSB	09/30/05	11/14/05	Not filed	32
	10-KSB	12/31/05	03/31/06	Not filed	28
	10-QSB	03/31/06	05/15/06	Not filed	26
	10-QSB	06/30/06	08/14/06	Not filed	23
	10-QSB	09/30/06	11/14/06	Not filed	20
	10-KSB	12/31/06	04/02/07	Not filed	15
	10-QSB	03/31/07	05/15/07	Not filed	14
	10-QSB	06/30/07	08/14/07	Not filed	11
	10-QSB	09/30/07	11/14/07	Not filed	8
	10-K*	12/31/07	03/31/08	Not filed	4
	10-Q*	03/31/08	05/15/08	Not filed	2
Total Filings Delinquent					30

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Environmental Controls, Inc.					
	10-Q	02/28/03	04/14/03	Not filed	63
	10-Q	05/31/03	07/15/03	Not filed	60
	10-K	08/31/03	12/01/03	Not filed	55
	10-Q	11/30/03	01/14/04	Not filed	54
	10-Q	02/28/04	04/13/04	Not filed	51
	10-Q	05/31/04	07/15/04	Not filed	48
	10-K	08/31/04	11/29/04	Not filed	44
	10-Q	11/30/04	01/14/05	Not filed	42
	10-Q	02/28/05	04/14/05	Not filed	39
	10-Q	05/31/05	07/15/05	Not filed	36
	10-K	08/31/05	11/29/05	Not filed	32
	10-Q	11/30/05	01/16/06	Not filed	30
	10-Q	02/28/06	04/14/06	Not filed	27
	10-Q	05/31/06	07/17/06	Not filed	24
	10-K	08/31/06	11/29/06	Not filed	20
	10-Q	11/30/06	01/16/07	Not filed	18
	10-Q	02/28/07	04/16/07	Not filed	15
	10-Q	05/31/07	07/17/07	Not filed	12
	10-K	08/31/07	11/29/07	Not filed	8
	10-Q	11/30/07	01/14/08	Not filed	6
	10-Q	02/28/08	04/14/08	Not filed	3
	10-Q	05/31/08	07/15/08	Not filed	0
Total Filings Delinquent	22				

National Real Estate Limited Partnership Income Properties

10-QSB	09/30/02	11/14/02	Not filed	68
10-KSB	12/31/02	03/31/03	Not filed	64
10-QSB	03/31/03	05/15/03	Not filed	62
10-QSB	06/30/03	08/14/03	Not filed	59
10-QSB	09/30/03	11/14/03	Not filed	56
10-KSB	12/31/03	03/30/04	Not filed	52

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Real Estate Limited Partnership Income Properties					
	10-QSB	03/31/04	05/17/04	Not filed	50
	10-QSB	06/30/04	08/16/04	Not filed	47
	10-QSB	09/30/04	11/15/04	Not filed	44
	10-KSB	12/31/04	03/31/05	Not filed	40
	10-QSB	03/31/05	05/16/05	Not filed	38
	10-QSB	06/30/05	08/15/05	Not filed	35
	10-QSB	09/30/05	11/14/05	Not filed	32
	10-KSB	12/31/05	03/31/06	Not filed	28
	10-QSB	03/31/06	05/15/06	Not filed	26
	10-QSB	06/30/06	08/14/06	Not filed	23
	10-QSB	09/30/06	11/14/06	Not filed	20
	10-KSB	12/31/06	04/02/07	Not filed	15
	10-QSB	03/31/07	05/15/07	Not filed	14
	10-QSB	06/30/07	08/14/07	Not filed	11
	10-QSB	09/30/07	11/14/07	Not filed	8
	10-K*	12/31/07	03/30/08	Not filed	4
	10-Q*	03/31/08	05/15/08	Not filed	2

Total Filings Delinquent 23

National Real Estate Limited Partnership Income Properties
II

10-QSB	09/30/02	11/14/02	Not filed	68
10-KSB	12/31/02	03/31/03	Not filed	64
10-QSB	03/31/03	05/15/03	Not filed	62
10-QSB	06/30/03	08/14/03	Not filed	59
10-QSB	09/30/03	11/14/03	Not filed	56
10-KSB	12/31/03	03/30/04	Not filed	52
10-QSB	03/31/04	05/17/04	Not filed	50
10-QSB	06/30/04	08/16/04	Not filed	47
10-QSB	09/30/04	11/15/04	Not filed	44

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Real Estate Limited					
Partnership Income Properties					
II					

<i>10-KSB</i>	12/31/04	03/31/05	Not filed	40
<i>10-QSB</i>	03/31/05	05/16/05	Not filed	38
<i>10-QSB</i>	06/30/05	08/15/05	Not filed	35
<i>10-QSB</i>	09/30/05	11/14/05	Not filed	32
<i>10-KSB</i>	12/31/05	03/31/06	Not filed	28
<i>10-QSB</i>	03/31/06	05/15/06	Not filed	26
<i>10-QSB</i>	06/30/06	08/14/06	Not filed	23
<i>10-QSB</i>	09/30/06	11/14/06	Not filed	20
<i>10-KSB</i>	12/31/06	04/02/07	Not filed	15
<i>10-QSB</i>	03/31/07	05/15/07	Not filed	14
<i>10-QSB</i>	06/30/07	08/14/07	Not filed	11
<i>10-QSB</i>	09/30/07	11/14/07	Not filed	8
<i>10-K*</i>	12/31/07	03/30/08	Not filed	4
<i>10-Q*</i>	03/31/08	05/15/08	Not filed	2

Total Filings Delinquent 23

Navarone, Inc.

<i>10-QSB</i>	06/30/05	08/15/05	Not filed	35
<i>10-QSB</i>	09/30/05	11/14/05	Not filed	32
<i>10-KSB</i>	12/31/05	03/31/06	Not filed	28
<i>10-QSB</i>	03/31/06	05/15/06	Not filed	26
<i>10-QSB</i>	06/30/06	08/14/06	Not filed	23
<i>10-QSB</i>	09/30/06	11/14/06	Not filed	20
<i>10-KSB</i>	12/31/06	04/02/07	Not filed	15
<i>10-QSB</i>	03/31/07	05/15/07	Not filed	14
<i>10-QSB</i>	06/30/07	08/14/07	Not filed	11
<i>10-QSB</i>	09/30/07	11/14/07	Not filed	8
<i>10-K*</i>	12/31/07	03/30/08	Not filed	4
<i>10-Q*</i>	03/31/08	05/15/08	Not filed	2

Total Filings Delinquent 12

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<i>NBG Radio Network, Inc.</i>					
	<i>10-KSB</i>	11/30/02	02/28/03	Not filed	65
	<i>10-QSB</i>	02/28/03	01/14/03	Not filed	66
	<i>10-QSB</i>	05/31/03	04/14/03	Not filed	63
	<i>10-QSB</i>	08/31/03	07/15/03	Not filed	60
	<i>10-KSB</i>	11/30/03	03/01/04	Not filed	52
	<i>10-QSB</i>	02/29/04	04/14/04	Not filed	51
	<i>10-QSB</i>	05/31/04	07/15/04	Not filed	48
	<i>10-QSB</i>	08/31/04	10/15/04	Not filed	45
	<i>10-KSB</i>	11/30/04	02/28/05	Not filed	41
	<i>10-QSB</i>	02/28/05	04/14/05	Not filed	39
	<i>10-QSB</i>	05/31/05	07/15/05	Not filed	36
	<i>10-QSB</i>	08/31/05	10/17/05	Not filed	33
	<i>10-KSB</i>	11/30/05	02/28/06	Not filed	29
	<i>10-QSB</i>	02/28/06	04/14/06	Not filed	27
	<i>10-QSB</i>	05/31/06	07/17/06	Not filed	24
	<i>10-QSB</i>	08/31/06	10/16/06	Not filed	21
	<i>10-KSB</i>	11/30/06	02/28/07	Not filed	17
	<i>10-QSB</i>	02/28/07	04/16/07	Not filed	15
	<i>10-QSB</i>	05/31/07	07/16/07	Not filed	12
	<i>10-QSB</i>	08/31/07	10/15/07	Not filed	9
	<i>10-KSB</i>	11/30/07	02/28/08	Not filed	5
	<i>10-Q*</i>	02/28/08	04/14/08	Not filed	3
	<i>10-Q*</i>	05/31/08	07/15/08	Not filed	0

Total Filings Delinquent 23

Net-Matrix Limited

<i>20-F</i>	09/30/01	04/02/01	Not filed	87
<i>20-F</i>	09/30/02	04/01/02	Not filed	75
<i>20-F</i>	09/30/03	03/31/03	Not filed	64
<i>20-F</i>	09/30/04	03/31/04	Not filed	52

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Net-Matrix Limited					
	20-F	09/30/05	03/31/05	Not filed	40
	20-F	09/30/06	03/31/06	Not filed	28
	20-F	09/30/07	04/02/07	Not filed	15
	20-F	09/30/08	03/31/08	Not filed	4

Total Filings Delinquent 8

*Regulation S-B and its accompanying forms, including Forms 10-QSB and 10-KSB, are in the process of being removed from the federal securities laws. See Release No. 34-56994 (Dec. 19, 2007). The removal is taking effect over a transition period that will conclude on March 15, 2009, so by that date, all reporting companies that previously filed their periodic reports on Forms 10-QSB and 10-KSB will be required to use Forms 10-Q and 10-K instead. Forms 10-QSB and 10-KSB will no longer be available, though issuers that meet the definition of a "smaller reporting company" (generally, a company that has less than \$75 million in public equity float as of the end of its most recently completed second fiscal quarter) will have the option of using new, scaled disclosure requirements that Regulation S-K now includes.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58242 / July 29, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2852 / July 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12793

In the Matter of

JAY J. SHAPIRO, CPA, P.C.
AND JAY J. SHAPIRO, CPA,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTIONS 4C AND 21C
OF THE SECURITIES EXCHANGE ACT
OF 1934 AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE

I.

On September 13, 2007, the Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, and Notice of Hearing against Jay J. Shapiro, CPA, P.C. (the "Firm" or "Shapiro P.C.") and Jay J. Shapiro, CPA ("Shapiro") (collectively "Respondents").

II.

Respondents have 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 them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

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III.

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

A. RESPONDENTS

1. The Firm is a California corporation and public accounting firm headquartered in Los Angeles, California. Shapiro P.C. prepared and issued an audit report dated January 12, 2004 in connection with its audit of Daleco Resources Corp. ("Daleco").

2. Shapiro, 57, of Los Angeles, California, is a certified public accountant licensed in the state of California since 1978. As engagement partner on the Daleco engagement, Shapiro participated in the preparation and issuance of the January 12, 2004 Daleco audit report.

B. FACTS

1. Daleco is a Nevada corporation based in West Chester, Pennsylvania. Daleco's common stock trades on the OTC Bulletin Board and is registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). Daleco reported \$1.5 million of revenues and total assets of \$25 million for fiscal year ended September 30, 2003.

2. Daleco has at all relevant times been an issuer as defined by the Sarbanes-Oxley Act of 2002 (the "Act").

3. The Firm audited Daleco's 2003 financial statements included in Daleco's annual report for fiscal year ended September 30, 2003, on Form 10-KSB, filed with the Commission on January 14, 2004.

4. The Firm prepared and issued an audit report dated January 12, 2004 (the "Daleco audit report"), which Daleco included in its Form 10-KSB for fiscal year ended September 30, 2003.

5. At the time the Firm issued the Daleco audit report, it was not registered with the Public Company Accounting Oversight Board (the "PCAOB"), as required by Section 102(a) of the Act.

6. Shapiro participated in auditing the 2003 financial statements included in Daleco's annual report for fiscal year ended September 30, 2003, on Form 10-KSB, filed with the Commission on January 14, 2004.

7. Shapiro participated in the preparation and issuance of the Daleco audit report, which was included in Daleco's Form 10-KSB.

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

8. The Firm received \$40,800 for conducting an audit of Daleco's 2003 financial statements and for issuing the Daleco audit report on those statements.²

C. VIOLATIONS

1. Section 4C(a) of the Exchange Act provides, in relevant part, that the Commission "may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission ... (1) not to possess the requisite qualifications to represent others ... or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder."

2. Rule 102(e)(1) of the Commission's Rules of Practice provides that the Commission "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission ... (i) not to possess the requisite qualifications to represent others ... or (iii) to have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder."

3. Section 102(a) of the Act provides that "it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer."³

4. The provisions of Section 102(a) of the Act became effective on October 22, 2003.⁴

5. Based on the conduct described above, the Firm willfully⁵ violated Section 102(a) of the Act.

6. Based on the conduct described above, Shapiro caused the Firm's violation of Section 102(a) of the Act.

² Subsequent to the institution of these proceedings, the Firm voluntarily reimbursed Daleco \$40,800 in audit fees along with \$10,964.72 in interest. In view of the Firm's reimbursement, the Commission deems its request for disgorgement and prejudgment interest satisfied.

³ A violation of the Act or any rule that the PCAOB issues under the Act is treated for all purposes in the same manner as a violation of the Exchange Act, including with respect to penalties. Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7202(b)(1) (West 2002).

⁴ Section 102(a) became effective "[b]eginning 180 days after the date of the determination of the Commission under Section 101(d)" of the Act that the Board was prepared to undertake its statutory responsibilities. The Commission made the required determination on April 25, 2003. See Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8223, Exchange Act Release No. 47746, 2003 WL 1956164 (Apr. 25, 2003).

⁵ A willful violation of the securities laws means merely that the person charged with the violation knows what he is doing. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000).

D. FINDINGS

1. Based on the foregoing, the Commission finds that the Firm and Shapiro did not possess the requisite qualifications to represent others.

2. Based on the foregoing, the Commission finds that the Firm willfully violated Section 102(a) of the Sarbanes-Oxley Act of 2002, and that Shapiro caused the Firm's violation of Section 102(a) of the Act.

IV.

On the basis of the foregoing, Respondents hereby consent to the entry of an Order by the Commission imposing the following remedial sanctions:

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

1. Jay J. Shapiro, CPA, P.C.

A. The Firm shall cease and desist from committing or causing any violations and any future violations of Section 102(a) of the Act.

B. The Firm is denied the privilege of appearing or practicing before the Commission as an accountant.

C. After one year from the date of this Order, the Firm may request that the Commission consider its 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 the Firm's work in the Firm's practice before the Commission will be reviewed either by the independent audit committee of the public company for which the Firm works or in some other acceptable manner, as long as the Firm practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) the Firm is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective. However, if registration with the PCAOB is dependent upon reinstatement by the Commission, the Commission will consider an application on its other merits;

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

(c) the Firm acknowledges responsibility, as long as the Firm appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

D. The Commission will consider an application by the Firm to resume appearing or practicing before the Commission provided that the Firm's state CPA license is current and the Firm 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 the Firm's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

2. Jay J. Shapiro, CPA

A. Shapiro shall cease and desist from committing or causing any violations and any future violations of Section 102(a) of the Act.

B. Shapiro is censured.

C. Shapiro may practice before the Commission as an independent accountant provided that:

1. The public accounting firm with which he is associated is registered with the PCAOB in accordance with the Act, and such registration continues to be effective; and

2. He has submitted to the Commission staff (Attention: Office of the Chief Accountant) the PCAOB's letter notifying the public accounting firm with which he is associated that its registration application has been approved.

By the Commission.

Florence E. Harmon
Acting Secretary


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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58238 / July 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13104

In the Matter of

Stephen H. Roebuck,

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 Stephen H. Roebuck ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

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

1. From October 2005 to June 2006, Respondent was a registered representative associated with broker-dealers registered with the Commission. Respondent, 41 years old, is a resident of Las Vegas, Nevada.
2. On July 14, 2008, a judgment was entered by consent against Respondent, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Daniel Kaiser, et al., Civil Action Number 2:08-cv-00888-JCM-LRL in the United States District Court, District of Nevada.
3. The Commission's complaint alleged that Respondent engaged in a "pump-and-dump" scheme in VMT Scientific, Inc. ("VMT Scientific") stock by purportedly merging a private company with VMT Scientific, a public company with no operations; issuing VMT Scientific shares to accounts controlled by Respondent; causing VMT Scientific to issue false and misleading press releases; and selling unregistered securities of VMT Scientific.

IV.

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

Accordingly, it is hereby ORDERED:

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

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

By the Commission.

Florence E. Harmon
Acting Secretary

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By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 29, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13105

In the Matter of

**Karting International, Inc.,
KDGsports.com, Inc.,
Keystone Mortgage Fund,
Keystone Mortgage Fund II, and
KwikWeb.com, Inc.,**

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") against Respondents Karting International, Inc., KDGsports.com, Inc., Keystone Mortgage Fund, Keystone Mortgage Fund II, and KwikWeb.com, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Karting International, Inc. (CIK No. 1126335) is a Nevada corporation located in Las Vegas, Nevada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Karting is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on November 28, 2003, which reported a net loss \$881,231 for the prior ten months.

2. KDGsports.com, Inc. (CIK No. 1095180) is a Nevada corporation located in Las Vegas, Nevada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). KDG is delinquent in its periodic filings with

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the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on September 17, 1999.

3. Keystone Mortgage Fund (CIK No. 793038) is a canceled California limited partnership located in Los Angeles, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Keystone 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 March 31, 1997.

4. Keystone Mortgage Fund II (CIK No. 812084) is a canceled California limited partnership located in Los Angeles, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Keystone Mortgage Fund II 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 March 31, 1999, which reported a net loss of \$49,889 for the prior three months.

5. KwikWeb.com, Inc. (CIK No. 1080235) is a revoked Nevada corporation located in Carlsbad, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). KwikWeb.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of \$623,517 for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

6. 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.

7. 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 and Rule 13a-13 requires issuers to file quarterly reports.

8. 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)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

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

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of

the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Florence E. Harmon
Acting Secretary

Attachment

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

Appendix 1

Chart of Delinquent Filings *Karting International, Inc., et al.*

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<i>Karting International, Inc.</i>					
	<i>10-KSB</i>	12/31/03	03/30/04	Not filed	52
	<i>10-QSB</i>	03/31/04	05/17/04	Not filed	50
	<i>10-QSB</i>	06/30/04	08/16/04	Not filed	47
	<i>10-QSB</i>	09/30/04	11/15/04	Not filed	44
	<i>10-KSB</i>	12/31/04	03/31/05	Not filed	40
	<i>10-QSB</i>	03/31/05	05/16/05	Not filed	38
	<i>10-QSB</i>	06/30/05	08/15/05	Not filed	35
	<i>10-QSB</i>	09/30/05	11/14/05	Not filed	32
	<i>10-KSB</i>	12/31/05	03/31/06	Not filed	28
	<i>10-QSB</i>	03/31/06	05/15/06	Not filed	26
	<i>10-QSB</i>	06/30/06	08/14/06	Not filed	23
	<i>10-QSB</i>	09/30/06	11/14/06	Not filed	20
	<i>10-KSB</i>	12/31/06	04/02/07	Not filed	15
	<i>10-QSB</i>	03/31/07	05/15/07	Not filed	14
	<i>10-QSB</i>	06/30/07	08/14/07	Not filed	11
	<i>10-QSB</i>	09/30/07	11/14/07	Not filed	8
	<i>10-KSB</i>	12/31/07	03/30/08	Not filed	4
	<i>10-Q¹</i>	03/31/08	05/15/08	Not filed	2
Total Filings Delinquent	18				
<i>KDGsports.com, Inc.</i>					
	<i>10-KSB</i>	12/31/99	03/30/00	Not filed	100

¹Regulation S-B and its accompanying forms, including Forms 10-QSB and 10-KSB, are in the process of being removed from the federal securities laws. See Release No. 34-56994 (Dec. 19, 2007). The removal is taking effect over a transition period that will conclude on March 15, 2009, so by that date, all reporting companies that previously filed their periodic reports on Forms 10-QSB and 10-KSB will be required to use Forms 10-Q and 10-K instead. Forms 10-QSB and 10-KSB will no longer be available, though issuers that meet the definition of a "smaller reporting company" (generally, a company that has less than \$75 million in public equity float as of the end of its most recently completed second fiscal quarter) will have the option of using new, scaled disclosure requirements that Regulation S-K now includes.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<i>KDGsports.com, Inc.</i>					
	<i>10-QSB</i>	03/31/00	05/15/00	Not filed	98
	<i>10-QSB</i>	06/30/00	08/14/00	Not filed	95
	<i>10-QSB</i>	09/30/00	11/14/00	Not filed	92
	<i>10-KSB</i>	12/31/00	04/02/01	Not filed	87
	<i>10-QSB</i>	03/31/01	05/15/01	Not filed	86
	<i>10-QSB</i>	06/30/01	08/14/01	Not filed	83
	<i>10-QSB</i>	09/30/01	11/14/01	Not filed	80
	<i>10-KSB</i>	12/31/01	04/01/02	Not filed	75
	<i>10-QSB</i>	03/31/02	05/15/02	Not filed	74
	<i>10-QSB</i>	06/30/02	08/14/02	Not filed	71
	<i>10-QSB</i>	09/30/02	11/14/02	Not filed	68
	<i>10-KSB</i>	12/31/02	03/31/03	Not filed	64
	<i>10-QSB</i>	03/31/03	05/15/03	Not filed	62
	<i>10-QSB</i>	06/30/03	08/14/03	Not filed	59
	<i>10-QSB</i>	09/30/03	11/14/03	Not filed	56
	<i>10-KSB</i>	12/31/03	03/30/04	Not filed	52
	<i>10-QSB</i>	03/31/04	05/17/04	Not filed	50
	<i>10-QSB</i>	06/30/04	08/16/04	Not filed	47
	<i>10-QSB</i>	09/30/04	11/15/04	Not filed	44
	<i>10-KSB</i>	12/31/04	03/31/05	Not filed	40
	<i>10-QSB</i>	03/31/05	05/16/05	Not filed	38
	<i>10-QSB</i>	06/30/05	08/15/05	Not filed	35
	<i>10-QSB</i>	09/30/05	11/14/05	Not filed	32
	<i>10-KSB</i>	12/31/05	03/31/06	Not filed	28
	<i>10-QSB</i>	03/31/06	05/15/06	Not filed	26
	<i>10-QSB</i>	06/30/06	08/14/06	Not filed	23
	<i>10-QSB</i>	09/30/06	11/14/06	Not filed	20
	<i>10-KSB</i>	12/31/06	04/02/07	Not filed	15
	<i>10-QSB</i>	03/31/07	05/15/07	Not filed	14
	<i>10-QSB</i>	06/30/07	08/14/07	Not filed	11
	<i>10-QSB</i>	09/30/07	11/14/07	Not filed	8
	<i>10-KSB</i>	12/31/07	03/30/08	Not filed	4
	<i>10-Q</i>	03/31/08	05/15/08	Not filed	2

Total Filings Delinquent

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Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Keystone Mortgage Fund					
	10-Q	06/30/97	08/14/97	Not filed	131
	10-Q	09/30/97	11/14/97	Not filed	128
	10-K	12/31/97	03/31/98	Not filed	124
	10-Q	03/31/98	05/15/98	Not filed	122
	10-Q	06/30/98	08/14/98	Not filed	119
	10-Q	09/30/98	11/16/98	Not filed	116
	10-K	12/31/98	03/31/99	Not filed	112
	10-Q	03/31/99	05/17/99	Not filed	110
	10-Q	06/30/99	08/16/99	Not filed	107
	10-Q	09/30/99	11/15/99	Not filed	104
	10-K	12/31/99	03/30/00	Not filed	100
	10-Q	03/31/00	05/15/00	Not filed	98
	10-Q	06/30/00	08/14/00	Not filed	95
	10-Q	09/30/00	11/14/00	Not filed	92
	10-K	12/31/00	04/02/01	Not filed	87
	10-Q	03/31/01	05/15/01	Not filed	86
	10-Q	06/30/01	08/14/01	Not filed	83
	10-Q	09/30/01	11/14/01	Not filed	80
	10-K	12/31/01	04/01/02	Not filed	75
	10-Q	03/31/02	05/15/02	Not filed	74
	10-Q	06/30/02	08/14/02	Not filed	71
	10-Q	09/30/02	11/14/02	Not filed	68
	10-K	12/31/02	03/31/03	Not filed	64
	10-Q	03/31/03	05/15/03	Not filed	62
	10-Q	06/30/03	08/14/03	Not filed	59
	10-Q	09/30/03	11/14/03	Not filed	56
	10-K	12/31/03	03/30/04	Not filed	52
	10-Q	03/31/04	05/17/04	Not filed	50
	10-Q	06/30/04	08/16/04	Not filed	47
	10-Q	09/30/04	11/15/04	Not filed	44
	10-K	12/31/04	03/31/05	Not filed	40
	10-Q	03/31/05	05/16/05	Not filed	38
	10-Q	06/30/05	08/15/05	Not filed	35

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Keystone Mortgage Fund					
	10-Q	09/30/05	11/14/05	Not filed	32
	10-K	12/31/05	03/31/06	Not filed	28
	10-Q	03/31/06	05/15/06	Not filed	26
	10-Q	06/30/06	08/14/06	Not filed	23
	10-Q	09/30/06	11/14/06	Not filed	20
	10-K	12/31/06	04/02/07	Not filed	15
	10-Q	03/31/07	05/15/07	Not filed	14
	10-Q	06/30/07	08/14/07	Not filed	11
	10-Q	09/30/07	11/14/07	Not filed	8
	10-K	12/31/07	03/30/08	Not filed	4
	10-Q	03/31/08	05/15/08	Not filed	2
Total Filings Delinquent	44				

Keystone Mortgage Fund II					
	10-Q	06/30/99	08/16/99	Not filed	107
	10-Q	09/30/99	11/15/99	Not filed	104
	10-K	12/31/99	03/30/00	Not filed	100
	10-Q	03/31/00	05/15/00	Not filed	98
	10-Q	06/30/00	08/14/00	Not filed	95
	10-Q	09/30/00	11/14/00	Not filed	92
	10-K	12/31/00	04/02/01	Not filed	87
	10-Q	03/31/01	05/15/01	Not filed	86
	10-Q	06/30/01	08/14/01	Not filed	83
	10-Q	09/30/01	11/14/01	Not filed	80
	10-K	12/31/01	04/01/02	Not filed	75
	10-Q	03/31/02	05/15/02	Not filed	74
	10-Q	06/30/02	08/14/02	Not filed	71
	10-Q	09/30/02	11/14/02	Not filed	68
	10-K	12/31/02	03/31/03	Not filed	64
	10-Q	03/31/03	05/15/03	Not filed	62
	10-Q	06/30/03	08/14/03	Not filed	59
	10-Q	09/30/03	11/14/03	Not filed	56
	10-K	12/31/03	03/30/04	Not filed	52
	10-Q	03/31/04	05/17/04	Not filed	50
	10-Q	06/30/04	08/16/04	Not filed	47

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Keystone Mortgage Fund II					
	10-Q	09/30/04	11/15/04	Not filed	44
	10-K	12/31/04	03/31/05	Not filed	40
	10-Q	03/31/05	05/16/05	Not filed	38
	10-Q	06/30/05	08/15/05	Not filed	35
	10-Q	09/30/05	11/14/05	Not filed	32
	10-K	12/31/05	03/31/06	Not filed	28
	10-Q	03/31/06	05/15/06	Not filed	26
	10-Q	06/30/06	08/14/06	Not filed	23
	10-Q	09/30/06	11/14/06	Not filed	20
	10-K	12/31/06	04/02/07	Not filed	15
	10-Q	03/31/07	05/15/07	Not filed	14
	10-Q	06/30/07	08/14/07	Not filed	11
	10-Q	09/30/07	11/14/07	Not filed	8
	10-K	12/31/07	03/30/08	Not filed	4
	10-Q	03/31/08	05/15/08	Not filed	2

Total Filings Delinquent

36

KwikWeb.com, Inc.

10-KSB	12/31/01	04/01/02	Not filed	75
10-QSB	03/31/02	05/15/02	Not filed	74
10-QSB	06/30/02	08/14/02	Not filed	71
10-QSB	09/30/02	11/14/02	Not filed	68
10-KSB	12/31/02	03/31/03	Not filed	64
10-QSB	03/31/03	05/15/03	Not filed	62
10-QSB	06/30/03	08/14/03	Not filed	59
10-QSB	09/30/03	11/14/03	Not filed	56
10-KSB	12/31/03	03/30/04	Not filed	52
10-QSB	03/31/04	05/17/04	Not filed	50
10-QSB	06/30/04	08/16/04	Not filed	47
10-QSB	09/30/04	11/15/04	Not filed	44
10-KSB	12/31/04	03/31/05	Not filed	40
10-QSB	03/31/05	05/16/05	Not filed	38
10-QSB	06/30/05	08/15/05	Not filed	35
10-QSB	09/30/05	11/14/05	Not filed	32
10-KSB	12/31/05	03/31/06	Not filed	28

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
<i>KwikWeb.com, Inc.</i>					
	<i>10-QSB</i>	03/31/06	05/15/06	Not filed	26
	<i>10-QSB</i>	06/30/06	08/14/06	Not filed	23
	<i>10-QSB</i>	09/30/06	11/14/06	Not filed	20
	<i>10-KSB</i>	12/31/06	04/02/07	Not filed	15
	<i>10-QSB</i>	03/31/07	05/15/07	Not filed	14
	<i>10-QSB</i>	06/30/07	08/14/07	Not filed	11
	<i>10-QSB</i>	09/30/07	11/14/07	Not filed	8
	<i>10-KSB</i>	12/31/07	04/01/08	Not filed	3
	<i>10-Q</i>	03/31/08	05/15/08	Not filed	2
Total Filings Delinquent		26			

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58239 / July 29, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2849 / July 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12790

In the Matter of

**CHOI DOW IAN HONG & LEE
ACCOUNTANCY
CORPORATION AND ERNEST
E. DOW, CPA,**

Respondents.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 4C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE**

I.

On September 13, 2007, the Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, and Notice of Hearing against Choi Dow Ian Hong & Lee Accountancy Corporation (the "Firm") and Ernest E. Dow ("Dow"). The Firm and Dow will be referred to hereafter collectively as "Respondents."

II.

Respondents have 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 them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

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III.

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

A. RESPONDENTS

1. The Firm is a California corporation and public accounting firm headquartered in Los Angeles, California. The Firm prepared and issued an audit report dated December 2, 2004 in connection with its audit of VALCAPX Acquisition Corp. ("VALCAPX").

2. Dow, 58, of Los Angeles, California, is a certified public accountant licensed in California since 1983. As engagement partner on the VALCAPX engagement, Dow participated in the preparation and issuance of the December 2, 2004 VALCAPX audit report.

B. FACTS

1. VALCAPX is a Nevada corporation based in Los Angeles, California. Its common stock is registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). VALCAPX reported no revenue and no assets for the fiscal years ended June 30, 2002, 2003, and 2004.

2. VALCAPX has at all relevant times been an issuer as defined by the Sarbanes-Oxley Act of 2002 (the "Act").

3. The Firm audited VALCAPX's 2002, 2003, and 2004 financial statements included in VALCAPX's annual report for the fiscal years ended June 30, 2002, 2003, and 2004 on Form 10-KSB, filed with the Commission on December 9, 2004.

4. The Firm prepared and issued an audit report dated December 2, 2004, which was included in VALCAPX's Form 10-KSB for the fiscal years ended June 30, 2002, 2003, and 2004 filed with the Commission on December 9, 2004.

5. Dow participated in auditing the 2002, 2003, and 2004 financial statements included in VALCAPX's annual report for fiscal years ended June 30, 2002, 2003, and 2004 on Form 10-KSB, filed with the Commission on December 9, 2004.

6. Dow participated in the preparation and issuance of an audit report dated December 2, 2004, which was included in VALCAPX's Form 10-KSB.

7. Even though the Firm had failed to register with the Public Company Accounting Oversight Board ("PCAOB"), the Firm issued, and Dow participated in the issuance of, an audit report on the financial statements of VALCAPX after the October 22, 2003 deadline.

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

8. The Firm received \$3,600 for conducting an audit of VALCAPX's financial statements for fiscal years 2002, 2003, and 2004, and for issuing an audit report on those statements.

C. VIOLATIONS

1. Section 4C(a) of the Exchange Act provides, in relevant part, that the Commission "may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission ... (1) not to possess the requisite qualifications to represent others ... or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder."

2. Rule 102(e)(1) of the Commission's Rules of Practice provides that the Commission "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission ... (i) not to possess the requisite qualifications to represent others ... or (iii) to have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder."

3. Section 102(a) of the Act provides that "it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer."²

4. The provisions of Section 102(a) of the Act became effective on October 22, 2003.³

5. Based on the conduct described above, the Firm willfully⁴ violated Section 102(a) of the Act.

D. FINDINGS

1. Based on the foregoing, the Commission finds that the Firm and Dow did not possess the requisite qualifications to represent others.

² A violation of the Act or any rule that the PCAOB issues under the Act is treated for all purposes in the same manner as a violation of the Exchange Act, including with respect to penalties. Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7202(b)(1) (West 2002).

³ Section 102(a) became effective "[b]eginning 180 days after the date of the determination of the Commission under Section 101(d)" of the Act that the Board was prepared to undertake its statutory responsibilities. The Commission made the required determination on April 25, 2003. See Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8223, Exchange Act Release No. 47746, 2003 WL 1956164 (Apr. 25, 2003).

⁴ A willful violation of the securities laws means merely that the person charged with the violation knows what he is doing. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000).

2. Based on the foregoing, the Commission finds that the Firm willfully violated Section 102(a) of the Sarbanes-Oxley Act of 2002.

IV.

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

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

1. **Choi Dow Ian Hong & Lee Accountancy Corporation**

A. The Firm is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After one year from the date of this Order, the Firm may request that the Commission consider its 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 the Firm's work in the Firm's practice before the Commission will be reviewed either by the independent audit committee of the public company for which the Firm works or in some other acceptable manner, as long as the Firm practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) the Firm is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective. However, if registration with the PCAOB is dependent upon reinstatement by the Commission, the Commission will consider an application on its other merits;

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

(c) the Firm acknowledges responsibility, as long as the Firm appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, 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 the Firm to resume appearing or practicing before the Commission provided that the Firm's state CPA license is current and the Firm 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 the Firm's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

2. Ernest E. Dow, CPA

A. Dow is censured.

B. Dow may practice before the Commission as an independent accountant provided that:

1. The public accounting firm with which he is associated is registered with the PCAOB in accordance with the Act, and such registration continues to be effective; and

2. He has submitted to the Commission staff (Attention: Office of the Chief Accountant) the PCAOB's letter notifying the public accounting firm with which he is associated that its registration application has been approved.

By the Commission.

Florence E. Harmon
Acting Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58240 / July 29, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2850 / July 29, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12794

In the Matter of

MICHAEL DEUTCHMAN, CPA,

Respondent.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTIONS 4C AND 21C
OF THE SECURITIES EXCHANGE ACT
OF 1934 AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE

I.

On September 13, 2007, the Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, and Notice of Hearing against Michael Deutchman, CPA ("Respondent" or "Deutchman").

II.

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, 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 Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

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III.

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

A. RESPONDENT

Deutchman, of Melville, New York, is a certified public accountant licensed in New York since 1971 and doing business as a sole proprietorship. Deutchman prepared and issued an audit report dated April 14, 2004, in connection with his audit of Cyber Grind, Inc. ("Cyber Grind").

B. FACTS

1. Cyber Grind, Inc. is a Nevada corporation based in Beverly Hills, California. Cyber Grind's common stock does not currently trade and is registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). Cyber Grind reported no revenues and no assets for fiscal year ended December 31, 2003.

2. Cyber Grind has at all relevant times been an issuer as defined by the Sarbanes-Oxley Act of 2002 (the "Act").

3. Although Respondent was aware of the Public Company Accounting Oversight Board ("PCAOB") registration requirement, at no point did Deutchman register with the PCAOB as a public accounting firm.

4. Respondent audited Cyber Grind's 2003 financial statements included in Cyber Grind's annual report for fiscal year ended December 31, 2003 on Form 10-KSB, filed with the Commission on April 14, 2004.

5. Respondent prepared and issued an audit report dated April 14, 2004, which was included in Cyber Grind's Form 10-KSB.

6. Respondent was aware of the registration requirement and the October 22, 2003 registration deadline for registration with the Board when Deutchman issued the audit report dated April 14, 2004.

C. VIOLATIONS

1. Section 4C(a) of the Exchange Act provides, in relevant part, that the Commission "may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission ... (1) not to possess the requisite qualifications to represent others ... or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder."

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

2. Rule 102(e)(1) of the Commission's Rules of Practice provides that the Commission "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission ... (i) not to possess the requisite qualifications to represent others ... or (iii) to have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder."

3. Section 102(a) of the Act provides that "it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer."²

4. The provisions of Section 102(a) of the Act became effective on October 22, 2003.³

5. Based on the conduct described above, the Respondent willfully⁴ violated Section 102(a) of the Act.

D. FINDINGS

1. Based on the foregoing, the Commission finds that Respondent did not possess the requisite qualifications to represent others.

2. Based on the foregoing, the Commission finds that Respondent willfully violated Section 102(a) of the Sarbanes-Oxley Act of 2002.

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:

² A violation of the Act or any rule that the PCAOB issues under the Act is treated for all purposes in the same manner as a violation of the Exchange Act, including with respect to penalties. Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7202(b)(1) (West 2002).

³ Section 102(a) became effective "[b]eginning 180 days after the date of the determination of the Commission under Section 101(d)" of the Act that the Board was prepared to undertake its statutory responsibilities. The Commission made the required determination on April 25, 2003. See Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8223, Exchange Act Release No. 47746, 2003 WL 1956164 (Apr. 25, 2003).

⁴ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

A. Deutchman shall cease and desist from committing or causing any violations and any future violations of Section 102(a) of the Act.

B. Deutchman is censured.

C. Deutchman may practice before the Commission as an independent accountant provided that:

1. The public accounting firm with which he is associated is registered with the PCAOB in accordance with the Act, and such registration continues to be effective; and

2. He has submitted to the Commission staff (Attention: Office of the Chief Accountant) the PCAOB's letter notifying the public accounting firm with which he is associated that its registration application has been approved.

By the Commission.

Florence E. Harmon
Acting Secretary


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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 58241 / July 29, 2008

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2851 / July 29, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-12788

In the Matter of

**BANKER & CO. AND
JITENDRA S. BANKER,**

Respondents.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 4C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE**

I.

On September 13, 2007, the Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, and Notice of Hearing against Banker & Co. ("the Firm") and Jitendra S. Banker ("Banker"). The Firm and Banker will be referred to hereafter collectively as "Respondents."

II.

Respondents have 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 them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

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III.

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

A. RESPONDENTS

1. The Firm is a public accounting firm headquartered in Costa Mesa, California. The Firm prepared and issued an audit report dated January 31, 2004, in connection with its audit of OTC Dreamwerks, Inc. ("OTC Dreamwerks"), an audit report dated May 21, 2004, in connection with its audit of Morgan Clark Management, Inc. ("Morgan"), and an audit report dated August 10, 2004, in connection with its audit of Mill Creek Research, Inc. ("Mill Creek").

2. Banker, 68, of Costa Mesa, California, has been licensed as a chartered accountant in England since 1969, but he is not licensed as a CPA in any American state. As engagement partner on the OTC Dreamwerks, Morgan, and Mill Creek engagements, Banker participated in the preparation and issuance of the January 31, 2004 OTC Dreamwerks audit report, the May 21, 2004 Morgan Clark audit report, and the August 10, 2004 Mill Creek audit report.

B. FACTS

1. OTC Dreamwerks is a Utah corporation based in Orange, California. During the relevant period, OTC Dreamwerk's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). OTC Dreamwerks reported no revenue or assets for fiscal year ended December 31, 2003. OTC Dreamwerks has at all relevant times been an issuer as defined by the Act.

2. The Firm audited OTC Dreamwerk's 2003 financial statements included in OTC Dreamwerk's annual report for fiscal year 2003 on Form 10-KSB, filed with the Commission on February 26, 2004. As part of that audit, Banker & Co. prepared and issued an audit report dated January 31, 2004, which was included in OTC Dreamwerk's Form 10-KSB.

3. Banker participated in auditing the 2003 financial statements included in OTC Dreamwerk's annual report for fiscal year 2003 on Form 10-KSB, filed with the Commission on February 26, 2004. As part of that audit, Banker participated in the preparation and issuance of an audit report dated January 31, 2004, which was included in OTC Dreamwerk's Form 10-KSB.

4. Morgan is a Utah corporation based in Orange, California. During the relevant period, Morgan's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. Morgan reported no revenue and no assets for fiscal year ended June 30, 2003. Morgan has at all relevant times been an issuer as defined by the Act.

5. The Firm audited Morgan's 2003 financial statements included in Morgan's annual report for fiscal year June 30, 2003 on Form 10-KSB, filed with the Commission on May

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

28, 2004. As part of that audit, Banker & Co. prepared and issued an audit report dated May 21, 2004, which was included in Morgan's Form 10-KSB.

6. Banker participated in auditing the 2003 financial statements included in Morgan's annual report for fiscal year June 30, 2003 on Form 10-KSB, filed with the Commission on May 28, 2004. As part of that audit, Banker participated in the preparation and issuance of an audit report dated May 21, 2004, which was included in Morgan's Form 10-KSB.

7. Mill Creek is a Utah corporation based in Seymour, Texas. During the relevant period, Mill Creek's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. Mill Creek reported revenues of \$200 and total assets of \$900,000 for fiscal year ended December 31, 2003. Mill Creek has at all relevant times been an issuer as defined by the Act.

8. The Firm audited Mill Creek's 2003 financial statements included in Mill Creek's annual report for fiscal year December 31, 2003 on Form 10-KSB, filed with the Commission on September 3, 2004. As part of that audit, Banker & Co. prepared and issued an audit report dated August 10, 2004, which was included in Mill Creek's Form 10-KSB.

9. Banker participated in auditing the 2003 financial statements included in Mill Creek's annual report for fiscal year December 31, 2003 on Form 10-KSB, filed with the Commission on September 3, 2004. As part of that audit, Banker participated in the preparation and issuance of an audit report dated August 10, 2004, which was included in Mill Creek's Form 10-KSB.

10. Even though the Firm had failed to register with the Public Company Accounting Oversight Board ("PCAOB"), the Firm issued, and Banker participated in the preparation and issuance of, audit reports on the financial statements of OTC Dreamwerks, Morgan, and Mill Creek after the October 22, 2003 deadline.

11. As part of the audits, the Firm received an aggregate of approximately \$5,300 for conducting the audits of the financial statements of OTC Dreamwerks, Morgan, and Mill Creek for which Banker & Co. filed audit reports after October 22, 2003.

C. VIOLATIONS

1. Section 4C(a) of the Exchange Act provides, in relevant part, that the Commission "may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission ... (1) not to possess the requisite qualifications to represent others ... or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder."

2. Rule 102(e)(1) of the Commission's Rules of Practice provides that the Commission "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission ... (i)

not to possess the requisite qualifications to represent others ... or (iii) to have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder.”

3. Section 102(a) of the Act provides that “it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.”²

4. The provisions of Section 102(a) of the Act became effective on October 22, 2003.³

5. Based on the conduct described above, the Firm willfully⁴ violated Section 102(a) of the Act.

D. FINDINGS

1. Based on the foregoing, the Commission finds that the Firm and Banker did not possess the requisite qualifications to represent others.

2. Based on the foregoing, the Commission finds that the Firm willfully violated Section 102(a) of the Sarbanes-Oxley Act of 2002.

IV.

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

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

1. Banker & Co.

The Firm is denied the privilege of appearing or practicing before the Commission as an accountant.

2 A violation of the Act or any rule that the Board issues under the Act is treated for all purposes in the same manner as a violation of the Exchange Act, including with respect to penalties. Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7202(b)(1) (West 2002).

3 Section 102(a) became effective “[b]eginning 180 days after the date of the determination of the Commission under Section 101(d)” of the Act that the Board was prepared to undertake its statutory responsibilities. The Commission made the required determination on April 25, 2003. See Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8223, Exchange Act Release No. 47746, 2003 WL 1956164 (Apr. 25, 2003).

4 A willful violation of the securities laws means merely that the person charged with the violation knows what he is doing. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000).

B. After one year from the date of this Order, the Firm may request that the Commission consider its 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 the Firm's work in the Firm's practice before the Commission will be reviewed either by the independent audit committee of the public company for which the Firm works or in some other acceptable manner, as long as the Firm practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) the Firm is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective. However, if registration with the PCAOB is dependent upon reinstatement by the Commission, the Commission will consider an application on its other merits;

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

(c) the Firm acknowledges responsibility, as long as the Firm appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, 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 the Firm to resume appearing or practicing before the Commission provided that the Firm's state CPA license is current and the Firm 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 the Firm's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

2. Jitendra S. Banker

A. Banker is censured.

B. Banker may practice before the Commission as an independent accountant provided that:

1. The public accounting firm with which he is associated is registered with the PCAOB in accordance with the Act, and such registration continues to be effective;

2. He has submitted to the Commission (attention: Office of the Chief Accountant) the PCAOB's letter notifying the public accounting firm with which he is associated that its registration application has been approved.

By the Commission.

Florence E. Harmon
Acting Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 58273 / July 31, 2008

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2855 / July 31, 2008

ADMINISTRATIVE PROCEEDING

File No. 3-13111

In the Matter of

JAMES B. KINNEY, CMA

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against James B. Kinney (the "Respondent" or "Kinney") pursuant to Rule 102(e)(3) 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 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 Public Administrative Proceedings Pursuant to Rule

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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102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions (the "Order"), as set forth below.

III.

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

1. Kinney, age 53, is and has been a certified management accountant ("CMA") licensed to practice in Canada. From August 2002 through April 2004 he was the Vice President of Finance for the Wireless business unit of Nortel Networks Corporation ("Nortel"), a Canadian telecommunications equipment manufacturer. Nortel's common stock is and at all relevant times was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and trades publicly on the New York and Toronto Stock Exchanges under the symbol "NT."

2. On May 2, 2008, a final judgment was entered against Kinney, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Exchange Act Sections 10(b) and 13(b)(5), and Exchange Act Rules 10b-5 and 13b2-1, and from aiding and abetting future 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 in the civil action entitled United States Securities and Exchange Commission v. Frank A. Dunn, et al., Civil Action Number 07-CV-8851 (LAP), in the United States District Court for the Southern District of New York. Kinney was also ordered to pay \$52,000 in disgorgement of ill-gotten gains, \$16,481 in prejudgment interest, and a \$75,000 civil money penalty.

3. The Commission's complaint alleged that, from the second half of 2002 through January 2003, Kinney determined that his business unit held tens of millions of dollars in excess reserves, and that he did not release those excess reserves as required under U.S. Generally Accepted Accounting Principles ("GAAP"), but instead used them for earnings management purposes. The complaint also alleged that, in early January 2003, during the 2002 year-end closing process, Kinney and other finance executives improperly established additional excess reserves in order to lower Nortel's consolidated earnings and bring it in line with internal and market expectations. As alleged, his efforts, in conjunction with those of other finance executives, helped erase Nortel's *pro forma* profit for the fourth quarter of 2002 and caused it to report a loss instead. The complaint also alleged that, in the first and second quarters of 2003, Kinney and other finance executives improperly released hundreds of millions of dollars in excess reserves as part of a company-wide effort to inflate consolidated earnings and pay bonuses. According to the complaint, these efforts turned Nortel's first quarter 2003 loss into a reported profit under U.S. GAAP, largely erased Nortel's second quarter loss and generated a *pro forma* profit in the second quarter.

IV.

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

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

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

B. After 5 years from the date of the 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;

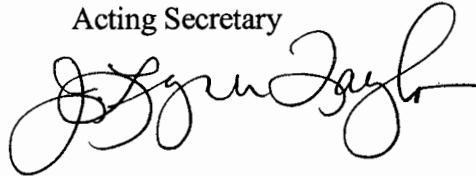
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(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 he is in possession of an accounting license in good standing and he has resolved any disciplinary issues with any applicable licensing authority. However, if the resolution of any disciplinary action by a licensing authority is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary

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

By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for July 2008, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act. Commissioner Atkins was Commissioner from July 20, 2002 to August 1, 2008.

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

CHRISTOPHER COX, CHAIRMAN

PAUL S. ATKINS, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

22 Documents

*Commissioner Watter -
not participating*

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
RELEASE NO. 58166 / July 15, 2008

EMERGENCY ORDER PURSUANT TO SECTION 12(k)(2) OF THE SECURITIES
EXCHANGE ACT OF 1934 TAKING TEMPORARY ACTION TO RESPOND TO
MARKET DEVELOPMENTS

False rumors can lead to a loss of confidence in our markets. Such loss of confidence can lead to panic selling, which may be further exacerbated by “naked” short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, this chain of events can threaten disruption of our markets.

The events preceding the sale of The Bear Stearns Companies Inc. are illustrative of the market impact of rumors. During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns’ stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms. In light of the potentially systemic consequences of a failure of Bear Stearns, the Federal Reserve took emergency action.

The Commission has taken a series of actions to address concerns about rumors. For example, in April, 2008, we charged Paul S. Berliner, a trader, with securities fraud and market manipulation for intentionally disseminating a false rumor concerning The Blackstone Group's acquisition of Alliance Data Systems Corp (“ADS”). The

Commission alleged that this false rumor caused the price of ADS stock to plummet, and that Berliner profited by short selling ADS stock and covering those sales as the false rumor caused the price of ADS stock to fall. See

<http://www.sec.gov/litigation/litreleases/2008/lr20537.htm>.

As another example, on July 13, 2008, the Commission announced that the SEC and other securities regulators would immediately conduct examinations aimed at the prevention of the intentional spreading of false information intended to manipulate securities prices. The examinations will be conducted by the SEC's Office of Compliance Inspections and Examinations, as well as the Financial Industry Regulatory Authority, Inc. and New York Stock Exchange Regulation, Inc. See

<http://www.sec.gov/news/press/2008/2008-140.htm>.

We intend these and similar actions to provide powerful disincentives to those who might otherwise engage in illegal market manipulation through the dissemination of false rumors and thereby over time to diminish the effect of these activities on our markets. In recent days, however, false rumors have continued to threaten significant market disruption. For example, press reports have described rumors regarding the unwillingness of key counterparties to deal with certain financial institutions. There also have been rumors that financial institutions are facing liquidity problems.

As a result of these recent developments, the Commission has concluded that there now exists a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets. Based on this conclusion, the Commission is

exercising its powers under Section 12(k)(2) of the Securities Exchange Act of 1934.¹

Pursuant to Section 12(k)(2), in appropriate circumstances the Commission may issue summarily an order to alter, supplement, suspend, or impose requirements or restrictions with respect to matters or actions subject to regulation by the Commission.

In these unusual and extraordinary circumstances, we have concluded that requiring all persons to borrow or arrange to borrow the securities identified in Appendix A prior to effecting an order for a short sale of those securities is in the public interest and for the protection of investors to maintain fair and orderly securities markets, and to prevent substantial disruption in the securities markets. This emergency requirement will eliminate any possibility that naked short selling may contribute to the disruption of markets in these securities. We described in the releases in which we proposed and adopted Regulation SHO the bases for the current requirements Regulation SHO imposes. We believe, however, that the unusual circumstances we now confront require the temporarily enhanced requirements we are imposing today.

IT IS ORDERED that, pursuant to our Section 12(k)(2) powers, in connection with transactions in the publicly traded securities of substantial financial firms, which entities are identified in Appendix A, no person may effect a short sale² in these securities using the means or instrumentalities of interstate commerce unless such person or its agent has borrowed or arranged to borrow the security or otherwise has the security

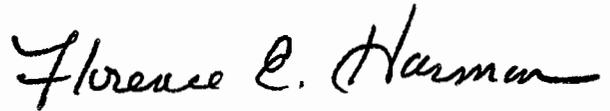
¹ This finding of an “emergency” is solely for purposes of Section 12(k)(2) of the Exchange Act and is not intended to have any other effect or meaning or to confer any right or impose any obligation other than set forth in this Order.

² The definition of “short sale” shall be the same definition used in Rule 200(a) of Regulation SHO and the requirements for marking orders “long” or “short” shall be the same as provided in Regulation SHO.

available to borrow in its inventory prior to effecting such short sale and delivers the security on settlement date.³

In order to allow market participants time to adjust their operations to implement the enhanced requirements, this Order shall take effect at 12:01 a.m. EDT on Monday, July 21, 2008. This Order shall terminate at 11:59 p.m. EDT on Tuesday, July 29, 2008 unless further extended by the Commission.

By the Commission.



Florence E. Harmon
Acting Secretary

³ Short sales to be effected as a result of a put options exercise are subject to this Order. In addition, we note that short sales used to hedge would also be subject to this Order.

Appendix A

<u>Company</u>	<u>Ticker Symbol(s)</u>
BNP Paribas Securities Corp.	BNPQF or BNPQY
Bank of America Corporation	BAC
Barclays PLC	BCS
Citigroup Inc.	C
Credit Suisse Group	CS
Daiwa Securities Group Inc.	DSECY
Deutsche Bank Group AG	DB
Allianz SE	AZ
Goldman, Sachs Group Inc	GS
Royal Bank ADS	RBS
HSBC Holdings PLC ADS	HBC and HSI
J. P. Morgan Chase & Co.	JPM
Lehman Brothers Holdings Inc.	LEH
Merrill Lynch & Co., Inc.	MER
Mizuho Financial Group, Inc.	MFG
Morgan Stanley	MS
UBS AG	UBS
Freddie Mac	FRE
Fannie Mae	FNM

Commissioner Walter -
not participating

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58179; File No. SR-Phlx-2008-31)

July 17, 2008

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendments No. 1 and 2 Thereto, Relating to Changes to Phlx's Governing Documents in Connection with the Acquisition of Phlx by The NASDAQ OMX Group, Inc.

I. Introduction

On April 21, 2008, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change in connection with the acquisition of the Exchange by The Nasdaq Stock Market, Inc., now known as The NASDAQ OMX Group, Inc. ("NASDAQ OMX"). On April 29, 2008, the proposed rule change was published for comment in the Federal Register.³ The Exchange filed Amendment Nos. 1 and 2 to the proposed rule change on May 30, 2008 and July 2, 2008, respectively.⁴ The Commission received no comments on the proposed rule change. This order

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 57703 (April 23, 2008), 73 FR 23293 ("Notice").

⁴ In Amendment No. 1, Phlx represented that, on May 6, 2008, the Exchange obtained shareholder approval of the proposed rule change, as required by Delaware General Corporation Law, and that no further action by the Exchange in connection with the proposed rule change is required. See also General Instruction E to Form 19b-4 (concerning completion of action by a self-regulatory organization on a proposed rule change). Phlx also clarified that routing by NASDAQ Execution Services, LLC ("NES") to Phlx, on behalf of The NASDAQ Stock Market LLC ("NASDAQ Exchange"), takes two forms. Amendment No. 1 is technical in nature, and therefore is not subject to notice and comment.

In Amendment No. 2, Phlx filed the complete Certificate of Incorporation and amended By-Laws of NASDAQ OMX in order to propose their adoption as rules of Phlx. The By-

provides notice of filing of Amendment No. 2 to the proposed rule change, and grants accelerated approval to the proposed rule change, as modified by Amendments No. 1 and 2.

II. Background

On November 7, 2007, NASDAQ OMX announced that it had entered into an agreement with the Exchange, pursuant to which NASDAQ OMX would acquire all of the common stock of the Exchange.⁵ Phlx shareholders would receive cash consideration for their common stock and would not retain any ownership interest in the Exchange.

The proposed acquisition would be effected through the merger of Pinnacle Merger Corporation, Inc. (“Merger Subsidiary”), a Delaware corporation and wholly-owned subsidiary of NASDAQ OMX, with and into the Exchange, with the Exchange surviving the merger (the “Merger”).⁶ The members of the board of directors of Merger Subsidiary would be selected by NASDAQ OMX from among the current Governors of the Exchange and would become the Board of Governors of Phlx (“Board”) immediately after the effective time of the Merger.⁷ The

Laws contained minor amendments to terminology to apply to Phlx all of the same provisions that are currently specifically applicable to the NASDAQ Exchange. The amended By-Laws were published for comment in a separate NASDAQ Exchange filing. See Securities Exchange Act Release No. 57761 (May 1, 2008), 73 FR 26182 (May 8, 2008) (notice of SR-NASDAQ-2008-035) (“Nasdaq Stock Market Proposal”).

⁵ The Exchange demutualized in 2004, though it is not publicly traded. See Securities Exchange Act Release No. 49098 (January 16, 2004), 69 FR 3974 (January 27, 2004) (SR-PHLX-2003-73) (approval order).

⁶ See proposed Section 1-1(ii) of the By-Laws (defining “NASDAQ OMX Merger”).

⁷ See proposed Section 4-3(b) of the By-Laws and Notice, supra note 3, 73 FR at 23295.

Exchange represents that the directors of Merger Subsidiary, and therefore the new Board, would satisfy the compositional requirements of the new Board, discussed below.⁸

After the Merger, the Exchange would be a wholly-owned subsidiary of NASDAQ OMX.⁹ NASDAQ OMX would operate the Exchange as a separate self-regulatory organization (“SRO”). Accordingly, Phlx would maintain its current registration as a national securities exchange, and maintain separate rules, membership rosters, and listings that would be distinct from the rules, membership rosters, and listings of NASDAQ OMX’s other national securities exchanges. Additionally, after the Merger, the Exchange would continue to operate the Stock Clearing Corporation of Philadelphia (“SCCP”),¹⁰ its wholly-owned clearing agency, and The Philadelphia Board of Trade (“PBOT”), its wholly-owned futures exchange subsidiary.

Separately, NASDAQ OMX also entered into an agreement with the Boston Stock Exchange, Inc. (“BSE”), pursuant to which NASDAQ OMX would acquire all of the outstanding membership interests in BSE (“BSE Acquisition”).¹¹ Following the closing of the BSE Acquisition and the Merger, NASDAQ OMX will be the sole owner of five SROs: NASDAQ

⁸ See infra notes 61-69 and accompanying text (discussing proposed compositional requirements of the Board).

⁹ The Exchange would have a single class of common stock, all of which would be held by NASDAQ OMX.

¹⁰ See Securities Exchange Act Release No. 58180 (July 17, 2008) (SR-SCCP-2008-01) (approving changes to SCCP’s articles of incorporation, including language clarifying that all of the authorized shares of SCCP common stock of are issued and outstanding and are held by Phlx).

¹¹ See Securities Exchange Act Release No. 57757 (May 1, 2008), 73 FR 26159 (SR-BSE-2008-23) (notice of proposed rule change related to BSE Acquisition); Securities Exchange Act Release No. 57782 (May 6, 2008), 73 FR 27583 (May 13, 2008) (SR-BSECC-2008-01) (notice of proposal to amend the articles of organization and by-laws of the BSECC to reflect its proposed acquisition by NASDAQ OMX).

Exchange, BSE, the Boston Stock Exchange Clearing Corporation (“BSECC”), Phlx, and SCCP (collectively, “SRO Subsidiaries”).

In the present filing, the Exchange has proposed to amend its certificate of incorporation (“Certificate”), by-laws (“By-Laws”), and certain rules (“Rules”) to reflect NASDAQ OMX’s proposed ownership of the Exchange. In general, the proposed changes are designed to address the Exchange’s proposed new ownership structure and conform Phlx’s governance provisions to those that are currently applicable to the NASDAQ Exchange. The Exchange is also using this opportunity to make several other changes to its governing documents to update certain language and make other minor changes that are not directly related to the proposed Merger.¹²

In addition, NASDAQ OMX has amended its By-Laws to make applicable to all of NASDAQ OMX’s SRO subsidiaries, including Phlx and SCCP (after the Merger), certain provisions of NASDAQ OMX’s Restated Certificate of Incorporation and NASDAQ OMX’s By-Laws. These provisions of NASDAQ OMX’s governing documents are designed to maintain the independence of each SRO subsidiary’s self-regulatory function, enable each SRO subsidiary to operate in a manner that complies with the federal securities laws, and facilitate the ability of each SRO subsidiary and the Commission to fulfill their regulatory and oversight obligations under the Act.¹³

¹² For example, as discussed in Section III.E.6, infra, the language relating to how the Exchange’s Weekly Bulletin is distributed would be updated to not restrict its distribution to mail, but rather to permit distribution by email and posting on the Exchange’s Web site. See Section 12-5(d) of the By-Laws.

¹³ See Amendment No. 2, supra note 4 (including the amended By-Laws of NASDAQ OMX to the Phlx’s proposal).

III. Discussion

After careful review, 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.¹⁴ In particular, the Commission finds that the proposed rule change is consistent with: (1) Section 6(b)(1) of the Act,¹⁵ which requires a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act; (2) Section 6(b)(3) of the Act,¹⁶ which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer (the “fair representation requirement”); and (3) Section 6(b)(5) of the Act,¹⁷ in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

As noted above, the Merger would result in NASDAQ OMX owning two additional SROs (Phlx and SCCP). The Commission believes that the ownership of Phlx and SCCP by the same public holding company that owns the NASDAQ Exchange would not impose any burden

¹⁴ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(1).

¹⁶ 15 U.S.C. 78f(b)(3).

¹⁷ 15 U.S.C. 78f(b)(5).

on competition not necessary or appropriate in furtherance of the purposes of the Act.¹⁸ Further, the Commission does not believe that the ownership by one holding company of two exchanges and one clearing agency presents any adverse competitive implications in the current marketplace. The Commission notes that it has previously approved proposals in which a holding company owns multiple SROs.¹⁹ The Commission continues to monitor such entities and notes that its experience to date with the issues raised by this ownership structure has not presented any concerns that have not been addressed, for example by the protections afforded at the holding company level.

In particular, as discussed below, though NASDAQ OMX is not itself an SRO, its activities with respect to the operation of Phlx and SCCP must be consistent with, and must not interfere with, the self-regulatory obligations of Phlx and SCCP.²⁰ Further, certain provisions of NASDAQ OMX's Certificate of Incorporation and By-Laws are rules of an exchange if they are stated policies, practice, or interpretations, as defined in Rule 19b-4 under the Act, of the exchange, and must be filed with the Commission pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder.²¹ Accordingly, Phlx has filed with the Commission the Certificate and amended By-Laws of NASDAQ OMX. Notably, NASDAQ OMX's amended By-Laws would make applicable to all of NASDAQ OMX's SRO subsidiaries, including Phlx and SCCP (after the Merger), certain provisions of NASDAQ OMX's Restated Certificate of Incorporation and

¹⁸ 15 U.S.C. 78f(b)(8) and 15 U.S.C. 78q-1(b)(3)(I).

¹⁹ See, e.g., Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.).

²⁰ See infra Section III.C.1 (discussing the relationship between NASDAQ OMX and Phlx).

²¹ 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

NASDAQ OMX's By-Laws that are designed to maintain the independence of each of its SRO subsidiaries' self-regulatory function. These provisions facilitate the ability of each SRO subsidiary and the Commission to fulfill their regulatory and oversight obligations under the Act.

Furthermore, the Commission believes that there is robust competition among market centers, as exchanges face increasing competition from non-exchange entities that trade the same or similar financial instruments, such as alternative trading systems.²² In addition, despite consolidation among exchanges, other entities have recently applied for exchange registration, which evidences the continued ability of entities to enter the marketplace and further increase competition among SROs.²³ Accordingly, as described above, the Commission does not believe that ownership by a single holding company of multiple SROs presents any burden on competition in violation of the Act.²⁴ Nevertheless, the Commission will continue to monitor

²² See, e.g., Securities Exchange Act Release No. 58092 (July 3, 2008), 73 FR 40144, 40144 (July 11, 2008) (where the Commission recognized that “[n]ational securities exchanges registered under Section 6(a) of the Exchange Act face increased competitive pressures from entities that trade the same or similar financial instruments...”).

²³ See, e.g., Securities Exchange Act Release No. 57322 (February 13, 2008), 73 FR 9370 (February 20, 2008) (File No. 10-182) (notice of filing of application and Amendment No. 1 thereto by BATS Exchange, Inc. for registration as a national securities exchange).

²⁴ The Commission notes that NASDAQ OMX also entered into an agreement with the BSE, pursuant to which NASDAQ OMX would acquire all of the outstanding membership interests in BSE. See Securities Exchange Act Release Nos. 57757 (May 1, 2008), 73 FR 26159 (May 8, 2008) (SR-BSE-2008-23) (notice of proposed rule change related to BSE Acquisition); and 57782 (May 6, 2008), 73 FR 27583 (May 13, 2008) (SR-BSECC-2008-01) (notice of proposal to amend the articles of organization and by-laws of the BSECC to reflect its proposed acquisition by NASDAQ OMX). If the Commission also were to approve the BSE Acquisition, NASDAQ OMX would be the sole owner of five SROs: NASDAQ Exchange, Phlx, SCCP, BSE, and the BSECC. The Commission will consider the implications of those proposed acquisitions when it reviews that proposal.

SROs, including those that are under common ownership, for compliance with the Act and the rules and regulations thereunder, as well as the SROs' own rules.

A. Capital Stock

The proposed Merger would result in NASDAQ OMX owning all of the issued, authorized, and outstanding common stock of the Exchange.²⁵ Accordingly, the Exchange proposes to amend the Certificate to reduce the amount of common and preferred stock, and to explicitly state that NASDAQ OMX will hold all of the common stock of the Exchange. Specifically, the Exchange proposes to: (1) reduce the amount of common stock that the Exchange has authority to issue from one million to 100 shares;²⁶ (2) state that all authorized shares of common stock shall be issued, outstanding, and held by NASDAQ OMX;²⁷ (3) eliminate the designation of Class A and Class B common stock;²⁸ (4) reduce the amount of

²⁵ See proposed Article FOURTH(c)(iv) of the Certificate and proposed Section 29-4(c) of the By-Laws.

²⁶ See proposed Article FOURTH of the Certificate.

²⁷ See proposed Article FOURTH(c)(iv) of the Certificate.

²⁸ See, e.g., proposed Article FOURTH of the Certificate and proposed Section 1-1(d) of the By-Laws. For example, Article FOURTH(b)(ii) sets forth the different dividend priority of holders of Class A common stock and Class B common stock in the event of a Liquidity Event (as defined in that subparagraph). This provision would be obsolete once only one class of common stock is authorized and outstanding. Correspondingly, the Exchange proposes to eliminate that language. Similarly, the Exchange proposes to eliminate Article FOURTH(c)(vi) of the Certificate, which governs the automatic conversion of Class A common stock, and language in Article FOURTH(c)(iii) of the Certificate that distinguishes between the voting rights of holders of Class A and Class B common stock.

On January 20, 2007, all Class A common stock converted to Class B common stock shares. See Phlx Annual Report 2006 at 42. Upon conversion to Class B, the eligibility of holders of Class A shares for a contingent dividend terminated. See id. The former holders of the Class A shares otherwise continued to have the same rights and privileges, including voting, as the Class B holders. See id.

preferred stock that the Exchange has authority to issue from 100,000 to 100 shares;²⁹ and (5) state that only one share of preferred stock, the single share of Series A Preferred Stock,³⁰ is outstanding.³¹ In addition, the Exchange proposes to delete or amend several provisions applicable to the Exchange's common stock that would become obsolete after the Merger because NASDAQ OMX would control 100% of the common stock.³² These changes are necessary to reflect the change in ownership of the Exchange after the Merger, and the Commission finds them to be consistent with the Act.

B. Ownership Concentration Limitations and Voting Limits

Phlx proposes to amend the Certificate to replace the current ownership concentration limitations and voting limitations with new restrictions that would recognize that, following the Merger, NASDAQ OMX would own all of the common stock of the Exchange. As discussed below, the Exchange proposes to delete language in Article FOURTH of the Certificate, which limits the amount of common stock of the Exchange that any person may own or vote, directly or indirectly, without prior Commission approval. In place of this restriction, Phlx proposes to

²⁹ See proposed Article FOURTH of the Certificate.

³⁰ The share of Series A Preferred Stock, which is currently issued and outstanding, is held by the Trust pursuant to the Trust Agreement. See Section 1-1(mm) of the By-Laws (defining "Trust") and Section 1-1(ee) of the By-Laws (defining "Trust Agreement"). The Trustee of the Trust is required, under Section 4.1 of the Trust Agreement, to vote the share as directed by the vote of the Member Organization Representatives of Member Organizations entitled to vote. This voting arrangement is designed to give Members a voice in the management of the Exchange and is necessary because, under Delaware law, only stockholders can elect the directors of a Delaware corporation. See Securities Exchange Act Release No. 49098, *supra* note 5, 69 FR at 3979. The Merger would not result in a transfer of ownership of the Series A Preferred Stock.

³¹ See proposed Article FOURTH(b)(iv) of the Certificate.

³² For example, Phlx proposes to amend the dividend rights of common stock (see proposed Article FOURTH(c)(ii) of the Certificate) and eliminate provisions governing common

amend its Certificate and By-Laws to prohibit Phlx from transferring or assigning its common stock without prior Commission approval and from issuing, transferring, or assigning its preferred stock without prior Commission approval.³³

The current Certificate imposes limits on direct and indirect changes in control of Phlx through voting and ownership limits applicable to holders of its common stock. These provisions enable the Commission, as well as the Exchange, to monitor potential changes in control of the Exchange, and thereby assist both the Commission and the Exchange in carrying out their regulatory responsibilities under the Act.³⁴ In particular, the Certificate currently provides that, unless approved by the Board and by the Commission under Section 19(b) of the Act, no Person (either alone or together with its Related Persons) may own (of record or beneficially), whether directly or indirectly, more than 40% of the then-outstanding shares of Phlx common stock. To the extent that such Person (or its Related Persons) purports to own more than 40% of the then outstanding shares of common stock of the Exchange, the Person (and its Related Persons) is not entitled to exercise any rights and privileges incident to ownership of

stock incentive compensation. See infra note 146 and accompanying text (discussing the proposal to eliminate incentive compensation).

³³ See proposed Article FOURTH(c)(iv) of the Certificate (restriction on transferring or assigning common stock). This subparagraph also provides that all authorized shares of common stock of the Exchange (100 shares) be issued and outstanding and reflects that all of the common stock would be held by NASDAQ OMX. The Commission notes that any proposed issuance of common stock would constitute an amendment to that provision, which would be subject to the filing of a proposed rule change with the Commission. See also proposed Section 29-4(c) of the By-Laws. See proposed Article FOURTH(a) and (b)(v) of the Certificate and proposed Section 29-4(d) of the By-Laws (restriction on issuing, transferring, or assigning preferred stock). See also infra note 43 (restrictions on the issuance of preferred stock).

³⁴ See Securities Exchange Act Release No. 49098, supra note 5, 69 FR at 3985.

shares in excess of the 40% limit.³⁵ The Certificate also provides that no Member (either alone or together with its Related Persons) may own, of record or beneficially, whether directly or indirectly, more than 20% of the then outstanding shares of common stock of the Exchange.³⁶ Moreover, unless approved by the Board and by the Commission under Section 19(b) of the Act, no Person, either alone or together with its Related Persons, has any right to vote, or to give any consent or proxy with respect to, more than 20% of the then outstanding shares of common stock of the Exchange.³⁷

Currently, the Board would need to approve an amendment to the By-Laws to permit any Person, together with its Related Persons, to exercise voting rights with respect to the shares in excess of the 20% voting limit or to own more than 40% of the outstanding shares of common stock.³⁸ Such amendment would need to be filed with the Commission pursuant to Section 19(b) of the Act,³⁹ which allows the Commission an opportunity to determine, among other things, whether any additional measures may be necessary to provide sufficient regulatory jurisdiction over the proposed controlling persons.⁴⁰

As proposed, NASDAQ OMX would acquire all of the common stock of the Exchange. To reflect such ownership by one entity, the Exchange proposes to eliminate the 40% ownership

³⁵ See Article FOURTH(b)(v)(A) of the Certificate.

³⁶ See Article FOURTH(b)(v)(B) of the Certificate.

³⁷ See Article FOURTH(b)(iii)(B) of the Certificate.

³⁸ The Board cannot approve such amendment with respect to Members.

³⁹ See Article FOURTH(b)(iii)(B)(1) and FOURTH(b)(v)(A)(1) of the Certificate.

⁴⁰ See Securities Exchange Act Release No. 49098, *supra* note 5, 69 FR at 3985. The Commission notes that this proposed rule change satisfies the requirements in existing Article FOURTH(b)(v)(A) and (b)(iii)(B) of the Certificate and that the Commission's approval will allow NASDAQ OMX to exceed the existing ownership and voting limits

and 20% voting limits. Phlx also proposes to eliminate the prohibition on any Member, either alone or together with its Related Persons, from owning (of record or beneficially) more than 20% of its outstanding common stock of the Exchange.⁴¹

In place of these restrictions, Phlx proposes to adopt new restrictions on the transfer or assignment of common stock. Specifically, proposed Article FOURTH(c)(iv) of the Certificate would be revised to state that: (1) all 100 authorized shares of common stock of the Exchange shall be issued and outstanding, and shall be held by NASDAQ OMX; and (2) NASDAQ OMX may not transfer or assign any shares of Phlx common stock to any entity, unless such transaction is approved by the Commission.⁴² The Exchange also proposes to adopt a restriction on the issuance of preferred stock, as well as similar restrictions on the transfer or assignment of preferred stock.⁴³

In addition, the NASDAQ OMX Certificate of Incorporation imposes limits on direct and indirect changes in control, which are designed to prevent any shareholder from exercising undue control over the operation of its SRO subsidiaries and to ensure that its SRO subsidiaries and the Commission are able to carry out their regulatory obligations under the Act. Specifically, no

in existing Article FOURTH. The proposed rule change will become operative upon consummation of the Merger.

⁴¹ See Article FOURTH(c)(v)(B) of the Certificate.

⁴² See also proposed Section 29-4(c) of the By-Laws.

⁴³ See proposed Section 29-4(d) of the By-Laws. The Exchange would have authority to issue 100 shares of preferred stock, of which one share would be designated Series A Preferred. See proposed Article FOURTH of the Certificate. Phlx has not issued, and does not currently intend to issue, any preferred stock other than the Series A Preferred Stock. See Notice, supra note 3, 73 FR at 23293. The restrictions on transfer or assignment would also apply to the Series A Preferred Stock. See proposed Article FOURTH(a) of the Certificate; see also proposed Article FOURTH(b)(v) of the Certificate. The proposed Merger would not impact the ownership of the one outstanding

person who beneficially owns shares of common stock, preferred stock, or notes of NASDAQ OMX in excess of 5% of the securities generally entitled to vote may vote the shares in excess of 5%.⁴⁴ This limitation would mitigate the potential for any NASDAQ OMX shareholder to exercise undue control over the operations of Phlx, and it facilitates Phlx's and the Commission's ability to carry out their regulatory obligations under the Act.

The NASDAQ OMX Board may approve exemptions from the 5% voting limitation for any person that is not a broker-dealer, an affiliate of a broker-dealer, or a person subject to a statutory disqualification under Section 3(a)(39) of the Act,⁴⁵ provided that the NASDAQ OMX Board also determines that granting such exemption would be consistent with the self-regulatory obligations of its SRO subsidiary.⁴⁶ Further, any such exemption from the 5% voting limitation would not be effective until approved by the Commission pursuant to Section 19 of the Act.⁴⁷

Phlx's proposed rule change reflects an amendment to the NASDAQ OMX By-Laws to require the NASDAQ OMX Board, prior to approving any exemption from the 5% voting limitation, to

share of Series A Preferred Stock, which will continue to be held by the Trust pursuant to the Trust Agreement.

⁴⁴ See Article Fourth.C, NASDAQ OMX Certificate.

⁴⁵ 15 U.S.C. 78c(a)(39). See Article Fourth.C.6, NASDAQ OMX Certificate.

⁴⁶ Specifically, the NASDAQ OMX Board must determine that granting such exemption would (1) not reasonably be expected to diminish the quality of, or public confidence in, NASDAQ OMX or the other operations of NASDAQ OMX, on the ability to prevent fraudulent and manipulative acts and practices and on investors and the public, and (2) promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to an facilitating transactions in securities or assist in the removal of impediments to or perfection of the mechanisms for a free and open market and a national market system. See Article Fourth.C.6, NASDAQ OMX Certificate.

⁴⁷ See Section 12.5, NASDAQ OMX By-Laws.

determine that granting such exemption would also be consistent with Phlx's self-regulatory obligations.⁴⁸

The Commission approved the existing limits in Phlx's Certificate to enable the Exchange to carry out its self-regulatory responsibilities, and to enable the Commission to fulfill its responsibilities under the Act.⁴⁹ After the Merger, these goals would be achieved by the proposed new restrictions on the transfer or assignment of Phlx capital stock and on the issuance of preferred stock, together with the ownership and voting restrictions on NASDAQ OMX's shareholders. In particular, the simplified provisions of Phlx's Certificate and By-Laws are tailored to an exchange whose common stock is wholly-owned by one company. By explicitly stating that NASDAQ OMX would be the owner of 100% of the Exchange's issued and outstanding common stock, and that no preferred stock has been issued other than the Series A Preferred Stock held by the Trust, any purported issuance, transfer, or assignment of any capital stock would constitute an amendment to the Certificate and By-Laws and therefore be subject to a filing with the Commission under Section 19 of the Act. Moreover, the NASDAQ OMX Certificate currently includes restrictions on any person voting shares in excess of 5%. The changes to the NASDAQ OMX By-Laws would require the NASDAQ OMX Board, prior to approving an exemption from the 5% voting limitation, to determine that granting such exemption would be consistent with Phlx's self-regulatory obligations.

Accordingly, the Commission finds that the elimination of the current ownership and voting limits and the adoption of new controls on the issuance, transfer, and assignment of Phlx capital stock, together with the ownership and voting limitations in NASDAQ OMX's Certificate

⁴⁸ See proposed Section 12.5, NASDAQ OMX By-Laws.

⁴⁹ See supra note 34 and accompanying text.

and By-Laws, are designed to prevent any shareholder from exercising undue control over the operation of Phlx and to ensure that Phlx and the Commission are able to carry out their regulatory obligations under the Act and thereby should minimize the potential that a person could improperly interfere with or restrict the ability of the Commission or Phlx to effectively carry out their respective regulatory oversight responsibilities under the Act.

C. Management of the Exchange

1. Relationship between NASDAQ OMX and Phlx

After the merger, Phlx would become a subsidiary of NASDAQ OMX. Although NASDAQ OMX is not an SRO and, therefore, will not itself carry out regulatory functions, its activities with respect to the operation of Phlx must be consistent with, and not interfere with, Phlx's self-regulatory obligations. Proposed changes to NASDAQ OMX's By-Laws would make applicable to all of NASDAQ OMX's SRO subsidiaries, including Phlx (after the Merger), certain provisions of NASDAQ OMX's Restated Certificate of Incorporation and NASDAQ OMX's By-Laws that are designed to maintain the independence of each of its SRO subsidiaries' self-regulatory function, enable each SRO subsidiary to operate in a manner that complies with the federal securities laws, and facilitate the ability of each SRO subsidiary and the Commission to fulfill their regulatory and oversight obligations under the Act.⁵⁰

Although NASDAQ OMX will not itself carry out regulatory functions, its activities with respect to the operation of its SRO subsidiaries, including Phlx and SCCP, must be consistent with, and not interfere with, those subsidiaries' self-regulatory obligations. The By-Laws of NASDAQ OMX include certain provisions to address this concern. In particular, the By-Laws of

⁵⁰ See Amendment No. 2, supra note 4 (including the amended By-Laws of NASDAQ OMX to the Phlx's proposal).

NASDAQ OMX specify that NASDAQ OMX and its officers, directors, employees, and agents irrevocably submit to the jurisdiction of the United States federal courts, the Commission, and each self-regulatory subsidiary of NASDAQ OMX for the purposes of any suit, action or proceeding pursuant to the United States federal securities laws, and the rules and regulations thereunder, arising out of, or relating to, the activities of any self-regulatory subsidiary.⁵¹

Further, NASDAQ OMX agreed to provide the Commission with access to its books and records.⁵² NASDAQ OMX also agreed to keep confidential non-public information relating to the self-regulatory function⁵³ of the Exchange and not to use such information for any non-regulatory purpose. In addition, the NASDAQ OMX Board, as well as its officers, employees, and agents are required to give due regard to the preservation of the independence of Phlx's self-regulatory function.⁵⁴ Similarly, the NASDAQ OMX Board, when evaluating any issue, would be required to take into account the potential impact on the integrity, continuity, and stability of the its SRO subsidiaries.⁵⁵ Finally, the NASDAQ OMX By-Laws require that any changes to the NASDAQ OMX Certificate and By-Laws be submitted to the Board of Directors of each of its

⁵¹ See proposed Section 12.3, NASDAQ OMX By-Laws.

⁵² See proposed Section 12.1(c), NASDAQ OMX By-Laws. To the extent that they relate to the activities of Phlx, all books, records, premises, officers, directors, and employees of NASDAQ OMX would be deemed to be those of the Phlx. See *id.*

⁵³ This requirement to keep confidential non-public information relating to the self-regulatory function shall not limit the Commission's ability to access and examine such information or limit the ability of directors, officers, or employees of the Nasdaq Holding Company from disclosing such information to the Commission. See proposed Section 12.1(b), NASDAQ OMX By-Laws. Holding companies with SRO subsidiaries have undertaken similar commitments. See, e.g., Securities Exchange Act Release No. 56955 (December 13, 2007), 72 FR 71979, 71983 (December 19, 2007) (SR-ISE-2007-101) (order approving the acquisition of International Securities Exchange, LLC's parent, International Securities Exchange Holdings, Inc., by Eurex Frankfurt AG).

⁵⁴ See Section 12.1(a), NASDAQ OMX By-Laws.

⁵⁵ See proposed Section 12.7, NASDAQ OMX By-Laws.

SRO subsidiaries, including the Exchange, and, if such amendment is required to be filed with the Commission pursuant to Section 19(b) of the Act, such change shall not be effective until filed with, or filed with and approved by, the Commission.

The Commission believes that the NASDAQ OMX By-Laws, as amended to accommodate the Merger, are designed to facilitate the Phlx's ability to fulfill its self-regulatory obligations and are, therefore, consistent with the Act. In particular, the Commission believes these changes are consistent with Section 6(b)(1) of the Act,⁵⁶ which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange.

The Commission also believes that under Section 20(a) of the Act⁵⁷ any person with a controlling interest in NASDAQ OMX would be jointly and severally liable with and to the same extent that NASDAQ OMX is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act⁵⁸ creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder. Further, Section 21C of the Act⁵⁹

⁵⁶ 15 U.S.C. 78f(b)(1).

⁵⁷ 15 U.S.C. 78t(a).

⁵⁸ 15 U.S.C. 78t(e).

⁵⁹ 15 U.S.C. 78u-3.

authorizes the Commission to enter a cease-and-desist order against any person who has been “a cause of” a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation.

2. Composition and Term of Board

The Exchange proposes to give its Board discretion to determine its size from time to time,⁶⁰ and after the Merger the Board would likely be reduced in size from its current slate of 23 Governors. Specifically, the Board would include one Governor who is the CEO, one Governor who is the Vice-Chair of the Board,⁶¹ one PBOT Governor,⁶² one Member Governor,⁶³ one

⁶⁰ See proposed Article SIXTH(a) of the Certificate and proposed Section 4-1 of the By-Laws.

⁶¹ The Vice-Chair would continue to be an individual who, anytime within the prior three years, has been a Member primarily engaged in business on the Exchange’s equity market or equity options market or who is a general partner, executive officer (vice-president or above) or a Member associated with a Member Organization primarily engaged in business on the Exchange’s equity market or equity options market. See Section 5-3 of the By-Laws. The term “Member Organization” is defined in Section 1-1(v) of the By-Laws.

⁶² A PBOT Governor would continue to be defined as a Governor who is a member of PBOT and is duly elected to fill the one vacancy on the Board allocated to the PBOT Governor. See Section 1-1(aa) of the By-Laws.

⁶³ A Member Governor would continue to be defined as a Governor who is a Member or a general partner or an executive officer (vice-president and above) of a Member Organization and is duly elected to fill the vacancy on the Board allocated to the Member Governor. See Section 1-1(u) of the By-Laws. Phlx proposes to amend its Certificate and By-Laws to reflect its proposal that the new Board consist of only one Member Governor. See proposed Article SIXTH(a)(ii) of the Certificate and proposed Sections 1-1(e), 1-1(u) and 4-1 of the By-Laws.

Stockholder Governor,⁶⁴ and a number of Independent Governors determined by the Board,⁶⁵ including the Designated Independent Governors. “Designated Independent Governors” would continue to be defined as those Independent Governors who are voted for by Members, and who are then elected to the Board by the Holder of the Series A Preferred Stock according to the vote of the Members.⁶⁶

Though it may be reduced in size, the Board would be composed, as it currently is, of a majority of Independent Governors, who, by definition, would have no Material Relationship with the Exchange, any affiliate of the Exchange, any Member of the Exchange, any Member affiliate, or any issuer of securities that are listed or traded on the Exchange or a facility of the Exchange.⁶⁷ Notably, the new Board would select its Chair from among its members that are Independent Governors, instead of the current arrangement where the CEO also serves as the Chairman of the Board.⁶⁸

⁶⁴ See proposed Section 4-1 of the By-Laws and proposed Article SIXTH(a)(iii) of the Certificate. A Stockholder Governor would be defined as a Governor who is an officer, director (or a person in a similar position in business entities that are not corporations), designee or an employee of a holder of common stock or any affiliate or subsidiary of such holder of common stock and is duly elected to fill the vacancy on the Board allocated to the Stockholder Governor. See proposed Section 1-1(hh) of the By-Laws; see also proposed Article SIXTH(a)(ix) of the Certificate.

⁶⁵ As discussed below, Independent Governors would continue to constitute a majority of the Board, and Designated Independent Governors, would, together with the Member Governor and the PBOT Governor, equal at least 20% of the total number of Governors. See Section 4-1 of the By-Laws.

⁶⁶ See Section 1-1(f) of the By-Laws and Article FOURTH(a)(iii) of the Certificate, which Phlx proposes to renumber (see proposed Article FOURTH(b)(iii)).

⁶⁷ See proposed Section 4-1 of the By-Laws (the Board shall be composed of a majority of Independent Governors); proposed Article SIXTH(a)(vii) of the Certificate (defining “Independent Governor”). The terms “Independent,” “Material Relationship,” and “Member” are defined in Sections 1-1(o), 1-1(s), and 1-1(t) of the By-Laws, respectively.

⁶⁸ See proposed Section 5-2 of the By-Laws. Currently, the Chairman of the Board is the CEO. See Article SIXTH(a)(v) of the Certificate and Sections 4-1 and 5-1 of the By-

The Commission finds that the proposed changes regarding the composition of the Board are consistent with the Act, including Section 6(b)(1) of the Act,⁶⁹ which requires, among other things, that a national securities exchange be organized to carry out the purposes of the Act and comply with the requirements of the Act.

Phlx proposes to set forth in detail the powers and duties of the Chair and Vice-Chair.⁷⁰ This provision is intended to be generally consistent with current NASDAQ Exchange By-Law Article VII, and the Commission finds it consistent with the Act.

The Exchange also proposes to change the term of office for all Governors from three years to one year⁷¹ and eliminate term limits for Governors.⁷² The Commission finds this consistent with the Act and notes that establishing one-year terms for directors is consistent with other proposals previously approved by the Commission.⁷³ Further, the Commission notes that neither Phlx's proposed parent company, NASDAQ OMX, nor NASDAQ Exchange have term

Laws (all providing that the Chairman of the Board shall be the individual then holding the office of CEO).

⁶⁹ 15 U.S.C. 78f(b)(1).

⁷⁰ See Article V of the By-Laws.

⁷¹ See proposed Section 4-3(a) of the By-Laws. That section currently provides that the Stockholder Governors, Independent Governors (including the Designated Independent Governors), Member Governors, and the PBOT Governor serve for three-year terms, which are staggered.

⁷² See proposed Section 4-3(a) of the By-Laws. That section currently prohibits Governors, except for the Chairman of the Board and the Vice-Chairman of the Board, from serving for more than two consecutive full terms.

⁷³ See, e.g., Securities Exchange Act Release No. 55293 (February 14, 2007), 72 FR 8033 (February 22, 2007) (SR-NYSE-2006-120) (approving one-year terms for NYSE Euronext directors). Additionally, the Restated Certificate of Incorporation of the NASDAQ Stock Market, Inc. also provides for one-year terms for directors other than Preferred Stock Directors.

limits for their respective boards.⁷⁴

In addition, Phlx proposes that, in the event of a vacancy in the office of Vice-Chair, the Nominating, Elections and Governance Committee would select a replacement to serve the remainder of the unexpired term, subject to approval by the Board.⁷⁵ This provision is intended to be generally consistent with current NASDAQ Exchange By-Law Article IV. Section 4-19 of the By-Laws designates, with specificity, when a Governor's term begins, and provides that a Governor's term ends only when his or her successor is elected and qualifies, or when the Governor resigns or is removed. The Exchange proposes to modify this provision to eliminate the reference to a Governor's term beginning at a particular time and provides that a Governor's term will end when a successor is elected or upon their earlier resignation, removal, or death. The Commission finds these changes consistent with the Act and believes that they should provide additional clarity and, therefore, would facilitate orderly successions of Governors.⁷⁶

3. Nomination, Election, and Removal of non-Designated Governors

The Exchange proposes changes to the nomination and election process for non-Designated Governors (i.e., Independent Governors, the Vice-Chair, the CEO, and the Shareholder Governor). These changes are primarily designed to simplify the process to accommodate a single Stockholder. Currently, the non-Designated Governors are nominated through different mechanisms, including: (1) the Nominating, Elections and Governance

⁷⁴ See Article IV of the NASDAQ OMX By-Laws and Article III of the NASDAQ Exchange By-Laws.

⁷⁵ See proposed Section 5-3 of the By-Laws.

⁷⁶ This proposed change is identical to a proposal by another national securities exchange recently approved by the Commission. See Securities Exchange Act Release No. 56955 (December 13, 2007), 72 FR 71979 (SR-ISE-2007-101) (approving proposed Section 3.2 of the by-laws of the International Securities Exchange, LLC).

Committee nominates the individual then holding the office of CEO as Chairman of the Board for election by the Stockholders; (2) the Chairman recommends a Vice-Chairman candidate to the Nominating, Elections and Governance Committee for election by Stockholders; and (3) the Nominating, Elections and Governance Committee review the qualifications of nominees, including independent nominees, for the Stockholder Governors and Independent Governors (excluding the Designated Independent Governors).⁷⁷ Phlx now proposes that the holder of its common stock present for nomination to the Nominating, Elections and Governance Committee the candidates for Vice-Chair, Stockholder Governor, and Independent Governors.⁷⁸ These candidates would be placed on the ballot and elected by the holder of common stock at the annual meeting of Shareholders. Thus, NASDAQ OMX, as sole holder of common stock of the Exchange, would nominate and elect all of the non-Designated Governors. This approach is consistent with the NASDAQ Exchange's processes for nomination of non-Member Representative Directors by a nominating committee that may seek the input and recommendations of NASDAQ OMX as the owner of the NASDAQ Exchange.⁷⁹

The Exchange also proposes to change the process for removing non-Designated Governors. Currently, non-Designated Governors may be removed only for cause, except that upon a recommendation by the Board to Stockholders such Governors may be removed without

⁷⁷ See Section 28-3 of the By-Laws.

⁷⁸ See proposed Section 28-3 of the By-Laws. As proposed, Section 28-3 has no provision for the nomination or election of the Chair of the Board because the Board would appoint its Chair from among the members of the Board who are Independent Governors. See proposed Section 5-2 of the By-Laws.

⁷⁹ See NASDAQ Exchange By-Law Article III, Section 6.

cause. An affirmative vote of two-thirds of the total number of Stockholders entitled to vote thereon is required to remove a non-Designated Governor. The proposed change would more explicitly permit the removal of non-Designated Governors with or without cause, and to allow removal of such Governors by the affirmative vote of a majority of the voting power entitled to vote for their election (i.e., NASDAQ OMX).⁸⁰ This change would reflect the Exchange's proposed status as a wholly-owned subsidiary of NASDAQ OMX. The Board would continue to have the ability to recommend to the Stockholder that a Governor be removed for any reason deemed sufficient by the Board,⁸¹ but such recommendation would no longer be a prerequisite for removal.

The Commission finds that the proposed changes to the nomination, election, and removal processes for non-Designated Governors are consistent with Section 6(b)(1) of the Act, which requires an exchange to be organized in a manner that allows it to carry out the purposes of the Act. The proposed changes appropriately streamline the nomination, election, and removal processes for non-Designated Governors in light of NASDAQ OMX's ownership of all of the common stock of the Exchange.

⁸⁰ See proposed Article SIXTH (b)(i) of the Certificate. The Exchange also proposes to allow any action required or permitted to be taken at any annual or special meeting of Stockholders to be taken by Stockholders (i.e., NASDAQ OMX) without a meeting, unless otherwise specified in the Certificate. See proposed Article SEVENTH of the Certificate and proposed Section 28-13 of the By-Laws. In light of NASDAQ OMX's ownership of all of the common stock of the Exchange, the Commission finds this change to be consistent with the Act.

⁸¹ See proposed Section 4-4 of the By-Laws.

4. Fair Representation

Section 6(b)(3) of the Act requires that the rules of an exchange assure fair representation of its members in the selection of its directors and administration of its affairs.⁸² As discussed above, the Exchange proposes to give its Board discretion to determine its size.⁸³ Members would, nevertheless, continue to select at least 20% of the Board after the Merger, including the Member Governor, the PBOT Governor,⁸⁴ and the Designated Independent Governors (collectively, the “Designated Governors”).⁸⁵ These Designated Governors would continue to be elected by the Holder of Series A Preferred Stock (i.e., the Trust⁸⁶), and therefore they would continue to be elected indirectly by the Members. Phlx proposes to change Section 3-7(a) of the By-Laws, which prohibits a Member Organization from endorsing more than one nominee for Governor, to clarify that Member Organizations are prohibited from endorsing more than one nominee per vacancy. This proposed change is designed to clarify the rights of Members in the independent nomination process by eliminating any ambiguity that each Member Organization may endorse one independent nominee per Designated Governor vacancy, not one independent nominee per election.

⁸² 15 U.S.C. 78f(b)(3).

⁸³ See supra note 60 and accompanying text.

⁸⁴ A PBOT Governor would continue to be defined as a Governor who is a member of PBOT and is duly elected to fill the one vacancy on the Board allocated to the PBOT Governor. See Section 1-1(aa) of the By-Laws; see also proposed Article SIXTH(a)(i) of the Certificate.

⁸⁵ The nominations process for Designated Governors (i.e., the Designated Independent Governors, the Member Governor, and the PBOT Governor) is described in Section 3-7 of the By-Laws.

⁸⁶ See supra note 30 (discussing the purpose and operation of the Trust).

Designated Governors currently may be removed only for cause, unless the Board recommends that they be removed without cause. In either case, removal of a Designated Governor requires a vote by Member Organization Representatives at an annual or special meeting.⁸⁷ Phlx proposes to simplify the process to provide that Designated Governors may be removed, with or without cause, only by vote of Member Organization Representatives at an annual or special meeting.⁸⁸ The Board would continue to have the ability to recommend to the Members that a Designated Governor be removed for any reason deemed sufficient by the Board,⁸⁹ but such recommendation would no longer be a prerequisite for removal. Importantly, the Commission notes that the Designated Governors, which are selected by a vote of the Members, may only be removed upon the affirmative vote of Members. While the Board may recommend to the Members that a Designated Governor be removed, the Board may not unilaterally remove a Designated Governor.

In addition, Members will be represented on key Standing Committees. Specifically, under the By-Laws, at least half of the Admissions Committee and the Foreign Currency Options Committee will continue to be required to be permit holders or participants or be associated with a Member Organization or participant organization,⁹⁰ and at least half of the Options Committee will continue to be required to be permit holders or be associated with a Member Organization.⁹¹

⁸⁷ See Article SIXTH(b)(iii) of the Certificate.

⁸⁸ See proposed Section 3-3 of the By-Laws. A special meeting of the Members could be called either by Members, the Board, or the Chair of the Board. See Section 3-2(b) of the By-Laws. Such Governors could be removed by the holder of the Series A Preferred Stock following a vote of the Member Organization Representatives. See proposed Article SIXTH (b)(ii) of the Certificate.

⁸⁹ See proposed Section 4-4 of the By-Laws.

⁹⁰ See Sections 10-6(a) and 10-17 of the By-Laws.

⁹¹ See Section 10-20 of the By-Laws.

Further, the By-Laws will continue to require that the Business Conduct Committee share jurisdiction over the revocation of permits and foreign currency options participations in connection with disciplinary matters with the Admissions Committee.⁹²

Several Standing Committees also may review proposed rule changes before such proposals are presented to the Executive Committee or the Board for approval for filing with the Commission. These committees on which Members serve would continue to perform this function after the Merger. For example, the Business Conduct Committee may review proposed changes to the disciplinary provisions that are set forth in Rule 960 before such proposals are presented to the Executive Committee or the Board.⁹³ Further, the Options Committee makes or recommends for adoption such rules as it deems necessary for the convenient and orderly transaction of business upon the equity and index options trading floor, as well as makes and enforces rules and regulations relating to order, decorum, health, safety and welfare on the equity and index options trading floor and the immediately adjacent premises of the Exchange.⁹⁴ Additionally, the Exchange proposes to ensure Member representation on the Quality of Markets Committee.⁹⁵ Finally, Designated Governors, which are selected by Members, would compose at least 20% of the Executive Committee.⁹⁶

⁹² See Section 10-6(b) of the By-Laws.

⁹³ The Business Conduct Committee is composed of nine members as follows: three Independent Governors; one Member or person associated with a Member Organization who conducts business on XLE; one Member who conducts options business at the Exchange; and four persons who are Members or persons associated with a Member Organization. See Section 10-11 of the By-Laws.

⁹⁴ See Section 10-20 of the By-Laws.

⁹⁵ See *infra* notes 133-134 and accompanying text (discussing Member representation on the Quality of Markets Committee).

⁹⁶ See *infra* text accompanying note 110 (discussing the composition of the Executive Committee).

The Commission finds that the selection of at least 20% of Governors of the Board,⁹⁷ the manner in which such Designated Governors will be nominated and elected,⁹⁸ the process for removing Designated Governors,⁹⁹ together with the representation of Members on key Standing Committees, satisfy the fair representation requirements of Section 6(b)(3) of the Act,¹⁰⁰ which requires that an exchange assure a fair representation of its members in the selection of its directors and administration of its affairs. The Commission also notes that these provisions are consistent with previous proposals approved by the Commission.¹⁰¹

5. Special Committee of the Board

Phlx proposes to delete references to a “special committee of the Board of Governors” that hears appeals from determinations of the Nominating, Elections and Governance Committee on appeals concerning eligibility for election to the Board.¹⁰² The special committee had been composed of Governors who were not then standing for re-election. However, because the Exchange proposes to eliminate the staggering of the Board and require all Governors to be elected annually, it would not be possible to form such a special committee. Instead, the Exchange proposes that the full Board preside over such appeals.¹⁰³

The Commission finds that this proposal is consistent with Sections 6(b)(1) and 6(b)(3)

⁹⁷ See proposed Article SIXTH(a)(iv) of the Certificate and proposed Section 4-1 of the By-Laws.

⁹⁸ See supra Section III.C.2 and infra Section III.C.4, respectively.

⁹⁹ See supra Section III.C.3.

¹⁰⁰ 15 U.S.C. 78f(b)(3).

¹⁰¹ See, e.g., Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (approving the application of the NASDAQ Exchange for registration as a national securities exchange) and 49098, supra note 5.

¹⁰² See proposed Section 11-1(b) of the By-Laws.

¹⁰³ See id.

of the Act.¹⁰⁴ In particular, the Commission notes that Designated Governors selected by the Members will constitute at least 20% of the Board, and therefore Members will be represented when the Board acts as an adjudicative body to hear appeals concerning eligibility for election to the Board.

6. Standing Committees of the Board

The Exchange proposes several changes to its Standing Committees, which reflect incremental modifications to the structure and scope of its current committees. As discussed below, the Commission finds these changes to be consistent with the Act, including Section 6(b)(1) of the Act,¹⁰⁵ which requires that a national securities exchange be organized in such a manner as to allow the exchange to carry out the purposes of the Act, comply with the requirements of the Act, and enforce compliance with the Act by its members and persons associated with its members.

Automation Committee and the Marketing Committee. The Exchange proposes to eliminate two Standing Committees: the Automation Committee¹⁰⁶ and the Marketing Committee.¹⁰⁷ According to the Exchange, these committees are no longer necessary because, after the NASDAQ OMX Merger, these functions would be guided and handled at the parent company level.¹⁰⁸ The Commission believes that the elimination of these Exchange committees,

¹⁰⁴ 15 U.S.C. 78f(b)(1) and 15 U.S.C. 78f(b)(3).

¹⁰⁵ 15 U.S.C. 78f(b)(1).

¹⁰⁶ See Section 10-10 of the By-Laws. The Automation Committee currently is charged with periodically reviewing and approving automation plans affecting the trading floors, subsidiaries and the Exchange's administrative areas.

¹⁰⁷ See Section 10-18 of the By-Laws. The Marketing Committee currently acts in an advisory capacity to the officers of the Exchange in marketing the services of the Exchange.

¹⁰⁸ See Notice, supra note 3, 73 FR at 23295.

combined with Phlx's reliance on NASDAQ OMX to perform the functions of those committees, is consistent with Section 6(b)(1) of the Act, which requires a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act. The Commission notes that, as the Exchange contemplates future changes to its automated trading systems, the Exchange would be required file any changes to its rules with the Commission pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder.¹⁰⁹

Executive Committee. In addition, the Exchange proposes to change the composition of the Executive Committee and limit its authority. Currently, Section 10-14(a) provides that the Executive Committee be composed of the following nine members: the Chairman of the Board, who serves as Chair of the Committee; the Vice-Chairman of the Board; the Chairman of the Finance Committee; the Chairmen of two floor committees; two Stockholder Governors; and two Independent Governors. Phlx proposes to amend this provision to allow the Board to determine the size of the committee, except that the Committee must include: the Chair of the Board, who would be the Chair of the Committee; the Vice-Chair of the Board; the Stockholder Governor; and a number of Designated Governors equal to at least 20% of the total number of Governors on the committee.¹¹⁰

The Executive Committee currently appoints, subject to approval by the Board, all members (except the Chairmen) of the Standing Committees, excluding the Nominating,

¹⁰⁹ 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

¹¹⁰ See supra text accompanying note 96 (discussing the representation of Designated Governors on the Executive Committee).

Elections and Governance Committee and the Executive Committee.¹¹¹ The Exchange now proposes to instead provide that the Board, instead of the Executive Committee, select all members of Standing Committees,¹¹² including most Standing Committee Chairs.¹¹³ This change would conform the Exchange's practice to how NASDAQ OMX currently operates.¹¹⁴ The Commission finds that these changes are consistent with Sections 6(b)(1) and 6(b)(3) of the Act.¹¹⁵

Audit Committee. Phlx proposes to modify the responsibilities of the Audit Committee to conform to similar responsibilities and processes of the Audit Committees of NASDAQ OMX and the NASDAQ Exchange.¹¹⁶ Specifically, Phlx proposes to replace the enumerated duties of the committee with respect to external auditors with a more general charge to select, evaluate and, where appropriate, replace the Exchange's independent auditors (or nominate the

¹¹¹ See Sections 10-1(b), 10-4, and 10-14(c) of the By-Laws. Chairmen of the Standing Committees are selected, subject to Board approval, by the Nominating, Elections and Governance Committee. See Section 10-19(d) of the By-Laws.

¹¹² See proposed Sections 10-1(b) and 10-4 of the By-Laws. Correspondingly, the Exchange proposes to delete Sections 10-14(c) and 10-19(d) of the By-Laws which provide, respectively, that the Executive Committee shall appoint members of the Standing Committees (excluding their Chairmen), subject to Board approval, and that the Nominating, Elections and Governance Committee shall select all Standing Committee Chairmen, subject to approval by the Board.

¹¹³ As amended, the By-Laws would specifically provide that: (1) the Chair of the Board is the Chair of the Executive Committee; (2) the Chair of the Board is the Chair of the Finance Committee; and (3) the Nominating, Elections and Governance Committee select its own Chair from among the members of such Committee who are Independent Governors. See proposed Sections 10-14(a), 10-15 and 10-19(a) of the By-Laws, respectively.

¹¹⁴ See NASDAQ OMX By-Law Article IV, Section 4.13.

¹¹⁵ 15 U.S.C. 78f(b)(1) and 15 U.S.C. 78f(b)(3).

¹¹⁶ See NASDAQ OMX Audit Committee Charter approved April 18, 2007 and NASDAQ Exchange By-Law Article III.

independent auditors to be proposed for ratification by the Stockholders).¹¹⁷ Phlx would also confer to the committee more specific responsibilities with respect to the Exchange's Internal Audit Department ("IAD"), including authority to hire or terminate the head of the IAD and determine the IAD's budget. Further, Phlx proposes to eliminate the requirement that the committee review all legal matters that may materially impact the Exchange's financial statements and all regulatory examination, inspection, and other reports. The Commission finds these changes consistent with Section 6(b)(1) of the Act, and notes that such changes are based on the Audit Committees of NASDAQ OMX and the NASDAQ Exchange.

Finance Committee. The Exchange proposes to change the composition of the Finance Committee and update the description of the committee's responsibilities.¹¹⁸ Currently, the committee is composed of the following nine members: the Chairman of the Board; the Vice-Chairman of the Board; one Stockholder Governor; four Independent Governors, and two Members or persons associated with a Member Organization, one of whom conducts business primarily on XLE or on the equity options floor. Phlx proposes that following the Merger, the Finance Committee would be composed of: the Chair of the Board; the Vice-Chair of the Board; a number of Designated Independent Governors equal to at least 20% of the total number of voting members on the Finance Committee; two Members or persons associated with a Member Organization who may be Governors one of whom conducts business on XLE or on the equity

¹¹⁷ Compare Section 10-9(b) of the By-Laws with proposed Section 10-9 of the By-Laws.

¹¹⁸ See proposed Section 10-15 of the By-Laws. The Exchange proposed to delete the Supplementary Material in Section 10-15, which sets forth a series of directives issued by the Board that were specifically applicable to the Finance Committee. These proposed changes are not directly related to the Merger.

options floor;¹¹⁹ and such other Governors as the Board may appoint.¹²⁰ Phlx states that the elimination of the requirement that one of the committee members “primarily” conduct business on XLE or the equities option floor would allow a greater pool of candidates to be eligible to serve on the Finance Committee and is consistent with a recent change to Section 10-11 of the By-Laws.¹²¹

The Exchange also would eliminate the current restriction that prohibits the Chair of the Board from creating tie votes of the Finance Committee, and would designate the Chair of the Board as the Finance Committee Chair.¹²² Finally, the Exchange proposes to delete the Supplementary Material that sets forth a series of directives issued by the Board that are specifically applicable to the Finance Committee.¹²³ Elimination of the Supplementary Material is designed to allow the Board flexibility in establishing capital expenditure policies, which may include delegation to Board committees and/or officers. The Exchange states that this more

¹¹⁹ Under the proposal, these committee members need not be Governors, but any non-Governor would serve in a non-voting capacity. See proposed Section 10-15 of the By-Laws.

¹²⁰ See proposed Section 10-15 of the By-Laws.

¹²¹ See Notice, supra note 3, 73 FR at 23296. The Commission notes that this change is similar to a recently-approved change to a different By-Law. See Securities Exchange Act Release No. 57023 (December 20, 2007), 72 FR 74398 (December 31, 2007) (SR-Phlx-2007-83) (approving a proposal to similarly expand the type of business that may be conducted to qualify as a Business Conduct Committee member).

¹²² Under the current provision, the Chair of the Committee must be either the Vice-Chair, Stockholder Governor, or Member Governor.

¹²³ Currently, the supplementary material relates to directives that are applicable to the Finance Committee in the exercise of its duties, powers and authority under the By-Laws. For example, the supplementary material states that the Finance Committee may authorize certain expenditures of any budgeted line items; may delegate to the staff of the Exchange so much of its authority to make expenditures as it deems appropriate; and shall perform its functions and act with the same powers and limitations for the Exchange and all subsidiaries of the Exchange. See Supplementary Material to Section 10-15 of the By-Laws.

flexible approach is consistent with NASDAQ OMX's processes.¹²⁴ The Commission finds that this proposal is consistent with Section 6(b)(1) of the Act, and notes that Phlx's obligation to adequately fund its regulatory oversight program¹²⁵ is unaffected by the proposed elimination of the Supplementary Material to Section 10-15 of the By-Laws.

Nominating, Elections and Governance Committee. The Exchange also proposes certain changes to the composition of the Nominating, Elections and Governance Committee. Currently, the committee is composed of three Independent Governors, at least one of which is a Designated Independent Governor, one Stockholder Governor, and one Member Governor. As proposed, the committee would be composed of four Independent Governors and one Member Governor.¹²⁶ The Exchange also proposes to delete the term limit applicable to this committee and delete the prohibition against members of this committee standing for re-election to the Board. These proposals are designed, according to the Exchange, to increase the pool of candidates eligible to serve on the Committee and the Board.¹²⁷ The Commission finds that these changes are consistent with Section 6(b)(1) of the Act. The Commission notes that it recently approved a similar Phlx proposal to increase the pool of candidates eligible to serve on one of Phlx's Standing Committees.¹²⁸

¹²⁴ See Notice, *supra* note 3, 73 FR at 23296.

¹²⁵ 15 U.S.C. 78s(g).

¹²⁶ See proposed Section 10-19(a) of the By-Laws.

¹²⁷ See Notice, *supra* note 3, 73 FR at 23296.

¹²⁸ See Securities Exchange Act Release No. 57023, *supra* note 121.

Quality of Markets Committee. Phlx proposes to clarify the requirement that the Quality of Markets Committee include at least as many Independent members¹²⁹ as it does the “combined number” of Stockholder-chosen members and members who are Members of the Exchange.¹³⁰ The addition of the language “combined number” makes clear that the number of Stockholder-chosen committee members¹³¹ are added to the number of Members serving on the committee¹³² and that total is then compared to the number of “Independent” committee members, who do not have to be Governors.

Additionally, the Exchange proposes to adopt a new requirement that at least 20% of the total number of committee members be Members.¹³³ This is designed to provide fair representation of Phlx members on this committee and harmonize the role of the committee with that of the NASDAQ Exchange’s Quality of Markets Committee.¹³⁴

7. Officers of the Exchange

The Exchange proposes various changes with respect to officers of the Exchange. First, the Exchange proposes to separate the roles of Chairman of the Board and CEO. The CEO

¹²⁹ “Independent” committee members would be “Independent” within the meaning of Section 1-1(o) of the By-Laws.

¹³⁰ See proposed Section 10-21 of the By-Laws.

¹³¹ NASDAQ OMX, as Stockholder, would select the Stockholder member(s) of this committee. See Notice, supra note 3, 73 FR 23296.

¹³² The Board would select the Member(s) serving on the committee pursuant to Section 10-1(b) of the By-Laws.

¹³³ See proposed Section 10-21 of the By-Laws.

¹³⁴ See NASDAQ Exchange By-Law Article III, Section 6. See supra text accompanying notes 95 and 97-100.

would be ineligible to serve as Chair of the Board,¹³⁵ and the By-Laws would be amended to describe separately the responsibilities of the Chair of the Board and the CEO.¹³⁶

Second, under the proposed rule change, the Board, instead of the CEO/Chairman, would appoint all officers of the Exchange, and would fix their duties, responsibilities, and terms of appointment.¹³⁷

Third, Phlx proposes to set forth in detail the powers and duties relating to the Chair, Vice-Chair, and officers of the Exchange.¹³⁸

Fourth, the Exchange proposes to create an office of President who would, in the absence of the Chair of the Board and the CEO, preside at all meetings of the Board at which the President is present. Additionally, the President would have all powers and duties usually incident to the office of the President, except as specifically limited by the Board, and would be charged with general supervision of Exchange operations.¹³⁹ The Exchange also proposes to delete current Section 5-5 of the By-Laws, which addresses contingencies in the event the Chairman of the Board is unable to serve. The elimination of this provision reflects the changes to the role of the Chair of the Board and the creation of a separate CEO position, as well as the new position of President.

¹³⁵ The Board would select its Chair from among the Independent Governors. See proposed Section 5-2 of the By-Laws.

¹³⁶ See proposed Sections 5-2 and 5-4 of the By-Laws. Under the current By-Laws, only the responsibilities of the Chairman of the Board are described (in Section 5-1 of the By-Laws).

¹³⁷ See proposed Sections 5-1, 5-4, 5-5, 5-8, 5-9 and 5-10 of the By-Laws.

¹³⁸ See Article V of the By-Laws. These provisions are intended to be generally consistent with current NASDAQ OMX By-Law Article VII, and NASDAQ Exchange By-Law Article IV.

¹³⁹ See proposed Section 5-5 of the By-Laws.

The Commission finds that these proposed changes are consistent with the Act, including Section 6(b)(1) of the Act, which requires, among other things, that a national securities exchange be organized to carry out the purposes of the Act and comply with the requirements of the Act. Under these circumstances, the Commission believes that the creation of an independent Chair of the Board should foster a greater degree of independent decision-making by the governing body of the Exchange and mitigate the conflict between an SRO's regulatory functions on the one hand, and its business operations on the other.

D. Interpretations of and Amendments to the By-Laws

The Exchange proposes to clarify the process governing By-Law interpretations and amendments. With respect to interpretations, Section 4-17 of the By-Laws grants to the Board power to interpret the By-Laws and rules adopted pursuant thereto, and provides that any such interpretations are final, binding, and conclusive. Phlx proposes to clarify that the Board must determine affirmatively whether such interpretations must be filed with the Commission as proposed rule changes, and, if so, provides that any such interpretation not become effective until filed with, or filed with and approved by, the Commission.¹⁴⁰

With respect to amendments, Section 22-1 currently allows the By-Laws to be amended by either: (1) an affirmative vote of a majority of the entire Board at any regular or special meeting of the Board; or (2) the affirmative vote of the holders of a majority of the shares of common stock of the Exchange then issued and outstanding at any regular or special meeting of the Stockholders. The Exchange proposes to amend this provision to state affirmatively that By-Law amendments must be filed with, or filed with and approved by, the Commission. The

¹⁴⁰ See proposed Section 4-17 of the By-Laws.

Exchange also proposes to require that both the Board and the holder of common stock of the Exchange approve proposed By-Law amendments.¹⁴¹

The Commission finds that proposed Sections 4-17 and 22-1 of the By-Laws are consistent with Section 6(b)(1) of the Act,¹⁴² because they reflect the obligation of the Board to ensure compliance with the rule filing requirements under the Act. Additionally, the Commission finds these changes to be consistent with Section 19(b)(1) of the Act and Rule 19b-4 under the Act, which require that an SRO file with the Commission all proposed rules, as well as all proposed changes in, additions to, and deletions of its existing rules. These provisions clarify that certain By-Law interpretations and all By-Law amendments constitute proposed rule changes within the meaning of Section 19(b)(2) of the Act and Rule 19b-4 under the Act,¹⁴³ and obligate the Exchange's Board to affirmatively make those determinations.

E. Other Changes

1. Provisions Applicable to Common Stock

Phlx proposes a number of changes that reflect the proposed ownership by NASDAQ OMX of all the common stock of the Exchange. For example, Phlx proposes to delete the following provisions: (1) Article FOURTH(b)(iv) of the Certificate, which requires written notice to the Board of intention to acquire more than 5% of the Exchange's outstanding common stock; (2) Section 29-1 of the By-Laws, which requires that sales, transfers, and other

¹⁴¹ See proposed Section 22-1 of the By-Laws. Under the current provision, By-Law amendments must be approved by either the Board or the holders of a majority of common stock of the Exchange. The Commission notes that Stockholder approval could be obtained outside of a regular or special meeting of the Stockholders by unanimous written consent pursuant to proposed Section 28-13 of the By-Laws.

¹⁴² 15 U.S.C. 78f(b)(1).

¹⁴³ See Section 3(a)(27) of the Act (defining proposed rule change).

dispositions of common stock be in blocks of 100 shares; (3) Section 29-2 of the By-Laws, governing lockups; (4) Section 29-5 of the By-Laws, regarding reimbursement for expenses incurred in connection with any transfer of capital stock; (5) Section 30-1 of the By-Laws, regarding stock certificates; (6) Section 30-2 of the By-Laws, concerning closing of the transfer books and determination of record dates; and (7) Article FOURTH(c)(v)(C) of the Certificate and Sections 29-4 and 30-3 of the By-Laws, which allow the Exchange to not register any transfer of capital stock of the Exchange that violates certain provisions of the Certificate or By-Laws. Additionally, existing provisions in Article XXIX of the By-Laws that contemplate a possible public offering of the Exchange's stock would be deleted and replaced with restrictions on stock transfer discussed above.¹⁴⁴ Because these provisions are applicable to non-public companies with several stockholders, the Exchange does not believe these provisions would be applicable following the Merger. In addition, the Exchange proposes to delete provisions that govern the use of common stock and/or common stock option incentive compensation that may be awarded to Governors and officers of the Exchange,¹⁴⁵ because such compensation would no longer be feasible if NASDAQ OMX owned 100% of the common stock of the Exchange.¹⁴⁶ The Commission finds that the elimination of these obsolete provisions are consistent with the Act and do not raise any novel regulatory issues.

¹⁴⁴ See supra notes 33-43 and accompanying text (discussing the proposed limits on issuing, transferring, and assigning Phlx capital stock).

¹⁴⁵ See Section 6-1 of the By-Laws.

¹⁴⁶ The Exchange notes that, in the future, potential equity stock compensation would likely consist of NASDAQ OMX stock. See Notice, supra note 3, 73 FR at 23295.

2. Specified Board Votes

Sections 13-5,¹⁴⁷ 13-7,¹⁴⁸ 17-4,¹⁴⁹ and 18-3¹⁵⁰ of the By-Laws reference an affirmative vote of either 14 or 15 Governors, which used to represent a supermajority of the Board. The Exchange proposes to modify these provisions to remove the numerical reference and instead require an affirmative vote of a majority of all Governors. This change is consistent with the governing documents of Phlx's proposed parent company, NASDAQ OMX, where a supermajority vote is required only when the voting power of the then-outstanding stock entitled to vote is implicated.¹⁵¹ The Commission finds that these changes maintain the requirement of a minimum majority Board vote and are consistent with Section 6 of the Act.

¹⁴⁷ Section 13-5 of the By-Laws (Liability of Officers, Directors and Substantial Stockholders) imposes personal liability on officers, directors, and substantial stockholders of a Member Organization that is an Exchange Member when that corporation violates the By-Laws or the Rules. The Board, however, may vote to relieve the person of such personal liability.

¹⁴⁸ Section 13-7 of the By-Laws (Violation of Terms of Registration) provides the Board may vote to terminate the registration of a Member Organization for violating or failing to meet of the terms and conditions of its registration.

¹⁴⁹ Section 17-4 of the by-Laws (Time for Settlement of Insolvent Member or Participant) allows for the termination of a permit or participation when a Member or foreign currency options participant whose permit or rights and privileges have been suspended fails to settle with his creditors and apply for reinstatement within six months from the time of such suspension (or within such further time as the Board of Governors grants) or fails to obtain reinstatement. The Board, however, may vote to grant to extend the time for settlement.

¹⁵⁰ Section 18-3 of the By-Laws (Responsibility of Member or Participant for Acts of His Organization) imposes personal liability on a Member or foreign currency options participant that is a general partner in a Member Organization or participant organization for violations of the By-Laws or Rules by the partnership. The Board, however, may vote to relieve the general partner of such personal liability or reduce the amount of such liability.

¹⁵¹ See, e.g., Section 4.6 of the NASDAQ OMX By-Laws.

3. Capital Stock

The Exchange proposes to eliminate the current provisions of Article XXIX of the By-Laws that govern restrictions on transfers of capital stock of the Exchange. The proposed new provisions of Article XXIX include but are not limited to transfer restrictions on the capital stock of the Exchange.¹⁵² In particular, proposed Sections 29-1, -2, -3, -5, -6, and -7 address stock certificates, stock ledgers, transfers of stock, and record date, respectively. The Exchange states that these are standard provisions for a Delaware stock corporation and contemplate ownership of all common stock of the Exchange by NASDAQ OMX.¹⁵³ The Commission notes that these new provisions are based on NASDAQ OMX By-Law Article IX, Capital Stock, Sections 9.1 through 9.7. The Commission finds that these changes are consistent with Section 6 of the Act and do not raise any novel regulatory issues.

4. Payment of Dividends

Proposed Section 29-8 of the By-Laws, which is similar to Section 15 of the LLC Agreement of the NASDAQ Exchange, would prohibit the Exchange from using Regulatory Funds to pay dividends.¹⁵⁴ The Commission finds that the prohibition on the use of regulatory fines, fees, or penalties to fund dividends is consistent with Section 6(b)(1) of the Act because it will further Phlx's ability to effectively comply with its statutory obligations and is designed to

¹⁵² The proposed restrictions on Phlx capital stock are discussed supra notes 33, 43, and accompanying text.

¹⁵³ See Notice, supra note 3, 73 FR at 23297.

¹⁵⁴ Proposed Section 1-1(kk) of the By-Laws defines "Regulatory Funds" as fees, fines, or penalties derived from the regulatory operations of the Exchange. However, Regulatory Funds do not include revenues derived from listing fees, market data revenues, transaction revenues, or any other aspect of the commercial operations of the Exchange even if a portion of such revenues are used to pay costs associated with the regulatory operations of the Exchange. See id.

ensure that the regulatory authority of the Exchange is not improperly used.¹⁵⁵ This restriction on the use of regulatory funds is intended to preclude Phlx from using its authority to raise regulatory funds for the purpose of benefiting its shareholders, or for other non-regulatory purposes, such as to fund executive compensation.

5. Special Meetings

Current Section 4-14 of the By-Laws empowers only the Chairman of the Board or, in certain, circumstances, the Vice-Chairman of the Board, to call special meetings of the Board. The Exchange proposes to broaden this provision to also allow the interim Chair of the Board to call special meetings of the Board, under certain circumstances. The Commission finds that this proposal is consistent with Section 6(b)(1) of the Act, which requires a national securities exchange to be organized in such a way so as to be capable of carrying out the purposes of the Act. In particular, the Commission believes that this change will provide additional flexibility where appropriate to the Board to convene special meetings to conduct the business of the Exchange.

6. Annual Report and Weekly Bulletin

Section 4-21 of the By-Laws requires the distribution of an annual, independently-audited financial report of the Exchange to Stockholders, Members, participants, Member Organizations, and participant organizations. Phlx proposes to delete this requirement and instead require that annual financial reports be kept on file at the Exchange and made available for inspection upon

¹⁵⁵ See, e.g., Securities Exchange Act Release No. 51029 (January 12, 2005), 70 FR 3233, 3241 (January 21, 2005) (SR-ISE-2004-29) (approving an International Securities Exchange, LLC rule interpretation that requires that revenues received from regulatory fees or regulatory penalties be segregated and applied to fund the legal, regulatory, and surveillance operations of the Exchange and not used to pay dividends to the holders of Class A Common Stock).

request to any Stockholder, Member, participant, Member Organization, or participant organization. The Exchange states that financial information on the Exchange also would be reflected in the public consolidated financial statements of NASDAQ OMX once the Merger is complete, and the Commission notes that this proposal does not affect the requirement that Phlx comply with Rule 6a-2 under the Act to amend its Form 1.¹⁵⁶ Further, Phlx proposes to change how its Weekly Bulletin is distributed. Section 12-5(d) of the By-Laws provides that it must be mailed, and the Exchange proposes to update this provision to permit distribution by email and posting on the Exchange's Web site. The Commission finds that these changes are consistent with Section 6 of the Act and do not raise any novel regulatory issues.

7. Stock Exchange Fund and Gratuity Fund

The Exchange proposes to eliminate Sections 9-1 through 9-6 of the By-Laws relating to the Stock Exchange Fund.¹⁵⁷ The purpose of the Stock Exchange Fund is to appoint trustees to manage the investment of certain funds of the Exchange and collect interest, dividends, and income from the funds for the Exchange. The Exchange believes these provisions are unnecessary because, after the Merger, the financial management of the Exchange will be overseen directly by the Board and subject to public company financial controls established by NASDAQ OMX. Similarly, the Exchange proposes to delete a provision in Section 4-4 of the By-Laws relating to the gratuity fund. This provision is obsolete, as the Exchange states that the fund no longer exists.¹⁵⁸

¹⁵⁶ 17 CFR. 249.1.

¹⁵⁷ Correspondingly, the Exchange proposes to delete references to the Stock Exchange Fund in Section 4-4 of the By-Laws.

¹⁵⁸ See Notice, supra note 3, 73 FR at 23295, n.31.

8. Miscellaneous Changes

Additionally, the Exchange proposes to make the following changes to the Certificate and By-Laws to correct typographical errors, effect stylistic changes, move text, and/or update the language to more accurately reflect current practices. The Exchange proposes to:

- change the title of the Certificate;
- update the address of its registered office in Delaware;¹⁵⁹
- correct an error by changing the term “Board of Directors” to “Board of Governors;”¹⁶⁰
- update cross-references;¹⁶¹
- add new definitions to its By-Laws and Rules;¹⁶²

¹⁵⁹ See proposed Article SECOND of the Certificate.

¹⁶⁰ See Article FOURTH of the Certificate

¹⁶¹ See proposed Article FOURTH(b)(iii) of the Certificate and proposed Sections 1-1(w) of the By-Laws.

¹⁶² For example, the Exchange proposes to add a definition of the terms: “Commission;” “NASDAQ OMX Merger” (Phlx also proposes to define the term “NASDAQ OMX Merger” in its proposed Rule 1(qq)); “Regulatory Funds;” “Preferred Stock;” and “Trust,” and update the definition of the term “Trust Agreement.” Additionally, Phlx would eliminate the defined term “Class A Common Stock” and modify the term “Common Stock,” in accordance with its proposal to issue only one class of common stock. The Exchange also proposes to modify the definitions of “Member Governor” and “Stockholder Governor” to correspond with its proposal to decrease the number of Member Governors from two to one, and the number of Stockholder Governors from six to one.

- eliminate certain language from the Certificate that is also in the By-Laws;¹⁶³
- replace the term “Chairman” with “Chair” in referencing the head of the Board¹⁶⁴ and the heads of Board committees;¹⁶⁵
- replace the term “Vice-Chairman” with “Vice-Chair;”¹⁶⁶
- replace references to the “director” of either the Membership Services or Examinations Departments in Sections 17-1 and 17-3 of the By-Laws with more general references to the departments;¹⁶⁷
- replace the terms “Stockholder” and “Stockholders” with stockholder and stockholders, respectively;¹⁶⁸
- replace “without” with “outside of” in Article TWELFTH of the Certificate;
- use the defined term “Member” (instead of “member”) in the definition of “non-member;”¹⁶⁹
- use the term “Member Organization” instead of “member organization;”¹⁷⁰

¹⁶³ The language in Article SIXTH(b)(i)-(ii) of the Certificate, which Phlx proposes to eliminate, is also in Section 4-4(b)(ix)-(x) of the By-Laws.

¹⁶⁴ See, e.g., proposed Section 4-11 of the By-Laws.

¹⁶⁵ See, e.g., proposed Section 8-1 of the By-Laws.

¹⁶⁶ See, e.g., proposed Section 4-14 of the By-Laws.

¹⁶⁷ Under the proposed rule, notices would still be required to be sent to these departments, but not necessarily to the director.

¹⁶⁸ See, e.g., Article TENTH of the Certificate. The term “Stockholder Governor” would remain, although the term “Stockholder Governors” would be made singular (i.e., “Stockholder Governor”) to reflect the Exchange’s proposal to reduce the number of such Governors from six to one.

¹⁶⁹ See proposed Sections 1-1(o), 1-1(y), 3-12(a), 10-14(d), 12-7, 13-1, 13-5, 13-8, 14-11, 16-1, and 20-3 of the By-Laws.

¹⁷⁰ See proposed Sections 4-6(b), 10-14(d), 10-17, and 17-2 (adding both Member Organization and participant organization) of the By-Laws.

- update the definition of “Trust Agreement,”¹⁷¹ and
- correct typographical errors in Section 4-4 of the By-Laws (i.e., add “the” to (b)(i), add “a” to (b)(vi), and replace “also” with “and.”

The Commission finds these changes to be consistent with Section 6 of the Act generally, including Section 6(b)(1). The proposed minor changes update the Exchange’s governing documents and make them more internally consistent, and thereby facilitate Members’ understanding of their obligations and the Exchange’s ability to administer its rules.

F. Changes to Exchange Rules

The Exchange proposes to amend Rule 98 (Emergency Committee) to provide the Board with discretion concerning the composition of the Emergency Committee. Currently, the composition of the Emergency Committee is fixed to consist of the Chairman of the Board, the On-Floor Vice-Chairman of the Exchange, the Off-Floor Vice-Chairman of the Exchange,¹⁷² and the Chairmen of the Options and Foreign Currency Options Committees. The Commission notes that other exchanges also have an emergency committee whose composition is determined by the board of the exchange.¹⁷³ The Commission believes that the proposed changes to Rule 98 (Emergency Committee) should provide the Board with greater flexibility to manage the affairs of the Exchange in an emergency and are consistent with Sections 6(b)(1) of the Act,¹⁷⁴ which

¹⁷¹ See proposed Section 1-1(ee) of the By-Laws.

¹⁷² The Exchange states that the position of Off-Floor Vice-Chairman of the Exchange no longer exists and reference to this position remained in Rule 98 inadvertently. See Notice, supra note 3, 73 FR at 23297.

¹⁷³ See, e.g., American Stock Exchange LLC Constitution, Article XII, Emergency Committee.

¹⁷⁴ 15 U.S.C. 78f(b)(1).

requires, among other things, a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act.

The Exchange also proposes to amend Rule 164 (Trading Halts) to provide the Board with discretion in designating the officers of the Exchange responsible for declaring any trading halts when in their opinion such suspension would be in the public interest. Currently, only the Chairman and Chief Executive Officer or his designee has the authority to suspend trading pursuant to Rule 164. The Commission believes that the proposed change to Rule 164 (Trading Halts) is consistent with the Act, and in particular with Sections 6(b)(1) and 6(b)(5) of the Act,¹⁷⁵ which require, among other things, that an exchange be organized and have the capacity to carry out the purposes of the Act and have rules designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest, because it will continue to allow the Exchange to respond in a timely manner, consistent with the Exchange's rules, to a situation where suspension of trading would be in the public interest. Currently, the Chairman and Chief Executive Officer¹⁷⁶ is authorized to suspend trading pursuant to Rule 164 or to delegate that power to another individual.¹⁷⁷ The Commission believes that, by making the Board responsible for trading suspension decisions, or alternatively for deciding to which Exchange officers that authority

¹⁷⁵ 15 U.S.C. 78f(b)(1) and 15 U.S.C. 78f(b)(5), respectively.

¹⁷⁶ Under the proposed rule change, there would no longer be one position entitled "Chairman and Chief Executive Officer." See *supra* Section III.C.7 and more specifically note 136 and accompanying text (explaining the proposal to separate the roles of Chairman and Chief Executive Officer).

¹⁷⁷ See Securities Exchange Act Release No. 54538 (September 28, 2006), 71 FR 59184, 59188 (October 6, 2006) (SR-Phlx-2006-43) (approving current Rule 164).

should be delegated, the proposal strengthens Board oversight of decisions to halt trading and makes Rule 164 less susceptible to any potential abuse of discretion.

Finally, the Exchange proposes to add to Rule 1 (Definitions) a definition of the NASDAQ OMX Merger.¹⁷⁸ The Exchange also proposes to amend Rule 972 (Continuation of Status After the NASDAQ OMX Merger) to reflect that current members, inactive nominees, member organizations, foreign currency options participants, foreign currency options participant organizations, as well as approved lessors of foreign currency options participations holding such status prior to the Merger would continue to hold such status following the Merger.¹⁷⁹ This change clarifies that current members and participants would continue in their current status following the Merger and would continue to have uninterrupted access to the Exchange.¹⁸⁰

G. Additional Reporting Requirements for Listing Affiliated Securities

The Exchange proposes to adopt new Rule 990, which is based on NASDAQ Exchange Rule 4370.¹⁸¹ Rule 990 would impose heightened requirements on Phlx if it lists a security of NASDAQ OMX or any of its affiliates (“Nasdaq Affiliates”). In the event that a Nasdaq Affiliate lists a security (the “Affiliate Security”) on Phlx, the proposed rule would require Phlx to file a report with the Commission on a quarterly basis detailing Phlx’s monitoring of: (1) the Nasdaq Affiliate’s compliance with the provisions of the Rule 800 Series; and (2) the trading of the Affiliate Security, including summaries of all related surveillance alerts, complaints,

¹⁷⁸ See proposed Rule 1(qq).

¹⁷⁹ This provision was adopted in connection with, and currently refers to, the Exchange’s 2004 demutualization.

¹⁸⁰ This provision was adopted in connection with, and currently refers to, the Exchange’s 2004 demutualization.

¹⁸¹ See NASDAQ Exchange Rule 4370. See also NYSE Rule 497, Additional Requirements for Listed Securities Issued by NYSE Euronext or its Affiliates.

regulatory referrals, trades cancelled or adjusted pursuant to Rule 163, investigations, examinations, formal and informal disciplinary actions, exception reports and trading data.

The Exchange also would be required to notify the Commission at the same time it notifies the Nasdaq Affiliate if the Exchange determines that the Nasdaq Affiliate was not in compliance with any of its listing standards. Phlx would be required to notify the Commission within five business days of its receipt of a plan of compliance from the Nasdaq Affiliate and advise the Commission on whether the plan of compliance was accepted by Phlx or what other action was taken with respect to the plan, and the time period provided to regain compliance with the Rule 800-Series, if any.

In addition, the Exchange would be required to commission an annual review and report by an independent accounting firm of the compliance of the Affiliate Security with the Rule 800 Series. The Exchange would be required to furnish promptly a copy of the report to the Commission.

The listing of an Affiliate Security on Phlx could potentially create a conflict of interest between the Phlx's regulatory responsibilities to vigorously oversee the listing and trading of an Affiliate Security on Phlx, and its own commercial or economic interests. Such listing may raise questions as to the Phlx's ability to independently and effectively enforce the Commission's and the Exchange's rules against a Nasdaq Affiliate. Proposed Rule 990 is designed to address this concern.

The Commission finds that that proposed Rule 990 is consistent with Sections 6(b)(1) and 6(b)(5) of the Act¹⁸² because it requires heightened reporting by Phlx to the Commission with respect to oversight of the listing and trading on Phlx of an Affiliate Security and will assist

Phlx in effectively enforcing its Rules with respect to the listing and trading of these securities. In addition, the requirement that an independent accounting firm review such issuer's compliance with Phlx's listing standards adds a degree of independent oversight to Phlx's regulation of the listing of these securities, which may mitigate any potential or actual conflicts of interest and should help ensure thorough oversight of the Affiliate Security on the same basis as any other listed security.

H. Restriction on Affiliation with NASDAQ OMX

1. Limitation on Phlx Members' Ownership of NASDAQ OMX

The Exchange proposes to adopt new Rule 985(a) to prohibit Members¹⁸³ and persons associated with Members from beneficially owning more than 20% of the then-outstanding voting securities of NASDAQ OMX.¹⁸⁴ Members that trade on an exchange traditionally had ownership interests in such exchange. As the Commission has noted in the past, however, a member's interest in an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to

¹⁸² 15 U.S.C. 78f(b)(1) and 15 U.S.C. 78f(b)(5), respectively.

¹⁸³ The Rules use the term "members" to refer to members of the Exchange (previously defined as "Members").

¹⁸⁴ See proposed Rule 985(a).

The Commission also notes that NASDAQ OMX's Restated Certificate of Incorporation imposes limits on direct and indirect changes in control that are designed to prevent any shareholder from exercising undue control over the operation of the exchange and to ensure that the exchange and the Commission are able to carry out their regulatory obligations under the Act. Specifically, no person, which would include any Member, who beneficially owns shares of common stock, preferred stock, or notes in excess of five percent of the securities generally entitled to vote may vote the shares in excess of five percent. See NASDAQ OMX Certificate of Incorporation Article Fourth.C.

that member.¹⁸⁵ A member that is a controlling shareholder of an exchange or an exchange's holding company might be tempted to exercise that controlling influence by pressuring or directing the exchange to refrain from, or the exchange otherwise may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions.¹⁸⁶

The Commission finds that the ownership restriction in proposed Rule 985(a), combined with the voting limitations in NASDAQ OMX's Certificate of Incorporation Article Fourth.C and By-Law 12.5,¹⁸⁷ is consistent with the Act, including Sections 6(b)(1) and 6(b)(5) of the Act. These limitations should minimize the potential that a Phlx member could improperly interfere with or restrict the ability of the Commission or the Exchange to effectively carry out their regulatory oversight responsibilities under the Act.

2. Limitations on Affiliation between Phlx and its Members

Proposed Rule 985(b) would prohibit Phlx or an entity with which it is affiliated from acquiring or maintaining an ownership interest in, or engaging in a business venture¹⁸⁸ with, a

¹⁸⁵ See Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14521, 14523 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080); 55389 (March 2, 2007) 72 FR 10575, 10578 (March 8, 2007) (SR-CBOE-2006-110); 55293 (February 14, 2007), 72 FR 8033, 8037 (February 22, 2007) (SR-NYSE-2006-120); 53382 (February 27, 2006), 71 FR 11251, 11257 (March 6, 2006) (SR-NYSE-2005-77); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131); 51149 (February 8, 2005), 70 FR 7531, 7538 (February 14, 2005) (SR-CHX-2004-26); 49718 (May 17, 2004), 69 FR 29611, 29624 (May 24, 2004) (SR-PCX-2004-08); 49098, *supra* note 5 at 3986; and 49067 (January 13, 2004), 69 FR 2761, 2767 (January 20, 2004) (SR-BSE-2003-19).

¹⁸⁶ See, e.g., Securities Exchange Act Release No. 49718, *supra* note 185 at 29624.

¹⁸⁷ See *supra* Section III.B (discussing the voting limits applicable to NASDAQ OMX securities).

¹⁸⁸ Phlx would define a "business venture" as an arrangement under which (A) Phlx or an entity with which it is affiliated and (B) a Member or an affiliate of a Member, engage in

Phlx member or an affiliate of a Phlx member in the absence of an effective filing with the Commission under Section 19(b) of the Act.¹⁸⁹ Further, the rule would prohibit a Phlx member from becoming an affiliate of Phlx or an affiliate of an entity affiliated¹⁹⁰ with Phlx in the absence of an effective filing under Section 19(b) of the Act. However, Rule 985(b) would exclude from this restriction two types of affiliations.

First, a Phlx member or an affiliate of a Phlx member could acquire or hold an equity interest in NASDAQ OMX that is permitted pursuant to proposed Rule 985(a) (i.e., less than 20% of the outstanding voting securities) without the need for the Exchange to file such acquisition or holding under Section 19(b) of the Act.¹⁹¹ Second, Phlx or an entity affiliated with Phlx could acquire or maintain an ownership interest in, or engage in a business venture with, an affiliate of a Phlx member without the need for the Exchange to file such affiliation under Section 19(b) of the Act, if there were information barriers between the member and Phlx and its facilities. These information barriers would have to prevent the member from having an “informational advantage” concerning the operation of Phlx or its facilities or “knowledge in advance of other Phlx members” of any proposed changes to the operations of Phlx or its trading systems. Further, Phlx may only notify an affiliated member of any proposed changes to its operations or trading systems in the same manner as it notifies non-affiliated members.

joint activities with the expectation of shared profit and a risk of shared loss from common entrepreneurial efforts. See proposed Rule 985(b)(i).

¹⁸⁹ 15 U.S.C. 78s(b).

¹⁹⁰ Phlx defines the term “affiliate” under proposed Rule 985(b) as having the meaning specified in Rule 12b-2 under the Act; provided, however, that for purposes of Rule 985(b), one entity shall not be deemed to be an affiliate of another entity solely by reason of having a common director.

Additionally, Phlx and its affiliated member may not share employees, office space, or data bases. Finally, the Board must certify, annually, that Phlx has taken all reasonable steps to implement, and comply with, the rule.

Proposed Rule 985 is based on the rules of Nasdaq, which the Commission previously found consistent with the Act.¹⁹² The Commission similarly finds that proposed Rule 985 is consistent with the requirements of Section 6(b)(5) of the Act, which requires that an exchange have rules designed, among other things, to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest.¹⁹³

The Commission is concerned about the potential for unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interests that could exist if an exchange were to otherwise become affiliated with one of its members, as well as the potential for unfair competitive advantage that the affiliated member could have by virtue of informational or operational advantages, or the ability to receive preferential treatment.¹⁹⁴ The Commission believes that Phlx's proposed rule is designed to mitigate these concerns by

¹⁹¹ As discussed above, proposed Rule 985(a) provides that "[n]o member or person associated with a member shall be the beneficial owner of greater than twenty percent (20%) of the then-outstanding voting securities of The NASDAQ OMX Group Inc."

¹⁹² See Nasdaq Rule 2130 and Securities Exchange Act Release No. 53128, *supra* note 101. See also Nasdaq Rule 2140 and Securities Exchange Act Release No. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ- 2006-006) (order approving Nasdaq's proposal to adopt Nasdaq Rule 2140, restricting affiliations between Nasdaq and its members).

¹⁹³ 15 U.S.C. 78f(b)(5).

¹⁹⁴ See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the New York Stock Exchange, Inc.'s merger with Archipelago Holdings, Inc.). See also Securities Exchange Act

requiring that Phlx file a proposed rule change in connection with proposed affiliations between Phlx and Members unless such affiliation is due to a Member's interest in NASDAQ OMX permitted under proposed Rule 985(a) or conforms to the specified information barrier requirements.

If Phlx entered into an affiliation with a member (or any other party) that resulted in a change to a Rule or the need to establish new Rules, as defined under the Act, then such affiliation would be subject to the requirements of Section 19(b) of the Act and Rule 19b-4 thereunder. Proposed Rule 985(b) would not affect this statutory rule filing requirement.

3. Exceptions to Limitations on Affiliation Between Phlx and its Members

NASDAQ OMX currently owns two broker-dealers: NES and NASDAQ Options Services, LLC ("NOS"). NES and NOS are members of Phlx. Absent relief, after the closing of NASDAQ OMX's acquisition of Phlx, NASDAQ OMX's ownership of NES and NOS would cause NES and NOS to violate the provision in proposed Rule 985(b) prohibiting Members from being affiliated with the Exchange.

Phlx has proposed that NES and NOS be permitted to become affiliates of the Exchange, subject to certain conditions and limitations. First, Phlx proposes that NES and NOS would only route orders to Phlx that first attempt to access liquidity on the NASDAQ Exchange.¹⁹⁵ Second,

Release No. 54170 supra note 192 (order approving Nasdaq's proposal to adopt a similar rule, Nasdaq Rule 2140, restricting affiliations between Nasdaq and its members).

¹⁹⁵ NES currently provides to NASDAQ Exchange members optional routing services to other market centers, including Phlx, as set forth in NASDAQ Exchange's rules. See NASDAQ Exchange Rules 4751, 4755, and 4758. NOS provides to NASDAQ Exchange members that are Nasdaq Options Market ("NOM") participants routing services to other market centers. Pursuant to NASDAQ Exchange's rules, NOS: (1) routes orders in options currently trading on NOM, referred to as "System Securities;" and (2) routes orders in options that are not currently trading on NOM ("Non-System Securities"). See NOM Rules, Chapter VI Sections 1(b) and 11. See also Securities Exchange Act Release

NES and NOS will remain facilities of the NASDAQ Exchange. Under NASDAQ Exchange rules, NES operates as a facility¹⁹⁶ of NASDAQ Exchange and routes orders to other market centers as directed by NASDAQ Exchange. Similarly, NOS is operated and regulated as a facility of NASDAQ Exchange with respect to its routing of System Securities (“NOS facility function”), and, consequently, the operation of NOS in this capacity will be subject to Exchange oversight, as well as Commission oversight.¹⁹⁷ NASDAQ Exchange is responsible for ensuring that NES and NOS, each a facility of the NASDAQ Exchange, are operated consistent with Section 6 of the Act and NASDAQ Exchange’s rules. In addition, NASDAQ Exchange must file with the Commission rule changes and fees relating to NES and NOS. Third, use of NES’s and NOS’s routing function by NASDAQ Exchange members will continue to be optional. Parties that do not desire to use NES may enter orders into the NASDAQ Exchange as immediate-or-cancel orders or any other order-type available through the NASDAQ Exchange that is ineligible for routing.¹⁹⁸ Similarly, NOM participants are not required to use NOS to route orders, and a

No. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) (“NOM Approval Order”). With respect to System Securities, NOM participants may designate orders to be routed to another market center when trading interest is not available on NOM or to execute only on NOM. See NOM Rules, Chapter VI, Section 11. See also NOM Approval Order, 73 FR at 14532-14533.

¹⁹⁶ See NASDAQ Exchange Rule 4758(b)(3). See also Securities Exchange Act Release No. 56708 (October 26, 2007), 72 FR 61925 (November 1, 2007) (SR-NASDAQ-2007-078) (“NES Routing Release”). As a facility of NASDAQ Exchange, NASDAQ Exchange Rule 4758(b) acknowledges that NASDAQ Exchange is responsible for filing with the Commission rule changes related to the operation of, and fees for services provided by, NES and that NES is subject to exchange non-discrimination requirements.

¹⁹⁷ See NOM Rules, Chapter 11(e). See also NOM Approval Order, supra note 195, 73 FR at 14533.

¹⁹⁸ See NASDAQ Exchange Rule 4758(b)(7).

NOM participant may route its orders through any available router it selects.¹⁹⁹ In addition, the Commission notes that NES and NOS are members of an SRO unaffiliated with the NASDAQ Exchange, which serves as their designated examining authority under Rule 17d-1.²⁰⁰

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest, and the potential for unfair competitive advantage.²⁰¹ Although the Commission continues to be concerned about potential unfair competition and conflict of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, the Commission believes that it is appropriate and consistent with the Act to permit NES and NOS to become affiliates of Phlx for the limited purpose of providing routing services for NASDAQ Exchange for orders that first attempt to access liquidity on NASDAQ Exchange's systems before routing to Phlx, and in light of the protections afforded by the other conditions described above.

III. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,²⁰² for approving the proposal, as modified by Amendment Nos. 1 and 2, prior to the thirtieth day after the date of publication of notice of filing of Amendment No. 2 in the Federal Register.²⁰³ In

¹⁹⁹ See NOM Rules, Chapter VI, Section 11(a) (allowing Participants to designate orders as available for routing or not available for routing). See also NOM Approval Order, supra note 195, 73 FR at 14533, n.91 and accompanying text.

²⁰⁰ See NASDAQ Exchange Rule 4758(b)(4), and NOM Rules, Chapter 11(e). See NES Routing Release, supra note 196; and NOM Approval Order, supra note 195, 73 FR at 14533, n.189 and accompanying text.

²⁰¹ See supra note 194 and accompanying text.

²⁰² 15 U.S.C. 78s(b)(2).

²⁰³ Pursuant to Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2), the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after

Amendment No. 2, Phlx proposed to adopt as rules of the Exchange the Certificate of Incorporation and By-Laws of NASDAQ OMX. The Certificate of Incorporation, as filed by the Exchange, was previously approved by the Commission as rules of Nasdaq.²⁰⁴ The NASDAQ OMX By-Laws were similarly approved by the Commission.²⁰⁵ As filed by the Exchange, the NASDAQ OMX By-Laws include certain new terminology to reflect the acquisition of Phlx by NASDAQ OMX. These changes were filed by NASDAQ Exchange as a proposed rule change, and were published for comment.²⁰⁶ The Commission received no comments on the proposed changes to the NASDAQ OMX By-Laws.

As discussed more fully above and in the NASDAQ Stock Market Proposal, certain provisions of NASDAQ OMX's Certificate and By-Laws are designed to facilitate the ability of NASDAQ OMX's SRO Subsidiaries, including Phlx, to maintain the independence of each of the SRO Subsidiaries' self-regulatory function, enable each SRO Subsidiary to operate in a manner that complies with the federal securities laws, and facilitate the ability of each SRO subsidiary and the Commission to fulfill their regulatory and oversight obligations under the Act.²⁰⁷ As stated above, the Commission finds that such provisions are consistent with the Act.²⁰⁸ Notably, the NASDAQ OMX Certificate and By-Laws are rules of NASDAQ Exchange that have been approved previously by the Commission, as noted above, and the changes to the

the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

²⁰⁴ See Securities Exchange Act Release No. 51328, supra note 101.

²⁰⁵ See id.

²⁰⁶ See Securities Exchange Act Release No. 57761, supra note 4.

²⁰⁷ See supra Section III.C.1 (discussing, for example the duty of the board, officers, employees and agents NASDAQ OMX to give due regard to the preservation of the independence of the Phlx's self-regulatory function).

NASDAQ OMX By-Laws were published for notice and comment, as noted above, and the Commission did not receive any comments thereon. Accordingly, the Commission finds good cause for approving the Phlx's proposal, as modified by Amendment Nos. 1 and 2, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2008-31 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2008-31. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those

²⁰⁸ See supra note 56 and accompanying text.

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Phlx-2008-31 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁰⁹ that the proposed rule change (SR-Phlx-2008-31), as modified by Amendment Nos. 1 and 2 thereto, be and hereby is approved on an accelerated basis.

By the Commission.



Florence E. Harmon
Acting Secretary

²⁰⁹ 15 U.S.C. 78s(b)(2).

Commissioner Walter
not participating

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58178; File No. SR-CBOE-2008-40)

July 17, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 thereto, to Provide for the Issuance of ITPs

I. Introduction

On April 9, 2008, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposal to provide for the issuance of up to 50 Interim Trading Permits (“ITPs”). The proposed rule change was published for comment in the Federal Register on April 17, 2008.³ The Exchange filed Amendment No. 1 to the proposed rule change on May 20, 2008, which reflected the vote of CBOE members approving the proposal.⁴ The Commission received two comment letters regarding the proposal,⁵ as well as two letters from CBOE addressing the concerns raised

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 57650 (April 11, 2008), 73 FR 20989 (“Notice”).

⁴ Amendment No. 1 is technical in nature and is therefore not subject to notice and comment. See also General Instruction E to Form 19b-4 (concerning completion of action by a self-regulatory organization on a proposed rule change). In its amendment, CBOE noted that its proposal was approved by an “overwhelming majority” of the CBOE members who voted thereon. CBOE also confirmed that no further action on the part of CBOE is required in connection with this proposed rule change.

⁵ See Letter from Lawrence J. Blum and Michael Mondrus, to Nancy M. Morris, Secretary, Commission, dated April 28, 2008 (“Blum/Mondrus Letter”) and Letter from Mark and Joan Andrew, to Nancy M. Morris, Secretary, Commission, dated May 12, 2008 (“Andrew Letter”).

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by the commenters.⁶ This order approves the proposed rule change, as modified by Amendment No. 1.

The proposed rule change would allow the Exchange to issue up to 50 ITPs, which would grant to the holders thereof the same trading privileges on the Exchange as regular transferable Exchange memberships. Individuals and organizations that obtain ITPs would be able to conduct their activities in a manner similar to holders of Exchange memberships and CBOE rules that apply to the holders of memberships would also apply to the holders of ITPs. The Exchange has proposed the authority to issue these permits in order to address the demand for trading access to the Exchange in the event that a shortage exists from time to time in the number of transferable Exchange memberships available for lease.

II. Discussion

After careful review of the proposal, the comment letters thereto, and the Exchange's response to comments, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder.⁷ In particular, the Commission finds that the Exchange's proposal is consistent with the requirements of Section 6(b)(5) of the Act,⁸ which requires that the rules of a national securities 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

⁶ See Letter from Joanne Moffic-Silver, Executive Vice President, General Counsel, and Corporate Secretary, CBOE, to Nancy M. Morris, Secretary, Commission, dated May 12, 2008 ("CBOE Letter 1") and Letter from Joanne Moffic-Silver, Executive Vice President, General Counsel, and Corporate Secretary, CBOE, to Nancy M. Morris, Secretary, Commission, dated May 15, 2008 ("CBOE Letter 2").

⁷ 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).

⁸ 15 U.S.C 78f(b)(5).

regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. The Commission also finds that the Exchange's proposal is consistent with the requirements of Section 6(b)(3) of the Act,⁹ which requires that the rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. The Commission also finds that the Exchange's proposal is consistent with Section 6(b)(8) of the Act,¹⁰ which requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

A. Issuances of ITPs under Proposed Rule 3.27(b)

The Exchange has proposed various requirements and specified certain processes in connection with the issuance of the ITPs. Specifically, an individual or organization would have to satisfy all requirements and be approved for membership in the Exchange to be eligible to apply for an ITP.¹¹ The Exchange would be able to issue one or more ITPs, subject to a cumulative maximum total of 50, if it determines that: (1) there are insufficient transferable Exchange memberships available for lease at that time at a rate reasonably related to the

⁹ 15 U.S.C 78f(b)(3).

¹⁰ 15 U.S.C 78f(b)(8).

¹¹ See proposed CBOE Rule 3.27(b).

indicative lease rate to meet existing demand for such leases;¹² and (2) it would be in the interest of fair and orderly markets to provide additional trading access under the circumstances (collectively, the “issuance findings”).

If the Exchange determines to issue ITPs, the Exchange would announce the number of ITPs that it would make available (limited by the number that are available for issuance, up to a cumulative maximum of 50), that the Exchange is taking applications for such permits, the objective process the Exchange would follow in issuing such permits,¹³ and the beginning and end dates during which individuals and organizations must submit applications for such permits.¹⁴ To be eligible to apply for an ITP, an individual or organization must meet all of CBOE’s requirements for membership in the Exchange and obtain CBOE’s approval for having met such requirements.¹⁵ CBOE is not proposing to change any of these requirements. An individual would be eligible to receive no more than one ITP in connection with a particular ITP issuance, with a maximum of eight such permits for a member organization and individuals and

¹² The “indicative lease rate” would be the highest “clearing firm floating monthly rate” of the Clearing Members that assist in facilitating at least 10% of the transferable membership leases. The “clearing firm floating monthly rate” would be the floating rate that a Clearing Member designates, in connection with transferable membership leases that the Clearing Member assisted in facilitating, for leases that utilize that monthly rate.

¹³ The Exchange would issue the ITPs in accordance with one of the following objective processes: (1) random lottery, (2) order in time, or (3) another objective process adopted pursuant to a rule filing submitted to the Commission under Section 19(b) of the Act, 15 U.S.C. 78s(b).

¹⁴ The Commission notes that although the number of permits to be issued is limited to a maximum of 50 permits, the Exchange could allocate ITPs in multiple issuances, each time in accordance with one of the objective processes. For example, the Exchange could decide to issue 10 permits by either an order-in-time process or a random lottery process.

¹⁵ See proposed CBOE Rule 3.27(b). See also, e.g., CBOE Rules 3.2 and 3.3 (setting forth qualification requirements for individuals and member organizations, including, among other things, that the person be registered as a broker or dealer pursuant to Section 15 of the Act).

member organizations affiliated with the member organization in connection with that issuance.¹⁶

Recipients of ITPs and all of their associated persons must remain in good standing and must pay all applicable fees, dues, assessments, and other charges assessed against CBOE members.¹⁷ An ITP would be non-transferable, except that: (1) a member organization may change the designation of the nominee in respect of each ITP it holds, and (2) an individual ITP holder may transfer that ITP to a member organization with which such individual is then associated.¹⁸

An ITP would remain in effect until the earlier of one of the following events: (1) CBOE is converted into a stock corporation or memberships in CBOE are converted into stock (collectively, a “Demutualization Transaction”), (2) the holder of the ITP notifies the Exchange in a form and manner prescribed by the Exchange that the holder is terminating that ITP,¹⁹ (3) the ITP is terminated as a result of a regulatory action by the Exchange, or (4) the Exchange terminates all ITPs through a rule filing approved by the Commission pursuant to Section 19(b) of the Act.²⁰ In the event of a Demutualization Transaction, holders of ITPs would be guaranteed to receive trading permits on the same terms as holders of transferable Exchange memberships who are eligible to receive trading permits in connection with that transaction.²¹

¹⁶ See proposed CBOE Rule 3.27(b).

¹⁷ See proposed CBOE Rule 3.27(f)(ii).

¹⁸ See proposed CBOE Rule 3.27(g)(iii).

¹⁹ If the holder of an ITP fails to notify the Exchange that he or she is terminating that ITP by the fifteenth day of the month, the holder would be required to pay to the Exchange an amount equal to the following month’s monthly access fee for an ITP. See Notice, *supra* note 3, 73 FR at 20991. The Exchange could reissue an ITP that had been terminated.

²⁰ See proposed CBOE Rule 3.27(c).

²¹ See proposed CBOE Rule 3.27(e)(ii).

The Commission notes that this provision is designed to ensure that there is no disruption in trading access in the event of such a Demutualization Transaction, and thus should help to promote the fair and orderly character of the Exchange's markets.

The Commission finds that the proposed framework and methodology that the Exchange would follow when issuing ITPs represents an objective methodology for the allocation of trading permits in a fair and reasonable manner and is consistent with the Act. The proposal provides the Exchange with the ability to address, from time to time, situations in which the demand for full trading access to the Exchange exceeds the supply of transferable memberships available for lease. The Commission believes that increasing the number of members in that situation is consistent with the Act because it would promote market liquidity and help to promote the fair and orderly character of CBOE's markets. The Commission also believes that the limit on the number of permits that may be obtained in any one issuance is consistent with the Act, including Section 6(c)(4) of the Act, which permits an exchange to limit the number of members of the exchange.²² The Commission believes that the limit should help minimize the chance for any broker or dealer to dominate any particular issuance and should provide a broad opportunity for access to the Exchange. Finally, the Commission notes that the additional number of permits that CBOE would have authority to issue represents a small percentage of its 930 outstanding memberships and is consistent with the Act, including Section 6(b)(5) thereunder, in that it should permit the Exchange to offer additional access where demand so warrants, and should facilitate transactions in securities by potentially deepening the pool of liquidity available on the Exchange. Therefore, the Commission finds that the provisions of the proposal governing the issuance and duration of ITPs are consistent with the requirements of the

²² 15 U.S.C. 78f(c)(4).

Act.

B. Fair Representation of ITP Holders

The Commission finds that the proposed rule change is consistent with Section 6(b)(3) of the Act,²³ which requires that the rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. ITP holders would be members of CBOE and would have all rights attendant thereto, except as expressly provided otherwise.²⁴

In particular, an ITP holder, or an officer of an ITP holder, would be eligible to serve as an at-large director on the Board of Directors of the Exchange (“CBOE Board”)²⁵ and on any Exchange committee to the same extent that a regular member could serve on that committee, except as provided otherwise.²⁶ Further, an ITP holder, or an officer of an ITP holder, would be eligible to serve on CBOE’s Nominating Committee in one of the six floor member and firm

²³ 15 U.S.C. 78f(b)(3).

²⁴ The Commission notes that the voting and representation rights of ITP holders are substantively identical to the provisions addressing the voting and representation rights provided to CBOE Stock Exchange (“CBSX”) permit holders that the Commission previously approved. See Securities Exchange Act Release No. 55326 (February 21, 2007), 72 FR 8816 (February 27, 2007) (order approving File No. SR-CBOE-2006-107).

²⁵ See proposed Section 6.1(a) of the CBOE Constitution. The Exchange also proposes to amend Section 6.1(a) to remove a reference to the commencement of the classification of the Board that was implemented in 2002, because the transition period has now passed.

²⁶ See proposed CBOE Rule 3.27(e)(i). The Commission notes that an ITP holder would be eligible to serve on Exchange committees that develop and/or review trading rules and would also be eligible for appointment to the Exchange’s Business Conduct Committee, whose members are periodically appointed to conduct hearings for specific disciplinary matters. See E-mail from Patrick Sexton, Associate General Counsel, CBOE, to Johnna B. Dumler, Special Counsel, Division of Trading and Markets, Commission, dated May 20, 2008.

member positions on that committee, notwithstanding the fact that the holder of an ITP would not be a regular member or an officer of a regular member.²⁷

ITP holders would have the same voting and petition rights as holders of transferable memberships, except that they would have no right to vote or petition concerning: (1) issues that relate to Exchange ownership matters, including without limitation those matters related to demutualization, mergers, consolidations, dissolution, liquidation, transfer, or conversion of assets of the Exchange, and (2) matters that relate to Article Fifth(b)²⁸ of CBOE's Certificate of Incorporation.²⁹ This limitation reflects the fact that ITP holders would have no interest in the assets or property of the Exchange, and would have no right to share in any distribution by the Exchange.³⁰

²⁷ See proposed Section 4.1(a) of the CBOE Constitution.

²⁸ Article Fifth(b) of CBOE's Certificate of Incorporation provides certain rights to members of the Board of Trade of the City of Chicago, Inc. ("CBOT") to become members of the CBOE without purchasing a separate CBOE membership (the "Exercise Right"). Pursuant to an interpretation of the Exchange that was recently approved by the Commission, CBOE believes that the acquisition of the CBOT by Chicago Mercantile Exchange Holdings, Inc. resulted in no persons any longer qualifying for the Exercise Right. See Securities Exchange Act Release No. 57159 (January 15, 2008), 73 FR 3769 (January 22, 2008) (order approving SR-CBOE-2006-106).

²⁹ See Section 2.6 of the CBOE Constitution and proposed CBOE Rule 3.27(g)(i). Under proposed Section 1.1(b) of the CBOE Constitution and proposed CBOE Rule 3.27(e)(i), ITP holders in good standing would be treated the same as members, except as provided in proposed Sections 2.1(c) and 2.6 of the CBOE Constitution, and except for purposes of Article Fifth(b) of the Certificate of Incorporation, Article Tenth of the Certificate of Incorporation, proposed Section 4.1(a) of the CBOE Constitution, proposed Section 6.1(a) of the CBOE Constitution, and as may be provided in the rules. Under Section 2.1(c) of the CBOE Constitution, an ITP holder would have no interest in the assets or property of the Exchange and no right to share in any distribution by the Exchange. Further, Section 2.6 of the CBOE Constitution would grant ITP holders the same voting and petition rights as regular members except that an ITP holder, like a CBSX member, would not have the right to vote or petition concerning the matters discussed above.

³⁰ See proposed Section 2.1(c) of the CBOE Constitution and proposed CBOE Rule 3.27(g)(ii).

C. Trading Rights of ITP Holders and Jurisdiction of the Exchange over ITP Holders

A holder of an ITP would have the same trading privileges on the Exchange as the holder of a transferable Exchange membership.³¹ Those rights would include the right to trade on the CBSX and the trading rights on the Exchange necessary to become a member of OneChicago, LLC. An organization that holds an ITP or that has an ITP registered for it in general would be treated the same as a “member organization” for purposes of the rules.³²

Holders of ITPs would be “members” of the Exchange under Section 3(a)(3) of the Act.³³ As members, ITP holders and their associated persons would be subject to the regulatory jurisdiction of the Exchange under the Act, and the Constitution and rules of the Exchange.³⁴ In this regard, for instance, ITPs may be suspended or revoked as a result of a disciplinary action under the amendments proposed for Rule 17.1. In particular, the Exchange would have the authority under proposed Rule 2.23 to revoke an ITP if the holder fails to pay any dues, fees, assessments, charges, fines or other amounts due to the Exchange within six months after such payment is due. In addition, the Exchange would have the authority under proposed Rules 16.3(c) and 16.4 to suspend or revoke the ITP of a holder that experiences financial difficulty. The Exchange also would have the authority under proposed Rule 17.1 to suspend or revoke an ITP if the holder has been disciplined by the Exchange.

³¹ See proposed CBOE Rule 3.27(e)(i).

³² See *id.* The Exchange notes that this provision is limited to the rules and is subject to the conditions imposed on ITP holder status in the CBOE Constitution and rules, including proposed Section 1.1(b) of the Constitution and proposed Rule 3.27(e)(i).

³³ 15 U.S.C. 78c(a)(3)(A).

³⁴ See proposed CBOE Rule 3.27(f)(i). See also 15 U.S.C. 78f(b)(6) and 15 U.S.C. 78f(c)(3). All Exchange members are required to be registered broker dealers. See CBOE Rules 3.2(a)(ii) and 3.3(a)(ii). The Commission has jurisdiction over all broker dealers.

Accordingly, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,³⁵ which requires an exchange to have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules and regulations thereunder, and the rules of the Exchange. The Commission also finds that the proposal is consistent with Section 6(b)(5) of the Act,³⁶ which requires, among other things, that the rules of the exchange promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In particular, ITP holders would have the same trading privileges on the Exchange and would be subject to the same regulatory jurisdiction of the Exchange as are applicable to holders of transferable Exchange memberships.

D. Transfer of ITP Holders to Open Leases

In connection with determining to issue ITPs, the Exchange sought and received feedback from the Exchange's Lessors Committee. According to the Exchange, some participants on that committee expressed the concern that the issuance of ITPs potentially could have a negative effect on the lease market for CBOE seats by reducing the demand for leases.³⁷ Further, the commenters to the proposal, while acknowledging CBOE's need to provide additional access to the Exchange, also expressed concern that the proposal would negatively impact the value of existing memberships and dilute the income stream to lessors of current memberships.³⁸

³⁵ 15 U.S.C. 78f(b)(1).

³⁶ 15 U.S.C. 78f(b)(5).

³⁷ See Notice, supra note 3, 73 FR at 20992.

³⁸ See Blum/Mondrus Letter, supra note 5. See also Andrew Letter, supra note 5, at 1-2.

Specifically, in the Blum/Mondrus Letter, commenters acknowledged CBOE's need to provide more trading access to the Exchange, but criticized the proposed expansion of access as effecting a reduction in the value of existing memberships and diluting the income stream to lessors of memberships.³⁹ In addition, the Blum/Mondrus Letter argued that the Exchange's proposal to issue 50 access permits to itself would put the Exchange in competition with seat owners, many of whom lease their seats to others.⁴⁰ Further, the Blum/Mondrus Letter noted that a petition was being circulated among CBOE members to request that the CBOE Board consider an alternate access proposal, and asked the Commission to hold hearings on the proposal.⁴¹ In the Andrew Letter, commenters similarly criticized the mechanics of the proposed ITP program.⁴² In particular, they argued that CBOE would be usurping the historical practice of seat owners pricing floor access and receiving revenue therefrom.⁴³

In its response to the commenters, the Exchange noted that the CBOE Board has explicit legal authority in Section 2.1(a) of CBOE's Constitution to adopt the proposed permit plan.⁴⁴ CBOE also noted that members would have an opportunity to vote on the merits of the plan.⁴⁵ In Amendment No. 1 to the proposed rule change, CBOE confirmed that it obtained both the requisite CBOE Board approval and membership approval, and confirmed that no further action by CBOE in connection with the proposal is necessary.⁴⁶ As approximately 82% of CBOE seats

³⁹ See Blum/Mondrus Letter, supra note 5.

⁴⁰ See id.

⁴¹ See id.

⁴² See Andrew Letter, supra note 5.

⁴³ See id. at 1.

⁴⁴ See CBOE Comment Letter 1, supra note 6, at 1.

⁴⁵ See id.

⁴⁶ See Amendment No. 1, supra note 4.

are currently leased,⁴⁷ the Commission notes that members who lease their seats had an opportunity to be heard on the proposal and have subsequently endorsed CBOE's proposed plan.

CBOE also noted that its members would be the ultimate beneficiaries of the plan and any revenues generated therefrom because they are the owners of the Exchange.⁴⁸ CBOE further noted that it is not unusual for an exchange to retain trading access fees, and noted that it currently does so with respect to CBSX permits.⁴⁹

In addition, CBOE proposed certain features designed to address the concerns of lessors of CBOE memberships. To minimize any potential negative impact on the market for leased CBOE memberships, the proposal provides a process by which CBOE would endeavor to facilitate the transfer of holders of ITPs to leases that become available or, if necessary, compensate a lessor who holds an unleased seat with a monthly payment equal to the indicative lease rate. In particular, if the Exchange is notified by one or more lessors that they have transferable Exchange memberships available for lease ("open leases") at a rate reasonably related, as determined by the Exchange in its sole discretion, to the indicative lease rate, then the Exchange would notify each ITP holder of the number of open leases and the names of the lessors with those open leases. The ITP holder could contact those lessors if the holder is

⁴⁷ Telephone call with Arthur Reinstein, Deputy General Counsel, CBOE, Patrick Sexton, Associate General Counsel, CBOE, Stan Leimer, Director CBOE Membership Department, CBOE, and Richard Holley III, Senior Special Counsel, and Johnna B. Dumler, Special Counsel, Division of Trading and Markets, Commission, and J. Daniel Aromi, Office of Economic Analysis, Commission, on June 11, 2008 ("June 11 Telephone Call").

⁴⁸ See CBOE Comment Letter 1, supra note 6, at 2.

⁴⁹ See id.

interested in transferring to an open lease.⁵⁰ Transfer to an open lease would be entirely voluntary for ITP holders.⁵¹

If, after a reasonable period of time following the process set forth in the paragraph above, a lessor notifies the Exchange that the lessor continues to have an open lease, the Exchange would compensate that lessor through a monthly payment equal to the indicative lease rate, provided the lessor is offering for lease the transferable membership subject to the open lease at a rate reasonably related to the indicative lease rate, as determined by the Exchange in its sole discretion.⁵² The lessor may, at any time thereafter, lease that membership to any qualified individual or organization and would be required to notify the Exchange in the event of such a lease. The Exchange would cease compensating the lessor if it receives such a notification or otherwise learns the lessor has leased that membership.

The Commission finds that the aspects of the proposal that relate to the Exchange's intention to facilitate the transfer of ITP holders to open leases, as well as the Exchange's proposal to compensate lessors who hold unleased seats that are offered for lease at a market rate when ITPs are outstanding, are consistent with the Act, including Section 6(b)(5) thereunder.⁵³ In particular, transfers of ITP holders to an open lease would be on a voluntary basis at the option of the ITP holder. Further, compensation to holders of CBOE transferable memberships

⁵⁰ The Exchange would provide a similar notification to each person who is a Temporary Member under Interpretation and Policy .02 of Rule 3.19, and transfer to an open lease would be entirely voluntary. See Notice, supra note 3, 73 FR at 20992, n.16.

⁵¹ See Notice, supra note 3, 73 FR at 20992.

⁵² The "indicative lease rate" would be determined in accordance with proposed Rule 3.27(b). See supra note 12 (further describing the indicative lease rate). In the event that the number of lessors receiving compensation pursuant to this provision becomes greater than the number of outstanding ITPs, the Exchange would compensate each such lessor on a pro-rated basis.

⁵³ 15 U.S.C. 78f(b)(5).

that are unable to lease their seats at market rates when ITPs are outstanding is a business decision of the Exchange that does not raise any issues under the Act.

The Commission does not believe that the necessary result of CBOE's ITP proposal is a reduction in the value of a CBOE membership or a decrease over time in the seat lease income paid to CBOE members. To the contrary, as CBOE provides additional trading access to the Exchange, the result could be an increase in liquidity that in turn increases the value of access to the Exchange. Further, the Commission notes that the Exchange has explicit authority in its Constitution to issue permits, and that CBOE members were informed of the proposal and have voted decidedly in favor of it. The Commission also notes that the Exchange currently receives trading access fees for permits to access CBSX, and the Commission notes CBOE's point that CBOE members, as owners of the Exchange, are the ultimate beneficiaries of the proposed permit plan and any revenues generated in connection therewith.

Similarly, the Commission does not believe that the proposal places the Exchange in competition with its members. When the Exchange determines to issue ITPs, consistent with the issuance findings, there would be insufficient seats available for lease at a rate reasonably related to the indicative lease rate. Thus, at the point in time of an issuance, the Exchange generally would not be in competition with any of its members who have open seats for lease at market rates. Further, the Exchange's use of the indicative lease rate is designed so that the Exchange will not issue ITPs at below-market rates. In particular, the indicative lease rate is an objective metric that is derived from lease rates determined by entities unaffiliated with the Exchange⁵⁴ in which there is a liquid market for leased seats.⁵⁵ Further, the Commission notes that the

⁵⁴ See supra note 12 (further describing the indicative lease rate).

⁵⁵ See Notice, supra note 3, 73 FR at 20990 (discussing the indicative lease rate) and June 11 Telephone Call, supra note 47. The Commission notes that, of the seats that are

Exchange considers the highest of the “clearing firm floating monthly rates” when it establishes the “indicative lease rate,” which the Commission believes alleviates the potential for any downward pressure on the market lease rate.⁵⁶

Accordingly, the Commission does not believe that the ITP proposal imposes any burden on competition, consistent with Section 6(b)(8) of the Act,⁵⁷ that is not necessary or appropriate in furtherance of the purposes of the Act. Specifically, the Exchange would issue ITPs, consistent with the issuance findings, when doing so would be in the interest of fair and orderly markets. In CBOE’s judgment, therefore, the issuance of a limited number of permits through an objective methodology would contribute to the vitality of its market, thereby increasing the attractiveness of CBOE’s market and consequently enhancing its value to CBOE members and other users of CBOE’s facilities. In addition, as discussed above, the Exchange has proposed to provide compensation to holders of CBOE memberships that are unable to lease their seats at market rates when ITPs are outstanding, which the Commission believes would mitigate any potential burden that the proposal might represent to lessors of CBOE memberships.

Finally, the Commission notes the desire of a commenter to have CBOE delay the proposal and have the Commission hold hearings on the proposal.⁵⁸ Section 19(b)(1) of the Act⁵⁹ requires CBOE to file with the Commission any proposed changes to, or interpretations of,

leased, more than 83% are currently facilitated by two clearing firms, such that the “clearing firm floating monthly rate” and the corresponding “indicative lease” rate are based on a significant and representative portion of the overall leased seat market.

⁵⁶ See supra note 12 (further describing the indicative lease rate).

⁵⁷ 15 U.S.C. 78f(b)(8).

⁵⁸ See Blum/Mondrus Letter, supra note 5.

⁵⁹ 15 U.S.C. 78s(b)(1).

its rules and the Commission is thereafter obligated to consider CBOE's proposal. In this instance, given the member vote and approval, the Commission is acting on CBOE's proposal.

E. ITP Fees

Holders of ITPs would be required to pay to the Exchange a monthly access fee. The monthly access fee would be established and adjusted through a proposed rule change that would be filed with the Commission under Section 19(b) of the Act.⁶⁰ Such fees would be due and payable in accordance with the provisions of the Exchange fee schedule and would be the same for all ITP holders.⁶¹ Commenters suggested that CBOE provide better justification for its claim to floor access revenue.⁶² In response, CBOE stated that, because its members own the Exchange, they are the ultimate beneficiaries of any revenues that may be generated by the permit plan and that the members will have an opportunity to be heard on that aspect of the proposal when they vote on the proposal.⁶³ CBOE also noted that the commenter incorrectly suggested that it is unusual for an exchange to set the level of and retain trading access fees, and noted that the CBSX permit plan is based on that model.⁶⁴ The Commission is not today approving the level of the monthly access fee for ITPs and notes that such fees would be the subject of a separate proposed rule change. Nevertheless, the Commission agrees with CBOE

⁶⁰ 15 U.S.C. 78s(b).

⁶¹ See proposed CBOE Rule 3.27(f)(ii).

⁶² See Andrew Letter, supra note 5, at 2.

⁶³ See CBOE Letter 2, supra note 6, at 2. On May 19, 2008, the CBOE membership approved the ITP plan. See Amendment No. 1, supra note 4.

⁶⁴ See CBOE Letter 2, supra note 6, at 2. CBOE also sought to clarify a reference in the Andrew Letter to trading access funds that, according to the Andrew Letter, are being held in "escrow." CBOE noted that the fees to be collected under its ITP proposal would not be held in escrow and no escrowed funds would be affected by its proposal. See id.

that it is consistent with Section 6(b)(4) of the Act⁶⁵ for exchanges to charge for access to their facilities.⁶⁶

F. Conforming Rule Changes to Accommodate ITPs and Clarifying Changes Relating to CBSX Permits

The Exchange proposed several conforming changes in its rules to ensure that individuals and organizations that receive ITPs can conduct their activities in a manner similar to holders of Exchange memberships.⁶⁷ These changes relate to, among other things, registration, designation of nominees, and qualifications. Other conforming changes have been made to the rules so that certain requirements related to the holders of memberships would apply to the holders of ITPs. For example, CBOE would amend Rule 3.2(c) to specify that individual ITP holders would be required to have authorized trading functions.⁶⁸

Additionally, though unrelated to the ITP proposal, CBOE also proposed to adopt several changes to clarify how CBSX permits currently are treated under the Certificate of Incorporation, Constitution, and rules. These changes, which adopt certain language that is also being proposed for ITPs, are non-substantive in nature and do not modify the rights of the holders of such permits or materially alter the status quo with respect to the Exchange's operation of CBSX.⁶⁹

⁶⁵ 15 U.S.C. 78f(b)(4).

⁶⁶ See, e.g., Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251, 11268 (March 6, 2006) (SR-NYSE-2005-77) (approving a process to determine an access fee for trading licenses and noting that the exchange would later file a separate proposed rule change to amend its fee schedule to establish the price).

⁶⁷ See Notice, supra note 3, 73 FR at 20992-94 (describing each such proposed rule change).

⁶⁸ See Notice, supra note 3, 73 FR at 20993.

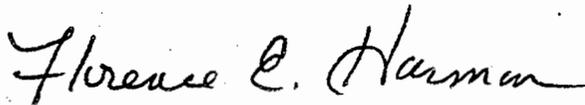
⁶⁹ For example, the Exchange proposes to change the terminology in CBOE Rule 3.26(c) to note that (except as indicated therein) CBSX permit holders are treated the "same as" members, rather than being "deemed to be" members for purposes of the Certificate of Incorporation, Constitution, and rules. In addition, the Exchange is proposing to amend CBOE Rule 3.26(c) to clarify that an organization that holds a CBSX permit or that has a

The Commission finds that the conforming and clarifying changes proposed by the Exchange are consistent with the requirements of Section 6 of the Act. In particular, the clarifying and conforming changes are non-substantive in nature and should provide greater clarity to market participants, including CBOE's members and CBSX permit holders, regarding the application and operation of the Exchange's rules.

III. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁷⁰ that the proposed rule change (SR-CBOE-2008-40), as modified by Amendment No. 1 thereto, be, and hereby is approved.

By the Commission.



Florence E. Harmon
Acting Secretary

CBSX permit registered for it shall be treated the same as a "member organization" for purposes of the CBOE rules. See Notice, supra note 3, 73 FR at 20993.

⁷⁰ 15 U.S.C. 78s(b)(2).

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
RELEASE NO. 58190 / July 18, 2008

AMENDMENT TO EMERGENCY ORDER PURSUANT TO SECTION 12(k)(2) OF
THE SECURITIES EXCHANGE ACT OF 1934 TAKING TEMPORARY ACTION TO
RESPOND TO MARKET DEVELOPMENTS

Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934,¹ on July 15, 2008, the Securities and Exchange Commission (“Commission”) issued an Emergency Order (the “Order”) related to short selling securities of certain specified substantial financial firms.² The Order takes effect on July 21, 2008. The Commission delayed the effective date to create the opportunity to address, and to allow sufficient time for market participants to make, adjustments to their operations to implement the enhanced requirements. The anticipated operational accommodations necessary for implementation of the Order are addressed herein.

A. Bona Fide Market Makers

The borrow and arrangement-to-borrow requirement of the Order does not apply to certain bona fide market makers. (The settlement date delivery requirement of the Order applies to these market makers.) The purpose of this accommodation is to permit market makers to facilitate customer orders in a fast-moving market without possible delays associated with complying with the borrow and arrangement-to-borrow requirement of the Order.

¹ 15 USC 78l(k)(2).

² See Securities Exchange Act Release No. 58166 (July 15, 2008) at <http://www.sec.gov/rules/other/2008/34-58166.pdf>

IT IS THEREFORE ORDERED that, pursuant to our Section 12(k)(2) powers, the following entities are excepted from the requirement of the Order that any person effecting a short sale in the publicly traded securities of substantial financial firms, as identified in Appendix A to the Order (“Appendix A Securities”)³, using the means or instrumentalities of interstate commerce, must borrow or arrange to borrow the security or otherwise have the security available to borrow in its inventory prior to effecting the short sale: registered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, that are selling short as part of bona fide market making and hedging activities related directly to bona fide market making in: (a) Appendix A Securities; (b) derivative securities based on Appendix A Securities, including standardized options; and (c) exchange traded funds of which Appendix A Securities are a component.

B. Documentation

Rule 203(b)(1)(iii) of Regulation SHO requires a broker or dealer to document its compliance with the “locate” requirement contained in Rule 203(b)(1)(i) of the regulation.⁴ Brokers and dealers have developed processes and procedures to meet this documentation requirement. Because the borrow or arrangement-to-borrow requirement in the Order constitutes the Commission’s “locate” requirement during the effectiveness

³ Appendix A incorrectly referenced “HSI” as a ticker symbol for HSBC Holdings PLC ADS. This reference to HSI is hereby removed from Appendix A. In addition, the reference to BNP Paribas Securities Corp. is hereby changed to BNP Paribas. See Appendix A attached as revised.

⁴ Rule 203(b)(1) of Regulation SHO provides: “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: (1) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (2) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (3) Documented compliance with this paragraph (b)(1).” 17 CFR 242.203(b)(1).

of the Order, brokers and dealers need not change their processes and procedures used to document compliance.

IT IS THEREFORE ORDERED that, pursuant to our Section 12(k)(2) powers, brokers and dealers must document compliance with the borrow and arrangement-to-borrow requirement of the Order and may use the same processes and procedures to document compliance with the Order as used for compliance with Regulation SHO, provided such processes and procedures would comply with Rule 203(b)(1) of Regulation SHO.

C. Sales of Restricted Securities

The Order does not apply to short sales of Appendix A Securities effected pursuant to Rule 144 of the Securities Act of 1933.⁵ This is consistent with Rule 203(b)(2)(ii) of Regulation SHO and will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity to meet the settlement date delivery requirement of the Order. Such sales, however, remain subject to the requirements of Regulation SHO.

IT IS THEREFORE ORDERED that, pursuant to our Section 12(k)(2) powers, the Order does not apply to any person that effects a short sale pursuant to Rule 144 of the Securities Act of 1933 (17 CFR 230.144) in an Appendix A Security.

D. Syndicate Offerings

The Order does not apply to short sales by underwriters, or members of a syndicate or group participating in distributions of Appendix A Securities in connection with an over-allotment of securities, or any lay-off sale by such person in connection with

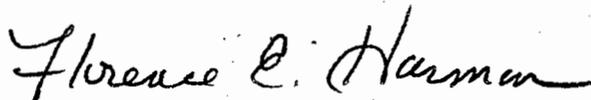
⁵ 17 CFR 230.144.

a distribution of Appendix A Securities through a rights or a standby underwriting commitment. It is not necessary for the Order to apply to such selling activity because it is addressed in Regulation M under the Securities Exchange Act of 1934,⁶ an anti-manipulation rule, and does not raise the same concerns as “naked” short selling in secondary markets.

IT IS THEREFORE ORDERED that, pursuant to our Section 12(k)(2) powers, the Order does not apply with regard to any sale by an underwriter, or any member of a syndicate or group participating in the distribution of an Appendix A Security, in connection with an over-allotment of securities, or any lay-off sale by such person in connection with a distribution of Appendix A Securities through a rights or a standby underwriting commitment. In addition, the Order does not apply with respect to a net syndicate short position created in connection with a distribution of an Appendix A Security that is part of a fail to deliver position at a registered clearing agency in Appendix A Securities if action is taken to close out the net syndicate short position no later than the 30th day after commencement of sales in the distribution.

The Commission believes that these amendments are necessary in the public interest and for the protection of investors to maintain fair and orderly securities markets, and to prevent substantial disruption to securities markets.

By the Commission.



Florence E. Harmon
Acting Secretary

⁶ 17 CFR 242.100 et seq.

Appendix A

<u>Company</u>	<u>Ticker Symbol(s)</u>
BNP Paribas	BNPQF or BNPQY
Bank of America Corporation	BAC
Barclays PLC	BCS
Citigroup Inc.	C
Credit Suisse Group	CS
Daiwa Securities Group Inc.	DSECY
Deutsche Bank Group AG	DB
Allianz SE	AZ
Goldman, Sachs Group Inc	GS
Royal Bank ADS	RBS
HSBC Holdings PLC ADS	HBC
J. P. Morgan Chase & Co.	JPM
Lehman Brothers Holdings Inc.	LEH
Merrill Lynch & Co., Inc.	MER
Mizuho Financial Group, Inc.	MFG
Morgan Stanley	MS
UBS AG	UBS
Freddie Mac	FRE
Fannie Mae	FNM

Commissioner Walter
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58191 / July 18, 2008

Admin. Proc. File No. 3-12714

In the Matter of the Application of

BOSTON STOCK EXCHANGE, INC.,
CHICAGO BOARD OPTIONS EXCHANGE, INC.,
INTERNATIONAL SECURITIES EXCHANGE, LLC,
NASDAQ STOCK MARKET LLC,
NATIONAL STOCK EXCHANGE, INC.,
NYSE ARCA, INC., AND
NEW YORK STOCK EXCHANGE LLC

Petitioning Participants

c/o Steven J. Abrams, Esq.
Ingram Yuzek Gainen Carroll & Bertolotti, LLP
250 Park Avenue
New York, New York 10177

OPINION OF THE COMMISSION

CONSOLIDATED TAPE ASSOCIATION/CONSOLIDATED QUOTATION PLAN –
REVIEW OF NATIONAL MARKET SYSTEM PLANS ACTION PURSUANT TO
RULE 608(d) UNDER THE SECURITIES EXCHANGE ACT OF 1934

Jurisdiction to Review Action of Plan

A majority of the participants of the Consolidated Tape Association Plan and the Consolidated Quotation Plan seeks review of the failure of the American Stock Exchange, in its capacity as the Network B Administrator, to comply with a majority vote of the participants directing it to deduct certain legal expenses incurred in connection with a settlement prior to allocating the settlement proceeds among the participants. Held, the Commission declines to exercise its discretion to review this action under Rule 608(d) of the Securities Exchange Act of 1934, and the application for review is dismissed.

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APPEARANCES:

Steven J. Abrams and Dean G. Yuzek, of Ingram Yuzek Gainen Carroll & Bertolotti, LLP, for Boston Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, Nasdaq Stock Market LLC, National Stock Exchange, Inc., NYSE Arca, Inc., and New York Stock Exchange LLC.

George T. Simon and Dean M. Jeske, of Foley & Lardner LLP, for American Stock Exchange, LLC, in its capacity as the Network B Administrator under the Consolidated Tape Association Plan and the Consolidated Quotation Plan.

Appeal filed: July 5, 2007

Last brief received: November 27, 2007

I.

The Boston Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated (“CBOE”), International Securities Exchange, LLC, Nasdaq Stock Market LLC (“Nasdaq”), National Stock Exchange, Inc., NYSE Arca, Inc. (“NYSE Arca”), and New York Stock Exchange LLC (“NYSE”) (collectively, the “Petitioning Participants”), pursuant to Rule 608(d)(1) of Regulation NMS of the Securities Exchange Act of 1934, 1/ (formerly Exchange Act Rule 11Aa3-2(e)(1)), 2/ petition us to compel the American Stock Exchange, LLC (“AMEX”), in its capacity as the Network B Administrator under the Consolidated Tape Association (“CTA”) Plan and the Consolidated Quotation (“CQ”) Plan (collectively, the “Plans”), 3/ to comply with the directions that a majority of the CTA participants issued to

1/ 17 C.F.R. § 242.608(d)(1). Exchange Act Rule 608(d) provides that the “Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective national market system plan.” Exchange Act Rule 608(d)(1) provides that “[a]ny action taken or failure to act by any person in connection with an effective national market system plan (other than a prohibition or limitation of access reviewable by the Commission . . .) shall be subject to review by the Commission, on its own motion or upon application by any person aggrieved thereby”

2/ In June 2005, Exchange Act Rule 11Aa3-2(e) was redesignated Exchange Act Rule 608(d) without any change in substance. See Regulation NMS, Securities Exchange Act Rel. No. 51808 (June 9, 2005), 85 SEC Docket 2264, 2338 (stating that, although Exchange Act Rule 608 renumbered Rule 11Aa3-2, the substance of the provision “remain[ed] largely intact”).

3/ The CTA is the policy-making body for the CTA Plan and administers the Consolidated Tape System, which makes available last sale transaction information for trades executed

(continued...)

AMEX. ^{4/} Those directions call for AMEX to reallocate certain settlement proceeds to the participants “net” of the legal expenses incurred in connection with certain litigation under the Plans. For the reasons set forth below, we decline to exercise our discretion to review this matter pursuant to Exchange Act Rule 608(d). ^{5/}

II.

Congress enacted the Securities Acts Amendments of 1975 ^{6/} to authorize the Commission to facilitate the establishment of a national market system that would employ communications systems to disseminate consolidated market information. ^{7/} Congress

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- ^{3/} (...continued)
in eligible securities. See, e.g., Cincinnati Stock Exch., 54 S.E.C. 857 (2000). The Consolidated Quotation System is the legal, operational, and administrative framework created pursuant to the CQ Plan for the collection, processing, and dissemination of quotation information for eligible securities. See Application Pursuant to Section 11A(a)(3)(B), Exchange Act Rel. No. 16518 (Jan. 22, 1980), 19 SEC Docket 367, 368; see also Order Directing Additional Briefs, Admin. Proc. File No. 10561 (Mar. 13, 2002) (settled CBOE case).
- ^{4/} There are eleven participants in the Plans, including the Petitioning Participants. The remaining four participants are AMEX, the Chicago Stock Exchange, Inc., the Philadelphia Stock Exchange, and Financial Industry Regulatory Authority, Inc. On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Because the events at issue here occurred before the consolidation, we use the designation NASD.
- ^{5/} See Am. Stock Exch., Inc., 54 S.E.C. 491, 497-99 (2000) (dismissing appeal and declining to exercise discretion under former Exchange Act Rule 11Aa3-2(e) to review action taken at CTA meeting concerning calculation of revenue generated from the sale of transaction information in derivative product known as “Diamonds”).
- ^{6/} Pub. L. No. 94-29, 89 Stat. 97.
- ^{7/} See, e.g., Regulation of Market Information Fees and Revenues, Exchange Act Rel. No. 42208 (Dec. 17, 1999), 71 SEC Docket 580, 581.

contemplated that a national market system would encourage both centralized trading and fair competition among markets. 8/

In 1978, various SROs filed with the Commission the CTA Plan and the CQ Plan. 9/ All of the SROs currently are participants in the CTA Plan and the CQ Plan. 10/ The Plans require participants to collect and report market information promptly to the Plan processors, who receive, consolidate, and disseminate it in accordance with the Plans. 11/

The SROs have developed four networks or systems to disseminate market information for different categories of securities. 12/ One of those networks, Network B, operates pursuant to the Plans and disseminates market information for certain securities that are admitted to dealings on the AMEX or regional exchanges but are not admitted to dealings on NYSE or Nasdaq. 13/ Each network has a member that is the day-to-day administrator of the network. 14/ AMEX is the network administrator designated by the Plans for Network B. 15/ AMEX enters into

8/ See Exchange Act Section 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C). See also Nasdaq Stock Mkt., LLC, Exchange Act Rel. No. 55909 (June 14, 2007), 90 SEC Docket 2553, 2554 (order accepting jurisdiction and establishing procedures). The Commission earlier had adopted a rule requiring every self-regulatory organization (“SRO”) to file a plan for collecting, processing, and disseminating on a consolidated basis reports of completed transactions in securities registered or admitted to trading on an exchange or over-the-counter. See Exchange Act Rel. No. 9850 (Nov. 8, 1972); Am. Stock Exch., 54 S.E.C. at 493; Nasdaq Stock Mkt., 90 SEC Docket at 2554-55.

9/ See Collection and Dissemination of Transaction Reports, Exchange Act Rel. No. 15250 (Oct. 20, 1978), 15 SEC Docket 1355, 1356; Dissemination and Display of Transaction Reports Quotation Information, Exchange Act Rel. No. 15251 (Oct. 20, 1978), 15 SEC Docket 1370, 1379.

10/ Regulation of Market Information Fees and Revenues, 71 SEC Docket at 582.

11/ Id. at 584.

12/ Id. at 582.

13/ Id. at 583. Network A also operates pursuant to the Plans. Id. Network A disseminates market information for certain securities that are admitted to dealings on the NYSE. Id.

14/ Id.

15/ CTA Plan Section I(t)(b); CQ Plan Section I(r)(b).

“arrangements on behalf of the Network B Participants so as to authorize vendors and other persons to receive and use CTA Network B information for purposes of assorted services.” 16/

The Plans and NASD rules set forth the terms and conditions under which market information is disseminated by the networks. 17/ For example, the Plans and NASD rules require that market information be disseminated exclusively to vendors and subscribers who have been approved by their respective administrators and who have contracted to receive such information. 18/ In accounting for these arrangements, the revenues derived from fees charged for a network’s market information are aggregated into a single pool. 19/ The network’s operating expenses are then paid directly out of the network’s revenues. 20/ After operating expenses are deducted, the network’s revenues are distributed to its participants in proportion to their share of the total transaction volume for the network. 21/ The participants are provided annually with audited financial statements of their finances. 22/

III.

In May 2004, AMEX learned that Edward D. Jones & Co. (“EDJ”) had under-reported its usage and dissemination of Network B market data and had failed to pay substantial usage fees to the network from 1988 to 2004. At the October 13, 2004 meeting of the CTA, AMEX notified the CTA participants of EDJ’s delinquent reporting and retroactive fee liability. AMEX reported that it would pursue a breach of contract claim against EDJ and also seek recovery of legal and arbitration expenses associated with the litigation. 23/

16/ CTA Plan Section IX(f).

17/ Regulation of Market Information Fees and Revenues, 71 SEC Docket at 584.

18/ Id.

19/ Id.

20/ Id.

21/ Id.

22/ Id.

23/ The Petitioning Participants filed a motion to introduce additional evidence pursuant to Rule 452 of our Rules of Practice, 17 C.F.R. § 201.452. The Petitioning Participants seek to introduce copies of (1) a statement of claim against EDJ that AMEX submitted to the American Arbitration Association; (2) two spreadsheets displaying calculations of the allocation of the EDJ settlement proceeds and associated legal expenses; and (3) minutes of additional CTA meetings addressing the allocation of the EDJ settlement proceeds and

(continued...)

In the fall of 2006, AMEX distributed to the participants audited financial statements for the years ending December 31, 2004 and 2005. Those statements noted that, “[i]f any revenues are recovered with respect to [the EDJ] matter, they will be distributed to the Plan Participants in accordance with the applicable share percentages in effect among the Plan Participants for each annual reporting period since 1988 for which underpayments are collected.” According to AMEX, “the EDJ legal [expenses] were included as Operating Expenses in [those] audited financial statements . . . which were provided to all Plan Participants.” Those financial statements, however, did not identify legal expenses nor any other expenses as separate line items under the broad category of “Operating Expenses.”

At a February 28, 2007 CTA meeting, the participants discussed a settlement offered by EDJ in connection with the arbitration that was scheduled to begin the following week. AMEX reported that EDJ had offered \$10.85 million to settle the dispute. AMEX asserted that acceptance of the EDJ settlement offer “would cancel the pending arbitration and eliminate further legal [expenses].” ^{24/} According to the minutes of that meeting, some participants sought a “breakdown of the recovery and its allocation” and insisted on reviewing the allocation with their respective managements before voting; however, AMEX asked for a vote “today,” with discussion of distribution of the settlement proceeds “later.” AMEX agreed to provide at some future date a schedule of the allocation of the settlement proceeds among the participants “based on yearly market share.” AMEX then moved to accept the \$10.85 million EDJ offer “to settle the entire dispute.” A majority of the participants voted to accept the offer, and EDJ paid the settlement amount to AMEX on March 5, 2007.

According to the minutes of the March 16, 2007 CTA meeting, the participants debated the allocation of the settlement proceeds. Nasdaq’s CTA representative asserted that the CTA Plan was unclear regarding the recovery of extraordinary costs but seemed to provide for the expensing of costs in the year in which they occurred. He maintained that the CTA Plan’s cost-expensing language did not cover the “special circumstances” of expensing legal costs associated with recovery of prior years’ usage fees because they were “more appropriately attributable” to the years in which the usage fees were incurred.

^{23/} (...continued)

legal expenses. Rule 452 requires a showing that there were reasonable grounds for failure to adduce such evidence previously and that the additional evidence is material.

In support of their motion, the Petitioning Participants assert that they did not have the opportunity previously to supplement the record that AMEX produced because they were not asked to provide information for inclusion in the record. AMEX does not oppose the motion. We believe that the information supplied by the Petitioning Participants is material to our further understanding of the nature of the dispute and have determined to admit it.

^{24/} According to AMEX, those legal bills already exceeded \$2 million.

AMEX argued that the legal expenses were normal expenses and should not be deemed "extraordinary" by virtue of it being the first time that the CTA had actually incurred legal expenses to recover usage fees. AMEX maintained that the CTA Plan "clearly" provides for legal expenses to be categorized as operating expenses in the year in which the expenses occurred. AMEX stated that the \$10.85 million settlement amount covered the principal, interest, and administrative charges for the entire claim and that "it was not possible to separate the funds by year." AMEX suggested that any deviation from that approach would require a plan amendment.

Nasdaq's CTA representative moved to have CTA direct AMEX to allocate each participant's share of those legal expenses in the same proportion as the amount the participant received from the EDJ settlement (the "March 16 motion"). AMEX objected that the motion would require a plan amendment. The resulting votes fell short of a majority and the March 16 motion failed to carry.

On March 19, 2007, AMEX distributed the EDJ settlement proceeds to the participants "based upon their applicable market share during the period of the claim and included as part of the first quarter 2007 distribution made to the [participants]," according to fiscal year 2006 audited financial statements. On April 3, 2007, the participants convened a telephone meeting to reassess the distribution of the EDJ settlement proceeds. The NYSE Arca representative reported that, based on "new information" from AMEX regarding the allocation of the legal costs relating to the EDJ settlement, allocating the legal expenses in the years in which they were incurred would be inequitable and inconsistent with the terms of the CQ Plan. She noted that AMEX had allocated to NYSE Arca \$1,244,000 in legal expenses and \$530,000 of the EDJ settlement proceeds, resulting in a \$714,000 loss to NYSE Arca. However, AMEX, as the Network B Administrator, allocated to AMEX, in its capacity as a participant, \$6,761,000 of the settlement proceeds, but required AMEX to pay only \$726,000 of the legal expenses. According to the minutes of that meeting, the AMEX representative responded that "the distribution was done in the same manner as previous distributions." The record does not identify those "previous distributions."

The NYSE Arca representative moved to apply the EDJ matter legal expenses and other costs associated with the negotiated settlement against the settlement dollars obtained prior to distribution to the participants, so as to ensure that no participant paid out-of-pocket costs for the settlement. AMEX objected to that approach. AMEX noted that the March 16 motion to distribute the settlement proceeds net of legal expenses did not carry; thus, AMEX instead had allocated the legal expenses based on the years in which the expenses were incurred. In response to AMEX's objection, a "simplified" motion was made:

To reallocate legal expenses and deduct those [expenses] prior to the distribution of the settlement funds from the EDJ case.

A majority of the participants voted in favor of this motion (the "April 3 vote"). AMEX refused to recognize the vote and declared it "null and void."

By letter dated June 4, 2007, AMEX notified the participants of its view that it could not comply with the April 3 vote because that motion would require AMEX "to reallocate expenses that were deducted from Net Income in prior years based upon the allocation of the EDJ settlement" and thus was "directly in conflict with [its] obligations under the CTA and CQ Plans." AMEX explained that distributions made to the participants "are specifically tied to the audited financial statements" of the Plans and "there is no provision in either Plan for retroactively changing those distributions absent a possible restatement of the audited financials." AMEX attached copies of the fiscal year 2004 and 2005 audited financial statements and stated that there was "no reserve established which would enable the [Plans] to reallocate EDJ related expenses deducted in those years based upon the allocation of any subsequent recovery." AMEX stated that "the vote recently taken by the [participants] to reallocate expenses in prior years is inconsistent with the audited statements of" the Plans, "inconsistent with the [Plans themselves] and can only be effectuated by an amendment to these Plans, which, as you know, requires unanimous consent of all the [participants]." AMEX added that, although the proposed resolution would require some participants to make payments to other participants to reimburse them for expenses charged against their distributions in prior years, the Plans do not provide for such payments.

On June 5, 2007, AMEX circulated a spreadsheet showing the allocation of the EDJ settlement proceeds among the participants based on their yearly market share, as promised at the February 28, 2007 meeting. At a June 6, 2007 CTA meeting, the participants agreed that the April 3 vote directed AMEX to distribute the EDJ settlement proceeds after netting out the legal expenses relating to the legal proceeding, required those participants that had received excess distributions from the settlement to return the excess amounts to AMEX, and directed AMEX to distribute the returned funds to those participants "that were from the settlement." AMEX again objected that such actions were inconsistent with the Plans. A majority of the participants approved a motion providing that each participant that owed money as set forth in AMEX's spreadsheet would return such amount to AMEX, which was instructed to withhold future distributions of proceeds from any noncomplying participant until the balance owed was "reduced to zero." AMEX reserved its right to contest the taking of that vote.

IV.

Exchange Act Rule 608(d) governs the Commission's authority to hear appeals from action taken pursuant to a national market system plan, such as the CTA Plan or CQ Plan. ^{25/} Exchange Act Rule 608(d) provides that the "Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective national market

^{25/} See Am. Stock Exch., 54 S.E.C. at 496 (citing Exchange Act Rule 11Aa3-2, the predecessor of Exchange Act Rule 608(d)); see supra note 2.

system plan” 26/ Exchange Act Rule 608(d)(1) provides that “[a]ny action taken or failure to act by any person in connection with an effective national system plan (other than a prohibition or limitation of access reviewable by the Commission pursuant to [other Exchange Act provisions]) shall be subject to review by the Commission, on its own motion or upon application by any person aggrieved thereby” 27/

We held in American Stock Exchange that, despite the apparent conflict between the predecessors of Exchange Act Rule 608(d) and subsection 608(d)(1), “Commission review of appeals under [Exchange Act] Rule 11Aa3-2[,]” (the predecessor of Exchange Act Rule 608(d)), “is discretionary.” 28/ We concluded that the language “shall be subject to review” in Exchange Act Rule 11Aa3-2(e)(1), the predecessor of Exchange Act Rule 608(d)(1), “does not make Commission review of national market system plan action mandatory.” 29/

In American Stock Exchange, AMEX sought discretionary review of CTA action to exclude from the calculation of AMEX’s annual share of CTA revenue, transactions in a

26/ 17 C.F.R. § 242.608(d) (emphasis added); see also Am. Stock Exch., 54 S.E.C. at 496.

27/ 17 C.F.R. § 242.608(d)(1) (emphasis added).

28/ Am. Stock Exch., 54 S.E.C. at 498 (concluding that, based on the release proposing Exchange Act Rule 11Aa3-2, “the Commission believed that its obligation to review an appeal from national market system plan action would be triggered only in the event that the Commission exercised its discretion in the first instance to undertake such a review.”). See also Procedures and Requirements for National Market System Plans, Exchange Act Rel. No. 16410 (Dec. 7, 1979), 18 SEC Docket 1306, 1313 (proposing Exchange Act Rule 11Aa3-2).

29/ Am. Stock Exch., 54 S.E.C. at 497.

Exchange Act Section 11A(b)(5), 15 U.S.C. § 78k-1(b)(5), provides for mandatory Commission review of any prohibition or limitation on access to services offered by a registered securities information processor upon application of an aggrieved person. See also Nasdaq Stock Mkt., 90 SEC Docket 2553 (jurisdiction mandatory where potentially excessive new participant entry fee may have constituted a denial of access); Cincinnati Stock Exch., 54 S.E.C. 857, 860 (jurisdiction mandatory where imposition of market data display fees on Cincinnati Stock Exchange specialists limited their access to a registered securities information processor’s services). CTA is a registered securities information processor. Id. None of the parties contends that this matter implicates our mandatory jurisdiction.

derivative product known as Diamonds. ^{30/} We declined to review that matter because the issues raised by the appeal failed “to implicate any of the broad objectives of the national market system – the public interest, the protection of investors, or the maintenance of fair and orderly markets” nor did the “appeal concern action related to our role in facilitating the establishment of a national market system.” ^{31/} We concluded that the “appeal concern[ed] individual financial interests, and not the broad objectives of the national market system.” ^{32/} We stated that the “Commission’s responsibility under the [Exchange] Act is not to act as the arbiter of individual competitive interests but instead to further the objectives set forth . . . under the [Exchange] Act, including those relating to the enhancement of competition in the securities industry.” ^{33/}

American Stock Exchange set forth the guidelines we use to exercise our discretionary jurisdiction under Exchange Act Rule 608(d). We have an abiding interest in the fair administration of the Plans and in policing against self-dealing to ensure that the Plans are operated in furtherance of the statutory objectives of the national market system. ^{34/} The Petitioning Participants have not persuaded us that those statutory objectives are implicated here.

Initially, we note that our inquiry in this matter is limited by the record assembled by AMEX and supplemented by the Petitioning Participants. The record consists primarily of selected minutes of CTA/CQ meetings between October 2004 and June 2007, audited annual financial statements for 2004-2006, selected correspondence, two spreadsheets, the arbitration claim that resulted in the settlement with EDJ, and composite copies of the CTA and CQ Plans. The minutes are not detailed, and there are no transcripts of the relevant meetings. As a result, our initial consideration of the case, which might have persuaded us to exercise our discretionary jurisdiction, has been hampered.

In support of their application, the Petitioning Participants assert that the “issues raised by this appeal pertain to the maintenance of fair and orderly markets, the removal of impediments to a national market system and the perfection of the mechanisms of a national market system, all objectives of the 1934 Act” and that “AMEX’s actions and failures allow the Commission to make each and every one of the findings” based on the statutory objectives. The Petitioning

^{30/} Am. Stock Exch., 54 S.E.C. at 491.

^{31/} Id. at 499 (dismissing appeal involving an “ordinary commercial dispute” between AMEX and the other participants).

^{32/} Id. at 500.

^{33/} Id. at 499-500 (quoting Procedures and Requirements for National Market System Plans, Exchange Act Rel. No. 17580 (Feb. 26, 1981), 22 SEC Docket 195, 198 (footnote omitted)).

^{34/} See 17 C.F.R. § 242.608(d).

Participants do not, however, articulate a nexus between the statutory policy and the issues raised by their appeal. They contend that AMEX failed to volunteer certain information about the settlement and allocation of its proceeds. They raise questions regarding whether the legal expenses should be characterized as ordinary or extraordinary expenses and the applicable time period over which the settlement proceeds and expenses should be allocated. As thus articulated, their concerns with respect to the allocation of the EDJ settlement and expenses involve an internal business controversy – a commercial dispute over the correct interpretation of the Plans that implicates neither the establishment or functioning of a national market system nor the Commission’s expertise in securities law. 35/ As we concluded in American Stock Exchange, we believe that resolution of such business disputes, without a satisfactory explanation of a clearer and closer connection to the statutory areas we are charged with supervising, should be left to the courts, which have experience in adjudicating such issues. 36/ Where the statutory objectives of the national market system are implicated, however, the Commission’s oversight of the administration of the Plans gives us a compelling interest in ensuring that the Network B administrator carries out its duties equitably and commensurately with those statutory objectives.

Although the Petitioning Participants mention that AMEX’s conduct is anti-competitive and invoke the Congressional public interest findings of Exchange Act § 11A(a)(1)(C)(ii) in favor of fair competition among exchange markets, 37/ they do not explain how the actions of AMEX burden competition and make no serious argument that the actions were anti-competitive. The Petitioning Participants also do not explain how their reference to anti-competitive behavior extends to an adverse effect on the functioning of the national market system, the public interest, the protection of investors, or the maintenance of fair and orderly markets. 38/

35/ See Am. Stock Exch., 54 S.E.C. at 500.

36/ See id. (dismissing what was “fundamentally a contract dispute”).

37/ 15 U.S.C. § 78k-1(a)(1)(C)(ii).

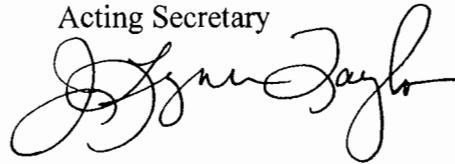
38/ AMEX challenges this appeal on timeliness grounds, claiming that the Petitioning Participants filed their petition two months after the expiration of the thirty day period within which to seek review. The Petitioning Participants dispute the date on which that thirty day period began to toll. In light of our decision here, we do not reach the timeliness issue.

For the foregoing reasons, we decline to exercise our discretion to entertain the Petitioning Participants' appeal pursuant to Exchange Act Rule 608(d).

An appropriate order will issue. 39/

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

Florence E. Harmon
Acting Secretary

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

By: J. Lynn Taylor
Assistant Secretary

39/ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Rel. No. 58191 / July 18, 2008

Admin. Proc. File No. 3-12174

In the Matter of the Application of

BOSTON STOCK EXCHANGE, INC.,
CHICAGO BOARD OPTIONS EXCHANGE, INC.,
INTERNATIONAL SECURITIES EXCHANGE, LLC,
NASDAQ STOCK MARKET LLC,
NATIONAL STOCK EXCHANGE, INC.,
NYSE ARCA, INC., AND
NEW YORK STOCK EXCHANGE LLC

Petitioning Participants

c/o Steven J. Abrams, Esq.
Ingram Yuzek Gainen Carroll & Bertolotti, LLP
250 Park Avenue
New York, New York 10177

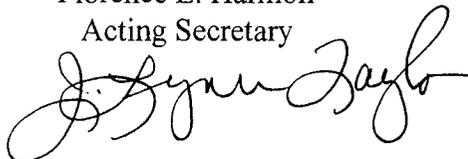
ORDER DISMISSING APPLICATION FOR REVIEW OF NATIONAL MARKET SYSTEM
PLANS ACTION PURSUANT TO RULE 608(d) UNDER THE SECURITIES EXCHANGE
ACT OF 1934

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

ORDERED that the Petition to Compel the Network B Administrator to Follow the
Direction of the CTA/CQ Plan Participants be, and it hereby is, dismissed.

By the Commission.

Florence E. Harmon
Acting Secretary



By: J. Lynn Taylor
Assistant Secretary

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed company is suspended for the period from 9:30 a.m. EDT, July 18, 2008, through 11:59 p.m. EDT, on July 31, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2757 / July 23, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13092

In the Matter of Thomas C. Palmer and
Aeneas Capital Management, L.P.

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(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Thomas C. Palmer, and that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(e) of the Advisers Act against Aeneas Capital Management, L.P. (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 Investment Advisers Act of 1940 ("Order"), as set forth below.

document 7 of 22

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Summary

These proceedings arise from the unauthorized transfers of cash from two hedge funds to satisfy margin calls of a third hedge fund. Specifically, Thomas C. Palmer ("Palmer"), while serving as the director of operations for Aeneas Capital Management, L.P. ("Aeneas"), made five unauthorized transfers of cash totaling \$13.4 million from Aeneas Evolution Portfolio, Ltd. ("Evolution") and Aeneas Portfolio Company, L.P. ("Portfolio") to a third hedge fund, Priam Holdings Ltd. ("Priam"), to satisfy Priam's margin calls. Evolution, Portfolio, and Priam are separate funds operated by Aeneas. As a result of this conduct, Palmer willfully aided and abetted and caused violations of Sections 206(1) and 206(2) of the Advisers Act. Aeneas also failed reasonably to supervise Palmer, who was responsible for making the unauthorized transfers, with a view towards preventing violations of Sections 206(1) and 206(2) of the Advisers Act. Moreover, Aeneas failed to have in place adequate policies and procedures designed to detect and prevent such unauthorized transfers of cash among funds.

Respondents

1. Thomas C. Palmer, age 39, resides in Yorktown Heights, New York and served as the director of operations for Aeneas Capital Management, L.P. As director of operations, Palmer maintained responsibility for, among other things, overseeing and managing margin balances for Evolution, Portfolio, and Priam.

2. Aeneas Capital Management, L.P. is a Delaware limited partnership. Aeneas is an investment adviser and is headquartered in Mt. Kisco, New York. During the relevant time period, Palmer was an employee of Aeneas Capital Management, L.P. and subject to its supervision. During the relevant time period, Aeneas Capital Management, L.P. employed three primary employees, including Palmer.

Other Relevant Entities

3. Aeneas Evolution Portfolio, Ltd. is a hedge fund. It is a Cayman Islands company organized on January 7, 2005. Its principal place of business is in Mt. Kisco, New York.

4. Aeneas Portfolio Company, L.P. is a hedge fund. It is a Cayman Islands limited partnership organized on February 4, 2000. Its principal place of business is in Mt. Kisco, New York.

5. Priam Holdings Ltd. is a hedge fund. It is a British Virgin Islands international business company incorporated on March 23, 2000. It is currently controlled by its prime broker.

Facts

A. The Unauthorized Transfers of Cash

6. Priam invested primarily in microcap foreign issuers that trade on the Malaysian securities exchanges. None of Priam's 14 investors was a U.S. person or entity.

7. Beginning in Spring 2006 and continuing into the summer, Priam accumulated a significant trading position in Iris Corporation, a Malaysian microcap issuer that trades on the Malaysian Stock Exchange but that does not trade on U.S. markets. Priam's position in Iris Corporation, as well as its positions in other issuers, was highly leveraged by using funds borrowed from its prime broker to trade on margin.

8. In early July 2006, the position sizes within the Priam portfolio were increased to the point where there were several margin calls that were satisfied by Palmer's requested transfers.

9. Palmer was at all relevant times the Aeneas employee with day-to-day responsibility for managing and overseeing margin balances for Evolution, Portfolio, and Priam. In an attempt to satisfy Priam's margin calls, Palmer made five separate transfers of cash to Priam from Evolution and Portfolio, despite knowing that Evolution, Portfolio, and Priam were separate funds. Palmer initiated these transfers by sending emails to Aeneas' prime broker instructing it to move the funds. The transfers totaled \$13.4 million and were as follows:

July 7, 2006:	Portfolio transferred \$100,000 to Priam
July 10, 2006:	Portfolio transferred \$2.7 million to Priam
July 12, 2006:	Portfolio transferred \$400,000 to Priam
July 13, 2006:	Portfolio transferred \$2.2 million to Priam, and Evolution transferred \$8 million to Priam

10. While the transfer of assets among funds may be permissible -- if, for example, the specific type of transfer is disclosed in the private placement memorandum and is consistent with the fiduciary obligations an investment adviser owes the fund it advises -- these transfers were neither disclosed nor consistent with Palmer's fiduciary obligations.

11. Palmer subsequently learned that Priam would incur an additional margin call due to a significant decrease in the value of Priam's portfolio. Evolution and Portfolio lacked readily transferable assets to satisfy the additional margin call. Palmer informed his supervisor, who was Aeneas' chief operating officer, of the situation and they called Priam's prime broker to let it know that Priam would be unable to satisfy the margin call.

12. The prime broker questioned the purpose of the cash transfers and was informed that the transfers were loans from Evolution and Portfolio to Priam. There was, however, no contemporaneous loan documentation to support this explanation.

13. The cash transfers were reversed in early August 2006 and the funds were sent back to Evolution and Portfolio. As a result, no investor funds were lost and Aeneas subsequently paid investors for the interest earned on the funds for the period during which they were in Priam's account. When Priam could not satisfy the subsequent margin call, Aeneas' prime broker took control of all securities positions held in Priam.

B. Aeneas Failed Reasonably to Supervise Palmer

14. Palmer reported to, and was supervised by, Aeneas' chief operating officer, who oversaw the legal and compliance functions of Aeneas. Prior to making the unauthorized transfers, Palmer tried to contact his supervisor to advise him of the margin situation. Palmer's supervisor was on vacation and Palmer was unable to reach him. Aeneas failed to have any policy in place identifying who would assume supervisory and compliance responsibilities in the absence of Palmer's supervisor.

15. Aeneas did not have any policies in place that outlined when it was permissible to transfer cash among funds. Significantly, Aeneas had neither procedures designed to detect the occurrence of cash transfers between funds nor procedures designed to determine if such transfers were permissible.

16. Aeneas did not have any policies or procedures in place for seeking approval to transfer cash between funds.

17. Aeneas failed reasonably to supervise Palmer, who knowingly made multiple unauthorized transfers of cash between funds. Aeneas did not have adequate policies and procedures designed to detect and prevent violations of the antifraud provisions of the Advisers Act, such as unauthorized transfers of cash.

Legal Analysis

18. Section 206(1) of the Advisers Act makes it unlawful for any investment adviser to employ any device, scheme, or artifice to defraud any client or prospective client. Under Section 206(2) of the Advisers Act, it is unlawful for any investment adviser to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Scienter is an element of a claim under Section 206(1) but not under Section 206(2). See SEC v. Steadman, 967 F.2d 636, 641, 643 & n.5 (D.C. Cir. 1992). The scienter element of Section 206(1) may be satisfied by a showing that the investment adviser was reckless. See id. at 641-42.

19. At the time of the cash transfers, Palmer knew that Priam lacked sufficient assets to satisfy the margin calls. Palmer further knew, or was reckless in not knowing, that Priam, Evolution, and Portfolio were separate funds with distinct investors and that he, on behalf of Aeneas, was not authorized to transfer cash among the funds to satisfy margin calls. Consequently, Palmer knowingly made multiple unauthorized cash transfers from Evolution and Portfolio to Priam in order to satisfy Priam's margin calls.

20. Based on the foregoing, Palmer willfully aided and abetted and caused violations of Sections 206(1) and 206(2) of the Advisers Act.

21. Section 203(e) of the Advisers Act authorizes the Commission to sanction an investment adviser that has failed reasonably to supervise, with a view to preventing violations of the federal securities laws, another person who commits such a violation, if such other person is subject to its supervision. The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. See In re Rhumblin Advisers, Advisers Act Rel. No. 1765 (Sep. 29, 1998); In re Scudder Kemper Investments, Inc., Advisers Act Rel. No. 1848 (Dec. 22, 1999) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees' unauthorized trading in client accounts); In re Nicholas-Applegate Capital Management, Advisers Act Rel. No. 1741 (Aug. 12, 1998) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from engaging in improper personal trading); In re Van Kampen American Capital Asset Management, Inc., Advisers Act Rel. No. 1525 (Sep. 29, 1995) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from mispricing fund securities).

22. Aeneas failed reasonably to supervise Palmer within the meaning of Section 203(e)(6) of the Advisers Act with a view to preventing and detecting his violations of the antifraud provisions of the Advisers Act. Moreover, Aeneas failed to establish or implement

adequate procedures regarding the transfer of cash among the three funds. Aeneas' failure to supervise and lack of adequate procedures allowed Palmer to make the unauthorized cash transfers.

Undertakings

23. Respondent Palmer shall provide to the Commission, within thirty days after the end of the twelve month suspension described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

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

Accordingly, it is hereby ORDERED that:

- A. Respondent Thomas C. Palmer cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act;
- B. Respondent Thomas C. Palmer 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;
- C. Respondent Thomas C. Palmer shall, within thirty (30) days from the date of the entry of this Order, pay a civil money penalty in the amount of \$65,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Thomas C. Palmer 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 Scott W. Friestad, Associate Director, U.S. Securities and Exchange Commission, Division of Enforcement, 100 F Street, NE, Washington, DC 20549-5631;
- D. Respondent Thomas C. Palmer shall comply with the undertakings enumerated in Section III, paragraph 23 above.
- E. Respondent Aeneas Capital Management, L.P. is censured; and

F. Respondent Aeneas Capital Management, L.P. shall, within thirty (30) days from the date of the entry of this Order, pay a civil money penalty in the amount of \$150,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Aeneas Capital Management, L.P. 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 Scott W. Friestad, Associate Director, U.S. Securities and Exchange Commission, Division of Enforcement, 100 F Street, NE, Washington, DC 20549-5631.

By the Commission.

Florence E. Harmon
Acting Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 23, 2008

In the Matter of

SWEDISHVEGAS, INC.

File No. 500-1

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of SwedishVegas, Inc.

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 commencing at 9:30 a.m. EDT, July 23, 2008, and terminating at 11:59 p.m. EDT, on August 5, 2008.

By the Commission.


Florence E. Harmon
Acting Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 25, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13099

In the Matter of

NEWBRIDGE SECURITIES
CORP., GUY S. AMICO,
SCOTT H. GOLDSTEIN,
ERIC M. VALLEJO, and
DANIEL M. KANTROWITZ,

Respondents.

ORDER INSTITUTING PUBLIC
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 8A OF THE SECURITIES ACT
OF 1933, AND 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 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 Newbridge Securities Corp. ("Newbridge"), Guy S. Amico ("Amico"), Scott H. Goldstein ("Goldstein"), Eric M. Vallejo ("Vallejo"), and Daniel M. Kantrowitz ("Kantrowitz"), collectively ("Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. **RESPONDENTS**

1. Newbridge, a Fort Lauderdale, Florida broker-dealer, has been registered with the Commission since 2000 and is a member of the Financial Industry Regulatory Authority ("FINRA"). Over the course of the past five years, FINRA has brought numerous actions against Newbridge for failing to comply with various broker-dealer regulations.

2. Amico, 45, resides in Wellington, Florida. Amico is an owner of Newbridge.

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3. Goldstein, 42, resides in Delray Beach, Florida. Goldstein is an owner of Newbridge. Goldstein has been disciplined by FINRA for supervisory failures at Newbridge.

4. Vallejo, 44, resides in Hollywood, Florida. Vallejo is Newbridge's head trader. Vallejo has been disciplined by FINRA for supervisory failures at Newbridge.

5. Kantrowitz, 45, resides in Boca Raton, Florida. Kantrowitz is a registered representative at Newbridge. In 1996, FINRA censured and fined Kantrowitz \$10,000, suspended Kantrowitz from associating with any member for 120 days in any capacity and required him to pay \$3,625 in restitution to NAIB Trading Corporation because he arranged a fictitious, profitable trade on behalf of a customer as a reward for the customer's business in violation of the FINRA Rules of Fair Practice. (FINRA Case Number CMS950084 filed July 24, 1995.) Kantrowitz participated in offerings of Concorde America, Inc. and Roanoke Technology Corp. stock, which were penny stocks.

B. OTHER RELEVANT ENTITIES AND INDIVIDUALS

6. Concorde America, Inc. ("Concorde") is a Nevada corporation with its principal place of business in Boca Raton, Florida. Concorde's securities, which are quoted on the Pink Sheets, are not registered with the Commission. On February 14, 2005, the Commission filed a civil injunctive action against Concorde and others based on their violations of the antifraud provisions of the federal securities laws for their participation in a fraudulent manipulation of Concorde shares. SEC v. Concorde America, Inc., Absolute Health and Fitness, Inc., et al., Case No. 05-80128-CIV-ZLOCH (S.D. Fla.). Concorde consented to all non-monetary relief sought in the complaint and the court entered a final judgment of permanent injunction on February 9, 2007.

7. Donald Oehmke ("Oehmke"), 58, resides in Kalamazoo, Michigan. Oehmke, a former registered representative, was permanently barred from association with any FINRA member in 1991. Oehmke controlled a shell company, which later became Concorde, and executed numerous fraudulent securities transactions in Concorde through Newbridge and another broker-dealer registered with the Commission ("other broker-dealer"). The Commission named Oehmke as a defendant in the Concorde action based on his violation of the antifraud provisions of the federal securities laws, for his participation in the fraudulent manipulation of Concorde shares. On November 28, 2006, the court entered a final judgment against Oehmke enjoining him from future violations of the antifraud provisions of the federal securities laws and imposing a penny stock bar, an unregistered offering bar, disgorgement in the amount of \$1,095,177, prejudgment interest of \$109,307, and a civil penalty of \$250,000.

8. Roanoke Technology Corp. ("Roanoke") is a Florida corporation headquartered in Rocky Mount, North Carolina. Roanoke's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. On January 15, 2008, the Commission revoked Roanoke's registration for its repeated failure to file required periodic reports. The stock was quoted on the Over-The-Counter Bulletin Board, then quoted on the Pink Sheets. Prior to the Commission revoking Roanoke's registration, the Commission filed a civil injunctive action on December 21, 2005 against Roanoke and others for their participation in a

fraudulent S-8 scheme, and charged Roanoke with antifraud, registration, and reporting violations of the federal securities laws. SEC v. Roanoke Technology Corp. et al., Case No. 6:05-CV-1880-ORL-3-KRS (M.D. Fla.). Roanoke consented to all non-monetary relief sought in the complaint and the court entered a final judgment of permanent injunction on September 27, 2006.

9. Thomas L. Bojadzjev (“Bojadzjev”), 29, resides in Orlando, Florida, and is purportedly a self-employed consultant. Bojadzjev participated in a sham S-8 scheme with Roanoke, and executed numerous fraudulent securities transactions in Roanoke through Newbridge. The Commission named Bojadzjev as a defendant in the Roanoke civil injunctive action based on his violations of the antifraud, registration, and reporting provisions of the federal securities laws for participating in the fraudulent S-8 scheme. On January 3, 2007, the court entered a judgment against Bojadzjev enjoining him from future violations of the antifraud, registration, and reporting provisions of the federal securities laws, and imposing a penny stock bar. On August 31, 2007, the court entered a final judgment against Bojadzjev ordering him to pay disgorgement in the amount of \$2,681,866, prejudgment interest of \$291,565 and a civil penalty in the amount of \$120,000.

C. OVERVIEW

10. This proceeding arises out of four primary events: (1) Kantrowitz’s manipulation of Concorde shares; (2) the unregistered distribution and Kantrowitz’s manipulation of Roanoke shares; (3) Newbridge, Amico, Goldstein, and Vallejo’s failure reasonably to supervise Kantrowitz in connection with his activities in Concorde and Roanoke; and (4) Newbridge’s violative activities concerning two initial public offerings (“IPOs”).

11. In 2003 and 2004, Kantrowitz engaged in the manipulation of Concorde and Roanoke shares on behalf of Oehmke and Bojadzjev, respectively. Kantrowitz used Newbridge’s market making capacity to manipulate the securities.

12. In October 2002 and December 2003, Newbridge was advised by the Commission’s examination staff of supervisory failures at Newbridge’s trading desk and the possibility that Kantrowitz’s business was facilitating unregistered offerings and engaging in other manipulative conduct. Despite these warnings, Newbridge failed to develop and implement policies, procedures, and systems reasonably designed to prevent and detect Kantrowitz’s manipulation of Concorde securities and his manipulation and unregistered distribution of Roanoke securities.

13. At all relevant times, Amico and Goldstein were Newbridge’s president and chief executive officer, respectively, and retained responsibility for developing reasonable firm supervisory procedures and retained supervisory authority over Kantrowitz. Amico and Goldstein delegated the day to day supervision of Kantrowitz to subordinates, however, they were on notice that this delegation was ineffective. Vallejo, the firm’s head trader, directly supervised Kantrowitz. Amico, Goldstein, and Vallejo all failed reasonably to supervise Kantrowitz.

14. Newbridge also violated the federal securities laws in connection with two initial public offerings when its registered representatives sent detailed emails concerning the offerings to customers during the "waiting period," the period after a registration statement is filed with the Commission but before the Commission declares it effective.

D. MANIPULATION OF CONCORDE

15. From June through October 2004, Kantrowitz engaged in a manipulation scheme involving the securities of Concorde that enabled Oehmke to reap more than \$5.8 million in sales proceeds by liquidating more than 1.5 million Concorde shares.

16. In June 2004, Oehmke obtained ten million shares of Concorde, which constituted almost all of Concorde's publicly tradable shares. Oehmke subsequently distributed the shares to a number of offshore nominee entities that maintained brokerage accounts at Newbridge and the other broker-dealer, who also made a market in Concorde.

17. Beginning on June 30, 2004, Oehmke directed Newbridge and the other broker-dealer's market making activities to increase Concorde's share price. At Oehmke's direction, Kantrowitz and the other broker-dealer placed increasing bids on Concorde stock, even though no Concorde shares were traded and no news items were disseminated. From June 30 to July 27, 2004, Kantrowitz manipulated Concorde's share price upward from \$0.01 to \$3.00.

18. Despite raising the bid price for Concorde shares on an almost daily basis, Kantrowitz was aware that Oehmke had no interest in buying Concorde shares. Oehmke had communicated to Kantrowitz that Oehmke intended to liquidate the large number of Concorde shares he deposited with the firm through an account he maintained at Newbridge as well as, in a representative capacity, through an account maintained by one of the offshore nominee entities.

19. After raising the price of Concorde shares under Oehmke's direction through increasing fictitious bids, Kantrowitz took part in a scheme to dispose of the shares without drawing attention to Oehmke's control over the supply of Concorde shares. Beginning in July 2004, Oehmke directed Kantrowitz and the other broker-dealer to sell his Concorde shares, which he had deposited at each firm.

20. Kantrowitz followed another Oehmke tactic designed to artificially stimulate market activity in Concorde shares. To further create the appearance of an active and competitive market, Oehmke directed wash trades between accounts he controlled and directed Newbridge and the other broker-dealer to post quotes to buy the stock. Kantrowitz followed Oehmke's instructions.

21. Additionally, Kantrowitz complied with Oehmke's instruction to stay "close" to and shadow the bids posted by the other broker-dealer in Concorde stock, by either posting the same or incrementally higher quotes, despite subsequent regulatory inquiries Newbridge received from the staff of the Division of Enforcement and FINRA with regard to

Oehmke's trading activities in Concorde shares, and an August 11, 2004 Concorde disclaimer press release that caused the stock price to drop more than 80%.

22. In August 2004, Oehmke started another campaign to raise Concorde's share price. Oehmke directed Kantrowitz and the other broker-dealer to make a series of incrementally higher bid quotes. By utilizing two market makers, Oehmke was able to cause Kantrowitz and the other broker-dealer to create the appearance of buyers at each firm engaging in a bidding war for the stock. Kantrowitz complied with Oehmke's instruction to incrementally increase Newbridge's bids in accordance to bids posted by the other broker-dealer. As a result, Kantrowitz and the other broker-dealer rapidly manipulated Concorde's share price upward on August 13, 2004 from \$1.75 to \$5.45 over a period of an hour and twenty minutes, creating another rise in Concorde's share price that enabled Oehmke to liquidate additional Concorde shares at a substantial profit.

23. Kantrowitz knew that Oehmke had no bona fide interest in buying Concorde shares. Through a series of instant-messages, Oehmke conveyed to Kantrowitz his manipulative intent. One example is Oehmke directing Kantrowitz to stay "close" to and shadow the bids posted by the other broker-dealer in Kantrowitz's quoting activities.

24. Based upon the foregoing, Kantrowitz knew or was reckless in not knowing that he was fraudulently manipulating the market in Concorde shares, in furtherance of Oehmke's manipulative scheme. Kantrowitz knew Oehmke wanted to liquidate a large number of Concorde shares and that Oehmke had no interest in buying any Concorde stock. Further, Kantrowitz knew that Oehmke was liquidating Concorde shares through the other broker-dealer, and was manipulating the market by having Kantrowitz shadow the other broker-dealer's bids and enter into trades with the other broker-dealer.

E. UNREGISTERED DISTRIBUTION OF ROANOKE

25. From November through December 2003, Bojadzijeve received 300 million shares of Roanoke, totaling nearly half of Roanoke's outstanding shares. Bojadzijeve posed as a consultant to the company and obtained these shares through a sham S-8 scheme. Bojadzijeve deposited his Roanoke holdings with Newbridge for liquidation, in blocks of 50 million shares.

26. Newbridge maintained an internal stock certificate deposit form that registered representatives were required to complete prior to liquidating any stock that a customer deposited in his account. A registered representative was required to complete a form for each deposit of securities. According to Newbridge's policies and procedures, no trades could be effected and no sales proceeds distributed until the form was completed.

27. Kantrowitz failed to inquire adequately as to the source of Bojadzijeve's Roanoke shares. Kantrowitz asked Bojadzijeve for the minimal information necessary to complete Newbridge's internal stock certificate deposit forms while ignoring Bojadzijeve's suspect and contradictory information regarding the source of his Roanoke shares.

28. When Kantrowitz belatedly completed Newbridge's internal stock certificate form for the blocks of Roanoke shares Bojadzijevev initially deposited with the firm, Kantrowitz falsely represented on the internal stock certificate form that Bojadzijevev received such shares through a private transaction. In contrast, Roanoke's public filing showed that Roanoke had issued Bojadzijevev shares through a Form S-8.

29. After Kantrowitz already began liquidating Bojadzijevev's Roanoke shares, Kantrowitz asked Bojadzijevev to obtain a letter from Roanoke confirming that his shares would not be cancelled. On November 28, 2003, Bojadzijevev faxed Kantrowitz a letter written by Roanoke's former president to Bojadzijevev which noted: "As we discussed, the 300 million shares registered on 11-21-2003 will not be cancelled under any circumstances. They will be issued to you in lots of 50 million, which keeps you under the 10% rule." Kantrowitz never questioned Roanoke's confirming letter outlining the highly suspect manner in which the company was issuing the shares to Bojadzijevev.

30. Kantrowitz repeatedly liquidated Bojadzijevev's shares and wired the sales proceeds despite the following: (1) Bojadzijevev repeatedly pressured Kantrowitz to process his wire requests faster; (2) Bojadzijevev informed Kantrowitz that his ability to deposit additional blocks of Roanoke shares depended on how quickly Newbridge wired out the proceeds of his sales; (3) Bojadzijevev informed Kantrowitz that he forwarded his Roanoke sales proceeds to a third party, a practice inconsistent with his claims that the shares were compensation for consulting services; and (4) Kantrowitz failed to complete the forms for each block of Bojadzijevev's Roanoke shares until after he liquidated each block.

F. MANIPULATION OF ROANOKE

31. In order to liquidate his S-8 shares into the market, Bojadzijevev instructed Kantrowitz to post increasing bids for Roanoke to artificially buoy the stock price. Kantrowitz complied and regularly quoted bids that were greater than or equal to the highest prevailing bids posted by other market makers.

32. Kantrowitz knew that Bojadzijevev had no interest in buying Roanoke shares. Bojadzijevev had communicated to Kantrowitz that Bojadzijevev intended to liquidate the large number of Roanoke shares he owned.

33. As a means of determining the highest price at which he could start liquidating his Roanoke shares, Bojadzijevev instructed Kantrowitz to "test" the market and post an ask quote in Roanoke. Kantrowitz complied before Bojadzijevev had yet to deposit any shares of Roanoke with Newbridge to sell.

34. Kantrowitz proceeded with other Bojadzijevev tactics designed to artificially stimulate market activity in Roanoke shares. At one point, Bojadzijevev's efforts to manipulate Roanoke's bid price upward was temporarily impeded when Kantrowitz's bid price came close to equaling the inside ask price being posted by another market maker. Bojadzijevev instructed Kantrowitz to purchase the shares offered by the market maker on the inside ask, effectively

removing those shares from the inside ask. Kantrowitz knew that Bojadzijeve was attempting to increase the inside ask so that he could continue directing Kantrowitz to increase Roanoke's bid price.

35. Kantrowitz also knew that Bojadzijeve was privy to information regarding when Roanoke planned to issue press releases. Bojadzijeve repeatedly told Kantrowitz when the company expected to issue news and even confirmed when the company actually issued press releases. Kantrowitz followed Bojadzijeve's instructions to post increasing bids in Roanoke stock, which enabled Bojadzijeve to time his sales of Roanoke shares with the issuance of Roanoke press releases.

36. Through a series of instant-messages, Bojadzijeve conveyed to Kantrowitz his manipulative intent. For example, Bojadzijeve told Kantrowitz, "I want to make 150k profit next batch trying to move this up." Nonetheless, Kantrowitz repeatedly complied with Bojadzijeve's instructions.

37. From November through December 2003, Kantrowitz enabled Bojadzijeve to raise over \$1.1 million in sales proceeds through the manipulation of Roanoke shares.

38. Based upon the foregoing, Kantrowitz knew or was reckless in not knowing that he was fraudulently manipulating the market in Roanoke shares in furtherance of Bojadzijeve's manipulative scheme. Kantrowitz knew Bojadzijeve wanted to liquidate a large number of Roanoke shares and that Bojadzijeve had no interest in buying any Roanoke stock. Further, Kantrowitz knew that Bojadzijeve was providing him with instructions to manipulate Roanoke's share price rather than for the purpose of effecting legitimate trades.

G. NEWBRIDGE, AMICO, GOLDSTEIN, AND VALLEJO FAILED REASONABLY TO SUPERVISE KANTROWITZ

39. Newbridge, Amico, Goldstein, and Vallejo failed reasonably to supervise Kantrowitz with a view to preventing his violations of the federal securities laws.

40. Newbridge failed reasonably to supervise Kantrowitz because it failed to develop reasonable systems to implement its policies and procedures to prevent and detect Kantrowitz's stock manipulations. While Newbridge's compliance manual contained an explicit description of manipulative activities and policies prohibiting such practices, the firm had no systems to implement its policies and procedures to prevent and detect Kantrowitz's manipulative conduct. The firm delegated to Vallejo supervisory responsibility over the trading desk, tasking him with the responsibility for monitoring for manipulative activity. Newbridge, however, failed to provide Vallejo with any systems or guidance as to how he was expected to prevent and detect such conduct. Vallejo failed to monitor the trading desk for manipulation.

41. Newbridge also failed to develop reasonable policies and procedures to prevent and detect Kantrowitz's unregistered offerings. Newbridge created the internal stock certificate deposit form in an effort, in part, to address unregistered stock distributions. The process for completing the form was ineffective because it allowed registered representatives to

obtain the requisite information by simply asking their customers, who could and did make self-serving statements. Other than confirm with transfer agents that the relevant stocks were clear to sell, Newbridge did not verify the accuracy of the information provided on the form. Newbridge's former chief compliance officer claimed that documentation, such as consulting agreements and stock loan agreements, was "normally" required to be submitted with the internal stock certificate deposit form to evidence the source of a customer's shares. However, neither the compliance manual nor the deposit form memorialized this requirement, and it was not adhered to in practice.

42. Furthermore, Newbridge failed to develop reasonable systems to implement the firm's policies and procedures with respect to the review of customer correspondence with a view to preventing and detecting Kantrowitz's misconduct. As noted above, instant messages played a central role in the Roanoke manipulation and unregistered distribution. Although FINRA required all broker-dealers to review instant messages starting in July 2003, Newbridge did not implement a policy to review instant messages until July 2004.¹ While Newbridge's compliance manual required supervisors to review other forms of correspondence (such as letters and faxes), there is no evidence that anyone at the firm performed that task at the trading desk. This is significant because a large part of the trading desk's activities consisted of servicing retail customers. At the least, Newbridge may have prevented and detected Kantrowitz's unregistered distribution of Roanoke shares if it had developed reasonable systems to implement its policies and procedures concerning correspondence review. As noted in Section 29 above, on November 28, 2003, Bojadzjev faxed Kantrowitz a suspect letter noting that he would be receiving his Roanoke shares in certain blocks to avoid the reporting requirements. There is no evidence that anyone at Newbridge ever reviewed that letter.

43. During Kantrowitz's trading of Concorde and Roanoke securities, Amico and Goldstein failed reasonably to supervise Kantrowitz with a view to preventing Kantrowitz's violations of the federal securities laws. Amico and Goldstein were the firm's president and chief executive officer, respectively, with supervisory responsibility over Kantrowitz. In a February 28, 2001 letter to FINRA regarding membership continuance of the firm, Newbridge represented that Amico had "ultimate supervisory authority" with respect to the firm's operations and was designated the responsibilities of "Hiring and Supervision of Registered Representatives And Associated Persons." In the same letter, Newbridge represented that Goldstein had "ultimate supervisory authority with respect to sales and compliance, and will be the report for trading." Amico and Goldstein claim that after Newbridge submitted this letter to FINRA, they subsequently delegated their "ultimate supervisory authority" for Newbridge's supervisory and compliance policies and procedures to the chief compliance officer, and supervisory oversight over Kantrowitz to Vallejo and the trading compliance officer.

44. Although Amico and Goldstein claim that they delegated responsibility for developing the firm's supervisory and compliance policies and procedures to the chief compliance

¹ NASD Notice to Members, 03-33 (July 2003), requires members to establish an adequate supervisory program if they allow instant messaging and to ensure that their use of instant messaging complies with FINRA and SEC recordkeeping requirements.

officer, they retained ultimate responsibility for Newbridge's supervisory policies and procedures with respect to preventing and detecting Kantrowitz's manipulative conduct and violations of Section 5 of the Securities Act because they reviewed and approved them, as well as all updates and could authorize exceptions to the firm's policies and procedures. Further, Amico and Goldstein were on notice that any delegation to the chief compliance officer to develop procedures was unreasonable because Commission examiners informed them twice that the firm's procedures regarding manipulation and unregistered distributions were deficient. Thus, Amico and Goldstein were responsible for the firm's failure to develop policies, procedures, and systems reasonably designed to prevent and detect Kantrowitz's market manipulations and participation in the unregistered offering of Roanoke securities, as outlined above.

45. Further, although Amico and Goldstein claim that they delegated day to day supervisory responsibility over Kantrowitz to Vallejo and the trading compliance officer, they were on notice that this delegation was ineffective. Soon after Kantrowitz joined Newbridge, the firm was subject to regulatory examinations in 2002 and 2003 that focused on Newbridge's inadequate supervisory policies and procedures relating to the trading desk and, in particular, Vallejo's supervision.² A December 31, 2003 letter from Commission examiners to Amico noted deficiencies in Vallejo's supervision of Kantrowitz and his penny stock business. The letter also expressed concern that a Kantrowitz customer was engaged in "what appeared to be the offer and sale of *unregistered securities*." (Emphasis added.)

46. Goldstein was aware during the time that Kantrowitz made a market in Roanoke that Vallejo and the trading compliance officer were overwhelmed in carrying out their supervisory responsibilities. Goldstein also was aware that Vallejo, in particular, was either behind or deficient in his supervisory responsibilities over the trading desk. At the same time, Goldstein knew that Kantrowitz was failing to comply with the firm's policies and procedures concerning the deposit form and was continuously liquidating a large number of stocks for his customers.

47. The Commission deficiency letters concerning inadequate supervisory oversight over Newbridge's trading desk and Vallejo's failures to carry out his supervisory responsibilities should have signaled to Amico and Goldstein that their delegation of supervision over Kantrowitz to Vallejo was unreasonable because Vallejo did not have adequate resources or support. Because Amico and Goldstein were on notice that their delegation was ineffective, they retained supervisory responsibility over Kantrowitz and are thus responsible for failing to conduct reasonable day to day supervision of Kantrowitz.

48. Amico and Goldstein profited from Kantrowitz's fraudulent unregistered offering and market manipulations. The profit was in the form of trading profits and transaction fees they indirectly received as owners of the firm.

² In addition to the Commission's exams discussed in the text that follows, FINRA conducted an examination in 2003 identifying numerous concerns about Newbridge's policies and procedures relating to the trading desk. FINRA noted that Newbridge "could not evidence that any type of review of customer account statements for the firm's traders was conducted."

49. Vallejo failed reasonably to supervise Kantrowitz with a view to preventing Kantrowitz's violation of the antifraud provisions of the federal securities laws. When Kantrowitz traded Concorde and Roanoke shares, Vallejo was Newbridge's head trader and was delegated supervisory responsibility over Kantrowitz. Vallejo failed reasonably to supervise Kantrowitz by failing to follow up on several red flags of suspicious conduct. For example, Vallejo was aware of unusual activities relating to Kantrowitz trading Concorde and Roanoke shares. Vallejo noticed a steep price increase in Concorde stock and had access to information showing Kantrowitz placing numerous successively higher bids in both Concorde and Roanoke, which was inconsistent with Vallejo's understanding of Kantrowitz's business – namely, a sell side practice of liquidating penny stocks. For both stocks, Kantrowitz's bids were higher or equal to the highest prevailing bids posted by other market makers the majority of the time. Vallejo failed to follow up on any of these red flags.

50. Vallejo profited from Kantrowitz's fraudulent market manipulations in the form of commissions that Vallejo received based on Kantrowitz's trading profits.

H. VIOLATIVE EMAILS SENT IN CONNECTION WITH INITIAL PUBLIC OFFERINGS

51. From June through July 2004, Newbridge violated the federal securities laws when its registered representatives sent communications to customers concerning two anticipated IPOs.

52. On April 30, 2004, Newbridge learned that Lumera Corp. ("Lumera") was planning an IPO, and took steps to attempt to participate as an underwriter. Lumera filed a registration statement with the Commission on May 19, 2004. During the waiting period, registered representatives are permitted to solicit indications of interest from customers for the offering, but are restricted in what information they can release to the public.

53. On June 28, 2004, approximately a month after Lumera filed its registration statement and during the waiting period, Newbridge held a due diligence meeting where the lead underwriter for Lumera's IPO distributed a sales memorandum marked "For Internal Use Only." Newbridge briefed its sales force and informed them that they were free to contact customers to solicit indications of interest.

54. On the following day, a registered representative in Newbridge's Fort Lauderdale, Florida branch sent an email to a prospective customer regarding the Lumera offering. The email provided a link to the preliminary prospectus, but also included prohibited details about the offering. For example, the registered representative inserted content from the internal sales memorandum and other information not contained in the preliminary prospectus. The email described Lumera as a nanotechnology company "addressing three primary multi-billion dollar markets." The email also noted that Lumera "will have revenue in 2004" and contained projections of revenue of "\$12-18 million and profitability of 0.10 – 0.16 per share for 2005."

55. During the next two weeks, the registered representative on over twenty separate occasions sent various versions of the email to over sixty individuals, many of whom did not maintain accounts at Newbridge. The registered representative continued his practice of providing a hyperlink to Lumera's preliminary prospectus, but only to some of the email recipients. Other registered representatives at Newbridge also improperly solicited investors for Lumera's IPO. These emails concerning the Lumera IPO were prohibited written offers during the waiting period.

56. Around the same time period, Newbridge registered representatives also improperly solicited investors for SandHill IT Security Acquisition Corp.'s ("SandHill") IPO by sending emails that included information not contained in the preliminary prospectus during the waiting period. The emails sometimes contained a hyperlink to SandHill's preliminary prospectus, but often improperly included projections and other information not included in the preliminary prospectus.

I. VIOLATIONS

57. As a result of the conduct described above, Kantrowitz willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities. Among other things, Kantrowitz participated in a scheme with Newbridge customers Oehmke and Bojadzijeve to manipulate Concorde and Roanoke stock, respectively.

58. As a result of the conduct described above, Newbridge and Kantrowitz willfully violated Sections 5(a) and 5(c) of the Securities Act by directly or indirectly, offering to sell and selling Roanoke shares through the use of any means or instrumentality of transportation, communication in interstate commerce, or of the mails when the Roanoke shares were not the subject of an effective registration statement.

59. As a result of the conduct described above, Newbridge, Amico, and Goldstein failed reasonably to supervise Kantrowitz, within the meaning of Section 15(b)(4)(E) as incorporated by reference in Section 15(b)(6) of the Exchange Act, with a view to detecting and preventing his violations of the registration and antifraud provisions of the federal securities laws.

60. As a result of the conduct described above, Vallejo failed reasonably to supervise Kantrowitz, within the meaning of Section 15(b)(4)(E), as incorporated by reference in Section 15(b)(6) of the Exchange Act, with a view to detecting and preventing his violations of the antifraud provisions of the federal securities laws.

61. As a result of the conduct described above, Newbridge willfully violated Section 5(b) of the Securities Act, which requires that a prospectus used after the filing of a registration statement meet the requirements of Section 10 of the Securities Act. Section 2(a)(10) of the Securities Act broadly defines "prospectus" to include any written communication that offers any security for sale. Emails are a form of written communication. As discussed above,

Newbridge willfully violated Section 5(b) of the Securities Act by sending emails to customers during the waiting periods for two IPOs that did not meet the requirements of Section 10 of the Securities Act.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement with prejudgment interest and civil penalties pursuant to Section 21B of the Exchange Act;

C. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Newbridge should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 5(a), 5(b), and 5(c) of the Securities Act, and whether Newbridge should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act;

D. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Kantrowitz should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, and whether Kantrowitz should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act; and

E. Whether, pursuant to Section 15(b)(6) of the Exchange Act, it is appropriate and in the public interest to bar Kantrowitz from participating in any offering of 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.

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 Respondents shall file Answers 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 Respondents fail to file the directed answers, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally 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.

Florence E. Harmon
Acting Secretary

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

*Commissioner Walter
not participating*

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58230 / July 25, 2008

Admin. Proc. File No. 3-12892

In the Matter of the Application of

JOHN D. AUDIFFEREN
c/o Norman B. Arnoff, Esq.
Burkhart, Wexler & Hirschberg, LLP
585 Stewart Avenue, Suite 750
Garden City, NY 11530

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY
PROCEEDINGS

Violations of Federal Reserve Board Regulations T and X

Improper Extension of Credit

Free Riding

Improper Benefit from Extension of Credit

Failure to Report Customer Complaint on Form U4

Conduct Inconsistent with Just and Equitable Principles of Trade

Former registered representative improperly extended credit and caused member firm of registered securities association to extend credit to customer, engaged in free riding with respect to customer's account, and enjoyed beneficial use of and shared in the profits of the improperly extended credit. Former registered representative caused member firm to extend credit improperly in registered representative's brokerage accounts with member

document 10 of 22

firm. Former registered representative also failed to report a customer complaint on Form U4. Held, association's findings of violations and the sanctions imposed are sustained.

APPEARANCES:

Norman B. Arnoff, of Burkhart, Wexler & Hirschberg, LLP, for John D. Audifferen.

Marc Menchel, James Wrona, and Carla Carloni, for FINRA.

Appeal filed: November 16, 2007

Last brief received: February 11, 2008

I.

John D. Audifferen, formerly a registered representative associated with a series of Financial Industry Regulatory Authority ("FINRA") member firms beginning in 1990, appeals from FINRA disciplinary action. ^{1/} FINRA found that, from January through March 2000, while Audifferen was a registered representative associated with FINRA member firm May Davis Group, Inc. ("May Davis"), Audifferen committed and caused May Davis to commit a number of violations involving the improper extension of credit for the purchase of securities in the account of Audifferen's customer, Keisha Williams. In addition, FINRA found that Audifferen engaged in "free riding" in that account, that he improperly benefitted from the extension of credit to that account, and that he shared in the profits of that account. FINRA also found that, in April and May 2000, Audifferen committed and caused May Davis to commit violations involving the improper extension of credit to Audifferen's personal May Davis cash and margin accounts by purchasing securities in these accounts with checks that were returned for insufficient funds. FINRA further found that in September 2001, Audifferen failed to disclose an April 2001 customer complaint on the Uniform Application for Securities Industry Registration or Transfer ("Form U4") filed in connection with his association with FINRA member firm J.P. Turner &

^{1/} On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Rel. No. 56146 (July 26, 2007), 72 FR 42190 (Aug. 1, 2007) (SR-NASD-2007-053). Because the action here was taken after that date, we use the designation FINRA in this proceeding, even though the proceeding was initiated by NASD's Department of Enforcement and the initial hearing panel in the case was a NASD Hearing Panel.

Company, LLC ("JPT"). FINRA found that all of the violations constituted conduct inconsistent with just and equitable principles of trade. ^{2/}

FINRA barred Audifferen in all capacities for his violations in connection with Williams's account, imposed an additional bar for Audifferen's violations in connection with his own accounts, ordered Audifferen to pay Williams restitution in the amount of \$7,835, and fined Audifferen \$9,665 for his conduct in connection with Williams's May Davis account. ^{3/} Our findings are based on an independent review of the record.

II.

Williams's May Davis Account

A. Funding the Account From July 1999 to July 2000, Audifferen was associated as a general securities representative with May Davis. Williams worked as a dancer at a night club, where she initially met Audifferen. She and Audifferen began a personal relationship in 1998.

Williams's annual income was approximately \$48,000, and, based on her December 1999 bank statement, she had approximately \$6,500 in a checking account and approximately \$10,000 in a savings account at the time. Her only investment experience involved an account with Charles Schwab, containing the shares of a single security, valued at approximately \$20,000. Williams testified that a friend had given her the securities in the account. She did not conduct any trading in the account, merely selling small amounts of the stock from time to time when she needed money.

In December 1999, at Audifferen's suggestion, Williams opened a May Davis cash brokerage account, for which Audifferen served as the representative. Audifferen filled out the new account form for Williams that stated that she worked in the real estate industry, had an annual income of \$100,000, total assets of \$1,000,000, and five years of investment experience. Williams testified that, although she signed the forms that Audifferen presented to her, she never read them and Audifferen did not explain them to her.

In early December 1999, Williams gave Audifferen a check for \$5,000, payable to S.G. Cowen Securities Corporation ("Cowen"), May Davis's clearing firm, to fund her account. On or about December 17, 1999, the bank returned this check for insufficient funds. On December 26, 1999, Williams wrote a second \$5,000 check to fund the account, which subsequently

^{2/} NASD Rule 2110 requires members and associated persons to conduct their business in a manner consistent with just and equitable principles of trade.

^{3/} "In light of the bars that [it] imposed for Audifferen's credit violations," FINRA did not impose an additional sanction for the Form U4 violations, although FINRA found that "a suspension of 30 days would be appropriate." FINRA also assessed costs against Audifferen totaling \$9,096.06.

cleared. Williams testified that this was the only deposit that she made into her May Davis account.

In January 2000, Audifferen asked Williams to give him a check for \$7,000, payable to Cowen. According to Williams, Audifferen claimed that "his only checking account was messed up, or he didn't receive his checks, and he needed a check for [\$]7,000." Williams provided Audifferen with a \$7,000 check, payable to Cowen, dated January 20, 2000, with the understanding that Audifferen "would deposit \$7,000 into [Williams's] checking account to cover the check."

Around the same time that Audifferen requested the \$7,000 check from Williams, he also asked her for two signed, otherwise blank checks. According to Williams, "[Audifferen] said the market moves quickly and he wanted to be able to respond without having to wait to receive my checks. [Audifferen] said they needed to be blank because he didn't know how much he would need until he was ready to complete a transaction." Williams provided Audifferen with two signed, otherwise blank checks at some point in late January 2000.

The Euniverse Purchase On January 21, 2000, Audifferen purchased 1,000 shares of the stock of Euniverse Inc. ("EUNI") for \$6,917.50, in Williams's May Davis account. Williams was not aware of and did not authorize this purchase. Williams did not remit any payment for the purchase. Cowen obtained an extension of the Regulation T due date, but Williams did not pay for the EUNI purchase by the extended date. ^{4/}

On February 7, 2000, Audifferen wrote a check to "Cash" from his checking account, and this check was cashed on the same date. Also on February 7, 2000, \$7,000 in cash was deposited into Williams's checking account. Williams testified that Audifferen made this deposit. According to Williams, Audifferen had her account number and could deposit money into her account. On approximately February 9, 2000, the \$7,000 check, payable to Cowen, that Williams had given Audifferen in January 2000 was deposited into Williams's May Davis account. Because of Audifferen's cash deposit in Williams's checking account, this \$7,000 check cleared. On or about March 3, 2000, Audifferen sold the 1,000 EUNI shares in Williams's May Davis account, for \$9,644.67, a profit of \$2,727.17.

The Max Internet Communications Purchase On January 25, 2000, Audifferen purchased 3,000 shares of Max Internet Communications Inc. ("MXIP") for \$63,105.00, in Williams's May Davis account. Williams was not aware of and did not authorize this purchase, and she did not remit payment. Cowen obtained a Regulation T extension, but Williams did not

^{4/} Under Regulation T, 12 C.F.R. § 220, if payment due on a securities transaction exceeds \$1,000 and is not received by the end of the period specified, the broker/dealer must either liquidate the position or apply for and receive an extension from its designated examining authority (a "Regulation T extension").

pay for the MXIP purchase by that date. Williams's bank account statements at the time show that she lacked the funds to make this purchase.

On February 10, 2008, Audifferen submitted one of the two blank checks Williams had provided, now made payable to Cowen in the amount of \$61,105, 5/ ostensibly to pay for the purchase of the MXIP shares in Williams's May Davis account. 6/ Audifferen never asked Williams whether she had sufficient funds in her checking account to cover the \$61,105 check. The bank subsequently returned the \$61,105 check for insufficient funds. Also on February 10, 2008, Audifferen sold the MXIP shares in Williams's May Davis account for \$76,392.45, generating a \$13,287.45 profit. Thus, no payment was ever made for the MXIP purchase, and the proceeds of the sale covered the initial purchase price.

On or about March 8, 2000, Williams received her February May Davis account statement and discovered the MXIP trades in her account. 7/ Williams testified that she never discussed any of these transactions with Audifferen before Audifferen entered the trades. According to Williams, after receiving her account statement, she questioned Audifferen several times about these transactions. Audifferen provided various explanations and grew angry with her for questioning him. Eventually, Williams grew frustrated with Audifferen's responses and ordered May Davis to close her account.

Transfer of Profits from Williams's Account to Audifferen Audifferen did not close Williams's May Davis account as she requested. Instead, on March 8, 2000, Audifferen requested a wire transfer of \$18,000 from Williams's May Davis account to her checking account. Soon after, Williams's bank called her to confirm wire transfer instructions from her checking account to Audifferen's checking account. Williams refused. She contacted Audifferen to determine the reason for the transfer. According to Williams's testimony, Audifferen became angry and told her it "was his money and I better send it back."

On March 9, 2000, Audifferen deposited in his checking account the second blank, signed check that Williams had given him, payable to Audifferen in the amount of \$17,500. On March 13, 2000, the bank returned the check for insufficient funds. According to Williams, Audifferen called her numerous times in the ensuing days demanding that she pay him \$17,500. On March

5/ It is unclear why the check was in the amount of \$61,105, when the purchase price of the MXIP stock was \$63,105.

6/ Williams testified that the handwriting on the \$61,105 check, other than the signature, was not hers. She further testified that she was familiar with Audifferen's handwriting and identified his handwriting on the check. The record contains other samples of Audifferen's handwriting, which he authenticated during his testimony.

7/ Because the EUNI sale did not occur until March 3, it first appeared on Williams's March 2000 May Davis account statement.

17, 2000, Williams authorized a wire transfer of \$17,500 from her checking account into Audifferen's checking account.

Williams continued to demand that Audifferen close her May Davis account. On May 23, 2000, she received a statement from May Davis that the account had been closed along with a check for her account balance. Audifferen's trading in Williams's May Davis account generated a profit of \$15,960.82, but Williams received only \$1,634.01 of the \$5,000 that she had initially invested. Williams complained to Audifferen that she should have received a greater amount of money. In addition, May Davis advised Williams that she might owe the Internal Revenue Service capital gains taxes on the full amount of the profits earned in her May Davis account, even though she did not receive any of the trading profits.

B. Pursuant to Section 19(e) of the Securities Exchange Act of 1934, 8/ we will sustain FINRA's decision if the record shows that Audifferen engaged in the violative conduct that FINRA found and that FINRA applied its rules in a manner consistent with the purposes of the Exchange Act. Based on our independent review of the record, we find that a preponderance of the evidence supports FINRA's findings of violation against Audifferen. 9/

Credit Extensions Exchange Act Sections 7(c) and 7(d) make it unlawful for broker-dealers and associated persons, respectively, to extend credit to their customers except in

8/ 15 U.S.C. § 78s(e).

9/ Audifferen states that "substantial evidence to support each and every element of each and every charge as stated is the mandated standard of proof in administrative disciplinary proceedings." It is well-established, however, that preponderance of the evidence is the applicable standard of proof in proceedings of this type (and Audifferen appears to acknowledge this elsewhere in his brief). See, e.g., David M. Levine, 57 S.E.C. 50, 73 n.42 (2003) (holding that preponderance of the evidence is the standard of proof in self-regulatory organization disciplinary proceedings); Kirk A. Knapp, 51 S.E.C. 115, 130 n.65 (1992) (stating that "the correct standard is preponderance of the evidence" in an NASD proceeding). Further, the Supreme Court has held that "circumstantial evidence can be more than sufficient" to satisfy the burden of proof in civil actions. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983); see also Donald M. Bickerstaff, 52 S.E.C. 232, 238 (1995) (finding that testimony may be "circumstantial" in the sense that a witness did not actually see the respondent engage in the violative conduct, yet still persuasive).

We also note that the preponderance standard is a higher standard of proof than substantial evidence. See, e.g., FPL Energy Maine Hydro LLC v. FERC, 287 F.3d 1151, 1160 (D.C. Cir. 2002) ("The 'substantial evidence' standard requires more than a scintilla, but can be satisfied by something less than a preponderance of the evidence.").

accordance with Regulation T. 10/ Under Section 220.8 of Regulation T, in a cash account like Williams's May Davis account, a broker-dealer may buy or sell securities for any customer if there are sufficient funds in the account or if the broker-dealer accepts in good faith that the customer will promptly make full cash payment for the security before selling it and does not anticipate selling the security prior to making payment. 11/

Audifferen's purchases of 1,000 shares of EUNI and 3,000 shares of MXIP in Williams's May Davis account violated Section 220.8 of Regulation T, and Exchange Act Sections 7(c) and 7(d). Audifferen knew that Williams did not know about the trades and that he purchased the securities without her knowledge. Moreover, Audifferen knew or should have known that Williams could not pay for the trades because she did not have the financial resources to do so. Williams bounced the initial \$5,000 check used to open her May Davis account. Williams also told Audifferen that she did not have the funds to cover the \$7,000 check she provided to Audifferen in January 2000. By purchasing stock in Williams's May Davis account for which Audifferen knew or should have known she could not pay, Audifferen caused May Davis to extend credit to Williams in violation of Section 220.8 of Regulation T and Exchange Act Section 7(c)).

Audifferen also personally extended credit to Williams in connection with the purchase of 1,000 shares of EUNI in violation of Exchange Act Section 7(d), by depositing \$7,000 of his own funds into Williams's checking account to cover Williams's \$7,000 check that he submitted as payment for the EUNI purchase. Audifferen argues that there is insufficient evidence to establish that he made the \$7,000 deposit. However, Williams testified that she lacked the funds to cover the check and that Audifferen was the only person who could have made that deposit because he was the only other person who had access to her bank account. The FINRA Hearing Panel found Williams's testimony to be credible, and we find no reason to reject this credibility determination. 12/

The circumstantial evidence also supports a finding that Audifferen deposited \$7,000 in cash in Williams's account. Williams gave Audifferen the \$7,000 check in late January. On February 7, 2000, Audifferen wrote a check for \$7,000, payable to "Cash" from his checking account, which was cashed the same day. Also on February 7, 2000, \$7,000 was deposited into

10/ 15 U.S.C. § 78g(c) and 15 U.S.C. § 78g(d), respectively. See, e.g., Michael Joseph Boylan, 47 S.E.C. 680, 687 (1981).

11/ 12 C.F.R. § 220.8.

12/ "Credibility determinations of an initial fact finder are entitled to considerable weight." Joseph Abbondante, Exchange Act Rel. No. 53066 (Jan. 6, 2006), 87 SEC Docket 203, 209 n.21 (citing Laurie Jones Canady, 54 S.E.C. 65, 78 n.23 (1999) (citing Anthony Tricarico, 51 S.E.C. 457, 460 (1993)), petition denied, 230 F.3d 362 (D.C. Cir. 2000)), petition denied, 209 Fed. Appx. 6 (2d Cir. 2006) (unpublished).

Williams's checking account, for which Audifferen had the account number. The next day, Audifferen submitted Williams's \$7,000 check, which he had held for over two weeks, as payment for the EUNI shares. This evidence, along with Williams's testimony, supports a finding that Audifferen improperly extended credit to Williams by depositing \$7,000 into Williams's checking account to cover the payment for the EUNI purchase.

"Free Riding" NASD Rule 2520(f)(9) prohibits "free riding" in cash accounts. "Free riding" occurs where a purchaser buys a security, expecting to pay for the security through its sale before payment is due. ^{13/} In a "free riding" transaction, the customer essentially borrows the funds to purchase the security when the member firm purchases the security on behalf of the customer before receiving payment, and, as a result, the firm extends credit impermissibly. ^{14/}

Audifferen's purchase and sale of 3,000 shares of MXIP violated the prohibition on "free riding" in NASD Rule 2520(f)(9). Audifferen executed the purchase and sale of these shares without Williams's knowledge. Williams never paid for these shares, and Audifferen sold the stock to cover the purchase price. The sales generated a profit of \$13,287.45.

On the same day that Audifferen sold the MXIP shares to cover the purchase price, he deposited Williams's personal check, which he had filled out in the amount of \$61,105, into her May Davis account. Williams's account had insufficient funds to cover the check, and Audifferen had no basis to believe that Williams had the funds to cover that check. By depositing the insufficient funds check on the same day that he sold the shares, Audifferen created the appearance that Williams had paid for the shares when, in fact, he sold the stock to cover the purchase price.

Audifferen disputes FINRA's finding that he filled out Williams's blank check in the amount of \$61,105 for the MXIP purchase. Audifferen argues that, pursuant to the Federal Rules of Evidence, FINRA could only establish that Audifferen's handwriting was on the check through the testimony of a handwriting expert. Although Audifferen acknowledges that the Federal Rules of Evidence do not apply in FINRA disciplinary proceedings, ^{15/} he suggests that the failure to apply those Rules here constitutes a violation of due process.

Audifferen's argument is unpersuasive. Williams testified that she was familiar with Audifferen's handwriting based on their two-year relationship and identified the handwriting on the \$61,105 check as that of Audifferen. The record contains numerous acknowledged and

^{13/} Prime Investors, Inc., 53 S.E.C. 1, 3-4 (1997).

^{14/} John Thomas Gabriel, 51 S.E.C. 1285, 1288 (1994), aff'd, 60 F.3d 812 (2d Cir. 1995) (Table).

^{15/} NASD Rule 9145(a) states, "The formal rules of evidence shall not apply in [a FINRA disciplinary proceeding]."

authenticated specimens of Audifferen's handwriting on checks and other documents. 16/ The FINRA Hearing Panel properly compared the handwriting on the \$61,105 check with those samples and found marked similarities. 17/ Based on our independent review of the record, we find no reason to overturn FINRA's conclusion.

In any event, Audifferen acknowledges that he was responsible for effecting all of the transactions in Williams's account at issue here. Thus, even were we to accept Audifferen's arguments that he did not complete the information on the \$61,105 check (which we do not), Audifferen purchased securities for Williams's account when he had no basis to believe that she had the funds to pay for the purchase. Shortly thereafter, he sold those securities to cover the purchase price and, in so doing, violated the prohibition against "free riding" in FINRA Rule 2520(f)(9).

Beneficial Use of Credit Extensions Exchange Act Section 7(f) prohibits registered persons from obtaining, receiving, or enjoying the beneficial use of an extension of credit for the purpose of purchasing securities unless the credit extension complies with Regulation T. 18/ Audifferen sold the EUNI and MXIP stock that he had purchased without Williams's knowledge or consent, using impermissible extensions of credit, for a profit of \$15,987. Audifferen then transferred funds from Williams's May Davis account into her checking account without her knowledge. Next, Audifferen attempted to transfer funds from Williams's checking account into his checking account, and when Williams refused to permit the transfer, he deposited into his checking account one of the signed, otherwise blank checks that Williams had given him. When that check was returned for insufficient funds, Audifferen importuned Williams for the next week until, on March 17, 2000, she agreed to wire \$17,500 from her checking account into Audifferen's checking account.

The proceeds from Audifferen's sales of EUNI and MXIP securities from Williams's May Davis account constituted the majority of the trading profits in that account. 19/ Audifferen

16/ In addition, the \$61,105 check was the check in Williams's checking account sequence immediately following the March 9, 2000 check for \$17,500 made out to Audifferen. This fact corroborates Williams's testimony that she provided the two blank, signed checks to Audifferen.

17/ See Daniel D. Manoff, 55 S.E.C. 1155, 1165 (2002) (holding that a handwriting expert was not necessary to authenticate a signature and that the Hearing Panel properly compared the actual signature with the purported signature and concluded they were not the same).

18/ 15 U.S.C. § 78g(f).

19/ The record indicates that Audifferen executed additional trades in Williams's account

(continued...)

purchased those securities by obtaining impermissible credit extensions and by “free riding” in Williams’s May Davis account. Accordingly, Audifferen’s receipt of those profits constitutes beneficial use of the impermissible credit extensions in violation of Exchange Act Section 7(f).

Profit Sharing NASD Rule 2330(f), as it read at the time of the transactions at issue here, restricted registered representatives from sharing directly or indirectly in the profits or losses in a customer’s account unless the representative received prior written authorization from the member firm carrying the account, and shared in the profits or losses only in direct proportion to the financial contribution that the representative made to the account. It is undisputed that Audifferen did not have permission from May Davis to share in the profits or losses in Williams’s account. Thus, by transferring trading profits from Williams’s May Davis account to her checking account and then demanding and receiving those funds, Audifferen impermissibly shared in the profits of Williams’s May Davis account.

Audifferen has argued at various points in this proceeding that Williams’s transfer of \$17,500 into his checking account constituted a repayment by Williams of an earlier cash gift or of an undocumented personal loan. As FINRA points out, Audifferen’s description of the transaction has been inconsistent; at the hearing, he described it as a gift, but later he described it as a loan. In addition, Audifferen provides no documentation to support the existence of a loan, and Williams testified credibly that Audifferen never gave or lent her any money. In any event, even if we were to accept Audifferen’s argument that the \$17,500 wire transfer from Williams was the repayment of an earlier loan, Audifferen admits that “the [\$17,500] payment was a means of giving [Audifferen] his share of a profitable trade.” Audifferen did not have authorization from May Davis to share in Williams’s profits and, thus, he was prohibited from doing so regardless of whether he characterizes those profits as a return of a gift or a repayment of a loan.

Willfulness In order to make a finding of willful conduct, we must find that Audifferen voluntarily committed the act that constitutes the violation, not that Audifferen was aware that he was violating a rule or that he acted with a culpable state of mind. ^{20/} The evidence shows that

^{19/} (...continued)

other than the EUNI and MXIP trades, but FINRA did not charge Audifferen with violations related to the other trades.

^{20/} Wonsover v. SEC, 205 F.3d 408, 413 (D.C. Cir. 2000). The cases Audifferen cites to support his claim that he did not willfully commit the violations in question are inapposite. In Buchman v. SEC, 553 F.2d 816 (2d Cir. 1977), the court vacated a Commission finding of willful violations of NASD Rules of Fair Practice based on a finding that the respondent’s conduct was “justified by confusion as to the true state of the market and as to the applicable law.” Here, Audifferen acknowledged that he understood Regulation T and other applicable provisions. Audifferen also relies on SEC

(continued...)

Audifferen voluntarily committed the acts that constitute the violations at issue in this proceeding. Audifferen executed the trades at issue (both purchases and sales) in Williams's May Davis account. With respect to the EUNI purchase, Audifferen personally deposited \$7,000 into Williams's checking account in order to pay for the purchase. With respect to the MXIP purchase and sale, Audifferen ordered the sale of the shares before May Davis had received any payment for their purchase and filled in and deposited the blank check Williams had provided him in the amount of \$61,105, purportedly to pay for the purchase. The evidence also shows that Audifferen induced Williams to transfer the proceeds of the EUNI and MXIP trades from her checking account to him. Audifferen was aware of what he was doing and was not coerced when he committed each of the acts constituting the violations. Thus, this evidence establishes that Audifferen acted willfully.

Audifferen claims that he did not act willfully because he believed that Williams would pay for the securities purchases he made in her May Davis account. This claim is undermined by the evidence. Audifferen consistently concealed the transactions from Williams, not informing her when he bought or sold stock in her account and providing evasive responses when she questioned him after receiving her account statement. Moreover, although not required to establish that Audifferen acted willfully, the evidence shows that Audifferen knew or should have known that Williams could not pay for the transactions he executed in her account within the required Regulation T period because she bounced the first \$5,000 check used to fund the account and she told Audifferen that she could not cover the \$7,000 check she gave him in January 2000. As a result, Audifferen also knew or should have known that he and May Davis would have to extend credit to Williams or permit her to "free ride" in order to complete the transactions. Therefore, even under a higher standard than mere willfulness, the evidence would support our findings of violations.

III.

Audifferen's May Davis Accounts

A. As noted above, Audifferen maintained both cash and margin accounts at May Davis. In April and May 2000, Audifferen deposited three checks (for a total of \$50,000) from his checking account into his May Davis cash and margin accounts to pay for securities purchases or to fund margin deposits. Two of the checks were for purchases in Audifferen's cash account, and the third check was for purchases in his margin account. Each check was returned for insufficient funds. Audifferen never provided the funds necessary to cover the bounced checks,

20/ (...continued)

v. Frank, 388 F.2d 486 (2d Cir. 1968), a case in which willfulness was not at issue, apparently in support of his argument that "an objective consideration of the complete context and all the necessary and relevant facts" would show that he did not act willfully. Our independent review of the record has included such a consideration, and we find that the record evidence supports FINRA's finding that Audifferen acted willfully.

and all of these stock purchases went unpaid. Pursuant to its clearing agreement with Cowen, May Davis was responsible for paying Cowen for these purchases. May Davis eventually sold the shares from Audifferen's margin account at a loss of \$8,362 and cancelled the trades in his cash account. May Davis suffered the loss on the sale of the shares and did not impose it on Audifferen.

Although Audifferen wrote these three checks with a total value of \$50,000, his bank statement for the period from March 16 to April 17, 2000 shows that Audifferen had only \$22,252.28 in his checking account and nothing in his savings account. His statement for the period from April 18 to May 15, 2000 states that Audifferen had only \$5,116.49 in his checking account and nothing in his savings account. In addition, May Davis's records indicate that Audifferen's income from his employment at the firm, which Audifferen testified was his sole source of income, was uneven and relatively low during the months preceding his submission of the checks in question. Further, in February 2000, Audifferen requested a pay advance from May Davis in the amount of \$21,400, citing financial "hardship" as the reason. Additionally, during the period from October 18, 1999 to July 18, 2000, Audifferen's bank account statements show seventeen returned checks, including the checks mentioned above. The record also indicates that, during the months prior to April and May 2000, Audifferen bounced checks in the May Davis accounts of his mother, over which Audifferen acknowledged having control.

B. Exchange Act Section 7(f), as discussed above, prohibits registered persons from enjoying the beneficial use of an improper extension of credit under Regulation T. Under Section 3(b) of Federal Reserve Board Regulation X, 21/ borrowers are prohibited from willfully causing broker-dealers to extend credit outside the parameters set forth in Regulation T. Section 220.8 of Regulation T, as discussed above, applies to cash brokerage accounts and prohibits broker-dealers from impermissibly extending credit to such accounts. Sections 220.4 and 220.12 of Regulation T apply to margin accounts and require that the borrower make a deposit of fifty percent of the security at issue in order to execute a purchase on margin. 22/

Audifferen violated these provisions when he deposited three separate insufficient funds checks into his May Davis accounts in April and May 2000. Audifferen acknowledges that all three checks bounced, that he never paid for the purchases made in his accounts, and that May Davis ultimately was responsible to Cowen for the cost of the purchases pursuant to the terms of its clearing agreement. By purporting to pay for stock purchases in his account with insufficient funds checks, Audifferen caused May Davis to extend credit in violation of Sections 220.8 of Regulation T with respect to Audifferen's cash account and in violation of Sections 220.4 and 220.12 of Regulation T with respect to his margin account. Audifferen violated Regulation X by willfully causing May Davis to extend credit outside the parameters set forth in Regulation T.

21/ 12 C.F.R. § 224.

22/ 12 C.F.R. §§ 220.4 and 220.12.

May Davis ultimately sold the shares that Audifferen “purchased” in his margin account at a loss. By causing May Davis to extend credit improperly to him, Audifferen was able to enjoy the potential of profiting from the purchase if the price of the shares increased without incurring any of the risk of loss if the share price decreased (as it ultimately did in this case). Thus, through this short-term ownership without risk of loss, Audifferen also violated Exchange Act Section 7(f) by obtaining the beneficial use of May Davis’s improper extension of credit.

Each of the violations in Audifferen’s May Davis accounts was willful. Audifferen knew that he was in a precarious financial situation. He had bounced a number of checks in the months prior to the transactions at issue here, and he had requested a pay advance from May Davis in February 2000, citing financial hardship as the reason. In addition, May Davis’s commission statements indicate that Audifferen’s income was erratic and likely insufficient to permit him to cover the checks at issue. Audifferen’s bank account statements from the months prior to the bounced checks indicate that he lacked sufficient funds to cover those checks. All of the evidence supports a finding that Audifferen knew that the checks he submitted to May Davis would bounce and that his brokerage accounts would have insufficient funds to cover the cost of the securities purchases. These facts are sufficient to establish willfulness.

Audifferen argues that the operations department at May Davis failed to inform him in a timely manner of the returned checks, and that neither May Davis nor Cowen made any effort to obtain a Regulation T extension. However, Audifferen was responsible for ensuring that his bank account contained sufficient funds to cover his stock purchases from his member firm. ^{23/} In addition, although knowledge and awareness of Regulation T is not necessary to establish that Audifferen acted willfully, Audifferen testified that he was familiar with Regulation T, and was aware of his obligation to pay for the securities he purchased in his May Davis accounts, a fact that further supports our finding that Audifferen was aware of what he was doing. He cannot shift the blame for his violations to his firm. ^{24/}

IV.

Audifferen’s J.P. Turner Form U4

A. On July 28, 2000, Audifferen resigned from his position with May Davis. From August 2000 through May 2001, Audifferen was associated with FINRA member firm Investec Ernst & Company (“Investec”). On April 17, 2001, Sandra Gabriele, an Investec customer, sent a letter to Investec alleging “misrepresentation and inappropriate conduct by [Audifferen]” and

^{23/} Cf. John F. Lebens, 52 S.E.C. 606, 608, 611 (1996) (holding that it is unethical for a registered person to take advantage of loose internal controls at his firm by purchasing securities when there are insufficient funds in the registered person’s account to pay for such securities).

^{24/} See, e.g., Prime Investors, 53 S.E.C. at 5-6 n.13.

complaining that Audifferen had fraudulently filled out Gabriele's options agreement and new account form and had engaged in unauthorized trading in her account. Gabriele did not specify the amount of damages she sought. On April 26, 2001, Audifferen denied Gabriele's claims in a letter he wrote to Investec's then-branch director of compliance.

On May 11, 2001, Gabriele sent a letter to the Commission's New York Regional Office in which she again set forth her complaints regarding Audifferen's conduct. The May 11 letter did not specify the damages that Gabriele claimed. On August 17, 2001, FINRA (then NASD) sent Audifferen a letter requesting a response to Gabriele's May 11 letter. On September 4, 2001, Audifferen sent a letter to FINRA denying all of the claims raised in Gabriele's complaint.

On September 5, 2001, Audifferen applied for a position with JPT, which agreed to hire him as a registered representative. In order to expedite Audifferen's registration, JPT downloaded a Form U4 that he had provided to a prior employer from the Central Registration Depository, directed Audifferen to review the Form U4 and update it as necessary, and then sign the Form U4 and return it to JPT.

Question number 231 on the Form U4 asked whether, within the prior twenty-four months, the applicant had been the subject of an investment-related, consumer-initiated, written complaint that alleged a sales practice abuse and claimed damages of \$5,000 or greater. The question stated that, if no damage amount was alleged in the written complaint, the complaint must be reported unless the member firm has made a good faith determination that the damages from the alleged misconduct would be less than \$5,000. Audifferen answered "no" to Question 231, signed the Form U4, and submitted it to JPT.

JPT learned of Gabriele's complaint in October 2001 when Investec submitted an updated Uniform Termination Notice for Securities Industry Registration ("Form U5") for Audifferen, which included information about the complaint. The JPT branch manager, the then-chair of JPT's ethics committee, and JPT's director of compliance at the time, all testified that JPT was unaware of Gabriele's complaint until Investec filed the revised Form U5. When the JPT branch manager asked Audifferen for an explanation of the complaint, he replied "that he wasn't aware of" it.

B. NASD Membership Rule IM-1000-1 prohibits the filing, in connection with registration as a registered representative, of information so incomplete or inaccurate as to be misleading. Form U4 is used by FINRA and other self-regulatory organizations to determine the fitness of

applicants for registration as securities professionals. 25/ Consequently, the candor and forthrightness of applicants is critical to the effectiveness of the screening process. 26/

It is undisputed that Audifferen signed and submitted a Form U4 in connection with his registration with JPT that failed to include Gabriele's complaint, even though Question 23I on the Form U4 instructed the applicant to disclose such complaints. In so doing, Audifferen violated NASD Rule IM-1000-1. Audifferen contends that, although he was aware of Gabriele's letters to Investec and to the Commission's New York office at the time he signed the Form U4, he believed that the letters were not complaints. 27/ However, the letters state that Audifferen engaged in unauthorized trading in Gabriele's account and that Audifferen filled in incorrect information on her options and new account agreements after Gabriele had signed them. We find that both of Gabriele's letters were written complaints and that a reasonable person would have understood them to be complaints within the meaning of Form U4.

Audifferen next argues that the complaint did not claim damages of \$5,000 or more. Although neither of Gabriele's letters specifies a damage amount, Form U4 states that, if no damage amount is specified, the complaint must be reported on Form U4 unless the firm has made a "good faith determination that the damages from the alleged conduct would be less than \$5,000." Audifferen has offered no evidence that Investec had made any such determination at the time he submitted the Form U4. In fact, when Investec ultimately submitted its revised Form U5 for Audifferen in October 2001, it listed Gabriele's alleged damages at \$10,119.

Audifferen also claims that he provided information about Gabriele's complaint to JPT, but that JPT lost the information. Audifferen presents no evidence to support this assertion. Moreover, three JPT officials testified that they received no information from Audifferen about the complaint and that they learned of it only when Investec updated its Form U5 for Audifferen. Further undermining Audifferen's claim that he disclosed the complaint to JPT, Audifferen's

25/ See, e.g., Daniel Richard Howard, 55 S.E.C. 1096, 1101 (2002), aff'd, 77 F. App'x 2 (1st Cir. 2003) (unpublished); Rosario R. Ruggiero, 52 S.E.C. 725, 728 (1996); Thomas R. Alton, 52 S.E.C. 380, 382 (1995), aff'd, 105 F.3d 664 (9th Cir. 1996) (Table).

26/ Guang Lu, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket 2639, 2648, aff'd, 179 F. App'x 702 (D.C. Cir. 2006).

27/ In support of this claim, Audifferen cites the testimony of Investec's branch compliance director in response to a question about when Investec began to investigate Gabriele's complaint. The testimony indicates that Investec may have begun its investigation when Gabriele visited Investec's office and made oral requests for documents related to her account prior to submitting the letters. Nothing in the testimony Audifferen cites, however, indicates that Investec did not consider the letter to be a complaint.

branch manager testified that when he first questioned Audifferen about Gabriele's complaint, Audifferen stated that he was unaware of it. 28/

* * *

We find that Audifferen willfully caused or committed violations of Section 220.8 of Regulation T, Exchange Act Sections 7(c), (d), and (f), and NASD Rules 2520(f)(9) and 2330(f) in connection with Williams's May Davis account. We also find that Audifferen willfully caused or committed violations of Sections 220.4, 220.8, and 220.12 of Regulation T, Section 3(b) of Regulation X, and Exchange Act Section 7(f) in connection with his own May Davis accounts. We further find that Audifferen violated NASD Membership Rule IM-1000-1 in connection with the Form U4 he filed with JPT. Each of these violations also constitutes a violation of NASD Rule 2110. 29/

V.

Audifferen's Procedural and Fairness Arguments

Audifferen argues that FINRA conducted the proceeding against him unfairly. He contends that: 1) witnesses who were associated with FINRA member firms were intimidated by warnings about their duty to testify truthfully; 2) the FINRA Hearing Panel improperly required the parties to discuss sanctions during the hearing before making any findings of violation; 3) the Hearing Officer acted as an advocate for FINRA's position during the hearing; 4) the Hearing Panel improperly considered evidence related to Audifferen's personal relationship with Williams; and 5) the entire proceeding was "fundamentally unfair."

Alleged Witness Intimidation Audifferen complains that counsel for FINRA Enforcement intimidated the registered individuals who testified at Audifferen's hearing when he reminded them of their obligations to testify truthfully. NASD Rule 9262 states that a person who is subject to the jurisdiction of FINRA shall testify under oath in any FINRA proceeding, and it is critical to the efficacy of NASD Rule 8210 that registered individuals who testify in FINRA disciplinary proceedings pursuant to Rule 8210 do so truthfully. Eight registered individuals testified before the FINRA Hearing Panel in this proceeding, two called by

28/ As discussed above, Audifferen responded to Gabriele's complaint in a letter to Investec dated April 26, 2001, which is inconsistent with his statement to his branch manager that he was unaware of the complaint.

29/ A violation of any Commission or NASD rule or regulation constitutes a violation of NASD Rule 2110, which requires member firms to conduct their business in accordance with just and equitable principles of trade. Stephen J. Gluckman, 54 S.E.C. 175, 185 (1999). NASD Rule 0115 applies all such standards to associated persons as well as member firms.

Audifferen and six called by FINRA Enforcement. At the beginning of the testimony of seven of the eight registered individuals, FINRA Enforcement counsel reminded the witness of his or her obligation to testify truthfully under NASD Rule 8210 and asked them to acknowledge that they understood that they could be subject to a disciplinary proceeding and the imposition of sanctions in the event that they testified untruthfully. ^{30/} These questions served only to refresh their awareness of their existing obligations. Moreover, Audifferen did not object to these questions before the Hearing Panel. He has introduced no evidence to suggest that any witness was intimidated by these questions into testifying untruthfully or into withholding relevant information. Thus, we find no merit to Audifferen's allegations of witness intimidation.

Addressing Sanctions During the Hearing Audifferen argues that the proceedings were unfair because the Hearing Panel required the parties to address sanctions prior to a determination by the Panel that Audifferen had committed the violations at issue. However, this is standard practice in all FINRA disciplinary proceedings. NASD's Code of Procedure, which the Commission approved, does not provide for a bifurcated proceeding in which liability is considered separately from sanctions. In addition, the Hearing Officer informed Audifferen of this aspect of the proceeding during a pre-hearing conference; Audifferen did not object; and he indicated that he understood the procedure. At the beginning of the hearing, the Hearing Officer again explained that sanctions would be considered during the hearing and that this procedure was not indicative of a finding of guilt. Audifferen again responded that he understood. Thus, we find no merit in Audifferen's argument that he was prejudiced by FINRA's standard procedure of considering the allegations of violative conduct and sanctions during the same hearing.

Allegations that Hearing Officer Acted as FINRA Advocate Audifferen argues that the Hearing Officer acted as an advocate for FINRA Enforcement by directing questions to FINRA Enforcement counsel, including during the counsel's closing argument. In support of this contention, Audifferen quotes without context a passage from the hearing transcript in which the Hearing Officer attempts to restate FINRA Enforcement's argument. We have carefully reviewed the record below with respect to these claims and find no unfairness or bias in the quoted passages. The Hearing Officer was not advocating on behalf of FINRA Enforcement, but rather was restating its argument in order to ensure that he understood it. ^{31/} There is no indication that the Hearing Officer prejudged this matter or sought to do anything other than clarify the FINRA counsel's argument.

^{30/} There appears to be no reason other than oversight why FINRA did not ask these questions of the eighth registered individual who testified (one of the two witnesses called by Audifferen).

^{31/} See, e.g., U.S. Sec. Clearing Corp., 52 S.E.C. 92, 101 (1994) (finding no bias where panel member's questions were directed at clarifying witness testimony).

Alleged Prejudicial Evidence Related to Audifferen's Relationship with Williams

Audifferen objects to the inclusion in the record of certain personal information about Williams as well as to the exact nature of the relationship between Audifferen and Williams. However, Audifferen elicited the evidence related to personal information about Williams from his examination of a witness that he called. Thus, this evidence was not, as Audifferen suggests, a theory "float[ed]" by FINRA. To the extent that Audifferen objects to the introduction of evidence related to the nature of his personal relationship with Williams, Audifferen cites no evidence to support his claim that such evidence prejudiced FINRA in making its findings against Audifferen. In addition, our de novo review of this matter cures whatever bias, if any, may have existed. 32/

General Fairness of the Proceeding In addition to the arguments described above, Audifferen alleges generally that "a view of the record demonstrates the hearing was fundamentally unfair." Based on our independent review of the record, we find that FINRA provided Audifferen with a fair proceeding. The Hearing Officer noted that Audifferen was appearing pro se and allowed him considerable leeway in presenting his case. For example, at the close of the first day of the hearing, the Hearing Officer permitted Audifferen to call three previously undisclosed witnesses, even though the parties had received instructions to submit their witness lists weeks in advance of the hearing. Furthermore, FINRA's National Adjudicatory Council accepted Audifferen's appeal of the FINRA Hearing Panel decision, even though the appeal was filed over sixteen months late. We find no merit to Audifferen's contention that FINRA's proceeding was "fundamentally unfair."

VI.

Our review of FINRA's sanctions is governed by Exchange Act Section 19(e)(2). 33/ Section 19(e)(2) provides that the Commission will sustain FINRA's sanctions unless it finds, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 34/ FINRA imposed a permanent bar for the violations involving Williams's May Davis account and a permanent bar for the violations involving Audifferen's May Davis accounts, ordered

32/ Robert Bruce Orkin, 51 S.E.C. 336, 344 (1993), aff'd, 31 F.3d 1056 (11th Cir. 1994).

33/ 15 U.S.C. § 78s(e)(2).

34/ 15 U.S.C. § 78s(e)(2). Audifferen does not claim, and the record does not show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

Audifferen to pay Williams \$7,835 in restitution, and fined Audifferen \$9,665. ^{35/} Audifferen argues that the sanctions imposed are “unduly punitive, harsh and certainly not remedial.”

We note initially that FINRA’s Sanction Guidelines recommend a bar in cases involving egregious violations of Regulation T. ^{36/} The Commission has stated, “[Exchange Act] Section 7(c) and Regulation T are integral parts of an over-all scheme designed to prevent dislocation of the economy by the excessive use of credit to finance securities transactions.” ^{37/} The statutes and rules prohibiting improper credit extension “protect public customers from the potential consequences of over-leveraging their securities purchases, and preserve the public interest by maintaining the financial integrity of broker-dealers.” ^{38/}

Audifferen’s violations of these important provisions were egregious. Audifferen, while employed as a registered representative of a FINRA member firm, made several unauthorized trades in the account of a customer who Audifferen knew had limited investment experience and financial resources. These unauthorized trades involved significant credit extension violations.

^{35/} FINRA arrived at the \$7,835 restitution figure by adding Williams’s estimated capital gains tax liability from the violative trades to the amount of her initial \$5,000 deposit that she did not recover. The restitution and fine total \$17,500, the amount that Audifferen obtained from the violative transactions. FINRA imposed no additional sanction for the violations involving Audifferen’s failure to disclose Gabriele’s complaint on his JPT Form U4, although it found that a thirty-day suspension would have been appropriate.

^{36/} FINRA Sanction Guidelines 33 (2006 ed.), available at <http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf>. There is no FINRA Sanction Guideline specifically applicable to improper sharing in a customer account, but the guideline applicable to violations of other sections of the same rule (Rule 2330) recommends a bar in egregious cases. Id. at 93 (guaranteeing a customer against loss). The Sanction Guidelines have been promulgated by FINRA in an effort to achieve greater consistency, uniformity, and fairness in the sanctions that are imposed for violations. See Perpetual Sec. Inc., Exchange Act Rel. No. 56613 (Oct. 4, 2007), 91 SEC Docket 2489, 2506 n.56. Since 1993, NASD has published and distributed the Sanction Guidelines so that members, associated persons, and their counsel will have notice of the types of disciplinary sanctions that may be applicable to various violations. Sanction Guidelines at 1. The Guidelines are not NASD Rules that are approved by the Commission, but NASD-created guidance for NASD Adjudicators, which the Guidelines define as Hearing Panels and the National Adjudicatory Council. Id. Although the Commission is not bound by the Sanction Guidelines, it uses them as a benchmark in conducting its review under Exchange Act Section 19(e)(2).

^{37/} Billings Assoc., 43 S.E.C. 641, 650 (1967).

^{38/} Gabriel, 51 S.E.C. at 1293.

and misrepresentations that resulted in losses and potential tax liabilities for his customer. By executing trades in Williams's account without her knowledge and for which she could not pay, Audifferen placed her in a position of financial risk and profited at her expense. Audifferen's misconduct in connection with his own May Davis accounts placed his member firm, May Davis, at financial risk. Because Audifferen never paid for the transactions at issue, he left May Davis responsible for the losses that resulted to Cowen, May Davis's clearing firm. Audifferen also attempted to conceal his misconduct from Williams and from May Davis.

FINRA found as an aggravating factor that Audifferen's conduct was willful, and we agree. Audifferen was an experienced member of the securities industry at the time of the violations, and he was aware of the requirements of Regulations T and X and the applicable Exchange Act provisions and NASD Rules. Audifferen had substantial indicia that Williams lacked the financial resources to pay for the transactions he executed in her account, yet he continued to execute these unauthorized trades over a period of several months, in one case funding a purchase with a blank check provided to him by Williams at his insistence. When Williams questioned Audifferen about the activity in her account, Audifferen provided evasive answers and grew angry with her. Audifferen also was aware of his own financial difficulties and his inability to cover the three checks he deposited into his May Davis accounts.

Audifferen fails to recognize the wrongfulness of his conduct. Although Audifferen testified that he knew the requirements of Regulation T, he attempts to blame Williams, a novice investor who was not aware of the transactions at issue, for the violations in her account. With respect to his own accounts, Audifferen blames May Davis's operations department for failing to notify him of the returned checks and to request Regulation T extensions for him. Audifferen exhibits a fundamental lack of respect and understanding for an important element of the securities industry's regulatory apparatus, which indicates a likelihood that Audifferen would repeat similar misconduct in the absence of a bar.

We further find the arguments raised by Audifferen in mitigation to be unavailing. Audifferen claims that he did not profit from his misconduct, but he received \$17,500 as a result of his violations in Williams's account. Audifferen also cites his "clean disciplinary history" in mitigation. However, the Commission has consistently rejected the argument that a lack of disciplinary history should be considered as a mitigating factor in connection with the imposition of sanctions in FINRA proceedings. ^{39/}

^{39/} Michael A. Rooms, Exchange Act Rel. No. 51467 (Apr. 1, 2005), 85 SEC Docket 444, aff'd, 444 F.3d 1208, 1214 (10th Cir. 2006) (lack of disciplinary history is not a mitigating factor in NASD disciplinary proceeding); Robert J. Prager, Exchange Act Rel. No. 51974 (July 6, 2005), 85 SEC Docket 3413, 3436 n.66 (rejecting argument that respondent's lack of disciplinary history serves as a mitigating factor) (citing Ernest A. Cipriani, 51 S.E.C. 1004, 1007 (1994)).

Contrary to Audifferen's argument that a bar serves no remedial purpose, we find a bar necessary to protect the investing public from harm. A bar prevents Audifferen from improperly extending credit to his customers or himself in the future and from benefitting financially from such credit extensions at the expense of his customers or his firm. A bar also will protect the public from Audifferen's willingness to place his own financial interests ahead of those of his customers and his firm.

Although Audifferen does not explicitly challenge FINRA's monetary sanctions, we find them to be in the public interest. Audifferen's payment of \$7,835 in restitution to Williams is a remedial measure that will compensate Williams for her losses and liabilities incurred in connection with Audifferen's unauthorized trading activity in her May Davis account. The fine of \$9,665 will serve the remedial purpose of ensuring that Audifferen does not profit from these violations. 40/

We find that the bars, restitution, and fine FINRA imposed against Audifferen are neither excessive nor oppressive, and we sustain FINRA's findings of violations. 41/

An appropriate order will issue.

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



Florence E. Harmon
Acting Secretary

40/ We note that FINRA did not impose any additional fine or restitution in connection with the losses May Davis suffered when it was forced to sell the shares Audifferen purchased in his own accounts with bounced checks.

41/ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58230 / July 25, 2008
Admin. Proc. File No. 3-12892

In the Matter of the Application of

JOHN D. AUDIFFEREN
c/o Norman B. Arnoff, Esq.
Burkhart, Wexler & Hirschberg, LLP
585 Stewart Avenue, Suite 750
Garden City, NY 11530

For Review of Disciplinary Action Taken By

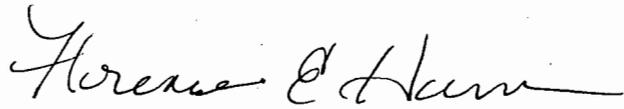
FINRA

ORDER SUSTAINING DISCIPLINARY ACTION

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

ORDERED that the findings of violation and imposition of sanctions by FINRA against John D. Audifferen be, and FINRA's assessment of costs be, and they hereby are, sustained.

By the Commission.



Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 25, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13101

In the Matter of

VIRAGEN, INC., and
VIRAGEN
INTERNATIONAL, INC.

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS AND
NOTICE OF HEARING PURSUANT TO
SECTION 12(j) OF THE SECURITIES
EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate and 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:

RESPONDENTS

1. Viragen, Inc. ("Viragen") is a Delaware corporation headquartered in Plantation, Florida with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The stock was traded on the American Stock Exchange ("AMEX"), until November 19, 2007 when the AMEX delisted it for failing to meet certain listing requirements. Viragen's common stock is presently quoted on the Pink OTC Markets, Inc. ("Pink Sheets") (ticker symbol "VRAI"). At the time of Viragen's last filing, it owned 77% of Viragen International, Inc.'s ("Viragen Int'l") outstanding common stock.

2. Viragen Int'l is also a Delaware corporation headquartered in Plantation, Florida. Viragen Int'l's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is presently quoted on the Pink Sheets (ticker symbol "VRGE").

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DELINQUENT FILINGS

3. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires issuers to file quarterly reports.

4. Viragen and Viragen Int'l each filed their last Forms 10-K for the year ended June 30, 2006 on September 27, 2006. Since then, Viragen and Viragen Int'l have each filed only three Forms 10-Q, for the quarters ended September 30, 2006, December 31, 2006 and March 31, 2007, and no Forms 10-K.

5. The following periodic filings are delinquent.

Form	Period Ended	Due on or about
10-K	06/30/07	09/28/07
10-Q	09/30/07	11/14/07
10-Q	12/31/07	02/14/08
10-Q	03/31/08	05/15/08

6. As a result of the conduct described above, Viragen and Viragen Int'l have failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

III.

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

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations; and,

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

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS FURTHER ORDERED that Respondents shall file Answers to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice [17 C.F.R. § 201.220].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310].

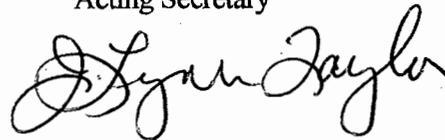
This Order shall be served forthwith upon Respondents personally or by certified mail.

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.

Florence E. Harmon
Acting Secretary



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

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8947; 34-58236; File No. 4-564]

Roundtable on International Financial Reporting Standards

AGENCY: Securities and Exchange Commission.

ACTION: Notice of roundtable discussion; request for comment.

SUMMARY: On August 4, 2008 from 1:00 pm to 5:00 pm, the Securities and Exchange Commission will hold a roundtable to discuss International Financial Reporting Standards ("IFRS") and to update the Commission on IFRS developments, including the experience with use of IFRS during the recent period of market turmoil. The roundtable will be organized as two panels. The panels will include investors, issuers, auditors, and other parties with experience in IFRS reporting. Additionally, representatives from the Financial Accounting Standards Board and the International Accounting Standards Board will be present as observers.

The roundtable will be held in the auditorium of SEC headquarters at 100 F Street, NE, Washington, DC. The roundtable will be open to the public with seating on a first-come, first-served basis. The roundtable discussions also will be available via webcast on the SEC's Web site at www.sec.gov. The roundtable agenda and other materials related to the roundtable, including a list of participants and moderators, will be accessible at <http://www.sec.gov/spotlight/ifrsroadmap.htm>. The Commission welcomes feedback regarding any of the topics to be addressed at the roundtable.

DATES: Comments should be received on or before August 11, 2008.

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

Electronic Comments

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- Use the Commission's Internet submission form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-564 on the subject line.

Paper Comments

- Send paper comments in triplicate to Florence Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

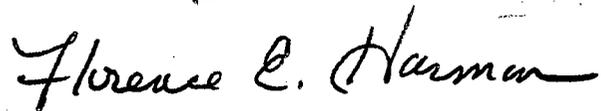
All submissions should refer to File No. 4-564. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/other.shtml>). Comments also will be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Liza McAndrew Moberg, Professional Accounting Fellow, at (202) 551-5300, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6561.

SUPPLEMENTARY INFORMATION: The Commission welcomes feedback regarding any of the topics to be addressed at the roundtable. The panel discussions will focus on:

- An update on IFRS developments
- Experience with the use of IFRS in practice, including during the recent period of market turmoil, more specifically:
 - Applying IFRS in the preparation of financial statements
 - Working with financial statements prepared pursuant to IFRS

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 29, 2008

*Commissioner Watter-
not participating*

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58248/ July 29, 2008

ORDER EXTENDING EMERGENCY ORDER PURSUANT TO SECTION 12(k)(2)
OF THE SECURITIES EXCHANGE ACT OF 1934 TAKING TEMPORARY ACTION
TO RESPOND TO MARKET DEVELOPMENTS

On July 15, 2008, the Commission issued an Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments (the "Order").¹ That Order took effect on July 21, 2008 and applies to the publicly traded securities of the substantial financial firms identified in Appendix A to the Order. The Commission updated the Order by an amendment dated July 18, 2008.² The Order, as amended (the "Emergency Order"), is currently set to terminate on July 29, 2008.

Pursuant to its authority under Section 12(k)(2)(C) of the Securities Exchange Act of 1934 ("Exchange Act"), the Commission is extending the Emergency Order. Section 12(k)(2)(C) authorizes the Commission to extend an emergency order issued pursuant to Section 12(k)(2)(A) of the Exchange Act for a total effective period of up to 30 calendar days, if the Commission finds that the emergency still exists and determines that an extension is necessary in the public interest and for the protection of investors to maintain fair and orderly securities markets.

The Commission has carefully reevaluated the current state of the markets in consultation with officials of the Board of Governors of the Federal Reserve System, the

¹ See Securities Exchange Act Release No. 58166 (July 15, 2008).

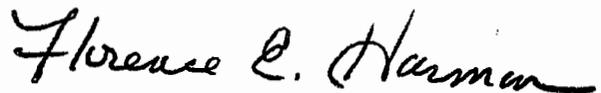
² See Securities Exchange Act Release No. 58190 (July 18, 2008).

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Department of the Treasury and the Federal Reserve Bank of New York. We note that the Board of Governors of the Federal Reserve System, in authorizing the creation of the temporary Primary Dealer Credit Facility ("PDCF"), was required to determine that "unusual and exigent circumstances" exist and that the PDCF remains available to the financial firms identified in Appendix A. The Commission continues to remain concerned about the ongoing threat of market disruption and effects on investor confidence, and has determined in this environment that the standards under Section 12(k)(2) for extending the Emergency Order have been met. Accordingly, the Commission has determined that extending the Emergency Order is in the public interest and necessary to maintain fair and orderly securities markets and for the protection of investors. Following expiration of the Emergency Order, the Commission will proceed immediately to consideration of rulemaking, which would become effective after notice and comment.

THEREFORE, IT IS ORDERED, pursuant to Section 12(k)(2)(C) of the Exchange Act, that the Emergency Order is extended such that it will terminate at 11:59 p.m. EDT on Tuesday, August 12, 2008.

By the Commission.



Florence E. Harmon
Acting Secretary

Commissioner Walter
not participating

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58259; File No. PCAOB-2008-01)

July 30, 2008

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 6, Evaluating Consistency of Financial Statements and Conforming Amendments.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on February 1, 2008, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rule described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On January 29, 2008, the Board adopted Auditing Standard No. 6, Evaluating Consistency of Financial Statements, and amendments to the Board's interim auditing standards ("the proposed rules"). The proposed rules text is set out below.

Auditing Standard No. 6
Supersedes AU secs. 420 and 9420

Evaluating Consistency of Financial Statements

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.

2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.

3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.^{1/} The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.^{2/}

^{1/} For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

^{2/} When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections ("SFAS No. 154"), to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements.^{3/}

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.^{4/}

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

^{3/} The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

^{4/} See SFAS No. 154, paragraph 2c.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.^{5/} In addition, the auditor should recognize a change in the reporting entity^{6/} by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

7. The auditor should evaluate a change in accounting principle to determine whether –

- a. The newly adopted accounting principle is a generally accepted accounting principle,
- b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,
- c. The disclosures related to the accounting change are adequate,^{7/} and
- d. The company has justified that the alternative accounting principle is preferable.^{8/}

^{5/} SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

^{6/} "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

^{7/} Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, Reports on Audited Financial Statements. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

^{8/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, Adequacy of Disclosure in Financial Statements, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.

Amendments to PCAOB Auditing Standards

Auditing Standards

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

Statement on Auditing Standards ("SAS") No. 101, "Auditing Fair Value Measurements and Disclosures," (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

- a. The text of footnote 4 to paragraph .19 is replaced with the following:
Statement of Financial Accounting Standard No. 157, Fair Value Measurements, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 410 (AU sec. 410, "Adherence to Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. Paragraph .02 is replaced with following paragraph, and the reference to footnote 1 is moved to the end of the new paragraph .02.
The fourth standard of reporting is:
The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should

contain a clear-cut indication of the character of the auditor's work, if any,
and the degree of responsibility the auditor is taking.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. The third sentence of paragraph .01 is replaced with the following:

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.
- b. Paragraphs .02, .05, .07, and .09-.18 are deleted.

AU sec. 9411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11-.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 420 (AU sec. 420, "Consistency of Application of Generally Accepted Accounting

Principles"), as amended, and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements") is amended as follows:

- a. Footnote 1 is deleted.
- b. Paragraph .04 is deleted.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

- a. In Paragraph .03, footnote 2 is deleted.
- b. In Paragraph .11, item .11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item .11d is added as follows:

"A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

- c. Paragraphs .14-.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.
- d. The text of paragraph .16 is replaced with the following:

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements
- e. Paragraphs .17-.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.^{12/} A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

^{12/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an

accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [describe accounting method change] in [year(s) of financial statements that reflect the accounting method change] due to the adoption of [name of accounting pronouncement].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [describe accounting method change] in [year(s) of financial statements that reflect the accounting method change].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.^{13/} The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

^{13/} The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

f. Paragraph .50 is deleted.

g. The text of paragraph .51 is replaced with the following:

Departures from generally accepted accounting principles related to

changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

h. In paragraph .52:

- The first three sentences of the paragraph are replaced with the following:

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The

following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

- In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable."

In the text of footnote 17, the first two sentences are deleted; the word, "However," is deleted at the beginning of the third sentence; the word "because" at the beginning of the third sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."

- i. The text of paragraph .57 is replaced with the following:
If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle.
Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent

years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

- j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.
- k. The first sentence of footnote 20 to paragraph .62 is deleted.
- l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, Consistency of Application of Generally Accepted Accounting Principles," with the phrase "PCAOB-Auditing Standard No. 6, Evaluating Consistency of Financial Statements"
- m. In the second sentence of paragraph .69:
 - Item (c) is inserted as follows:

(c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,
 - Item (c) is changed to (d)
 - Item (e) is inserted as follows:

(e) if applicable, a reference to the company's disclosure of the correction of the misstatement,
 - Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item
- n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."
- o. In paragraph .74:

- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
- In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of Report," as amended, is amended as follows:

- a. The text of footnote 3 to paragraph .06 is replaced with the following:
See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB").

First, in May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, Accounting Changes and Error Corrections,^{9/} which superseded Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes.^{10/} SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those

^{9/} Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, Accounting Changes and Error Corrections (2005) ("SFAS No. 154").

^{10/} Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes (1971). SFAS No. 154 also superseded SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements.

financial statements."^{11/} Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, the Board adopted a new auditing standard on evaluating consistency, which will supersede AU sec. 420, and conforming amendments to AU sec. 508, Reports on Audited Financial Statements, of its interim auditing standards.

Second, the FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, The Hierarchy of Generally Accepted Accounting Principles.^{12/} The FASB's proposed standard would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in the auditing standards. Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly,

^{11/} See SFAS No. 154, paragraph 2j.

^{12/} FASB, Proposed Statement of Financial Accounting Standards, The Hierarchy of Generally Accepted Accounting Principles, Exposure Draft (April 2005).

the Board adopted amendments to its auditing standards to remove the GAAP hierarchy.^{13/}

The proposed standard and amendments to the Board's interim standards are intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2007-003 (April 3, 2007). A copy of PCAOB Release No. 2007-003 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board received 11 written

^{13/} If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

comments. The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

Evaluating Consistency

Under Auditing Standard No. 6, auditors are required to evaluate the consistency of a company's financial statements and report on inconsistencies. The new standard updates these requirements and aligns them more closely with SFAS No. 154^{14/} by requiring the auditor's report to recognize a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. Based on a discussion at an October 2005 meeting of the Board's Standing Advisory Group, the Board understands that this requirement is consistent with current practice. The new standard focuses on the auditor's responsibilities regarding events that warrant recognition in the auditor's report on the financial statements—changes in accounting principles and corrections of misstatements in previously issued financial statements.^{15/} The standard also clarifies that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

^{14/} Because SFAS No. 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle and corrections of errors, Auditing Standard No. 6 omits the accounting guidance that was included in AU sec. 420.

^{15/} AU sec. 420 also required recognition of those events. However, it only required recognition in the auditor's report of the correction of a misstatement involving an accounting principle. In addition, unlike AU sec. 420, the new standard does not describe the accounting changes that do not require recognition in the auditor's report.

Materiality

There were several comments on materiality. Some commenters suggested that the standard should specifically state that the auditor need not recognize the correction of a misstatement that is immaterial to the previously issued financial statements. Another suggested that the standard should remind the auditor that professional judgment is required to evaluate consistency. Another commenter said that additional guidance on materiality as applied to individual matters in the financial statements would be helpful in applying the standard. Others suggested that clarity would be improved by inserting the word "material" in several places.

In general, the Board's view is that the purpose of the standard is to provide direction on evaluating consistency; for example, the accounting periods the auditor should evaluate, the recognition in the auditor's report of consistency matters prescribed by the accounting standards, and the related audit reporting requirements. Because an audit is predicated on the use of reasoned judgment and the consideration of materiality in planning, performing, and reporting on the audit, the Board does not believe it is necessary for this standard to specifically direct the auditor to exercise judgment and apply materiality. Further, materiality is a concept that is defined under the federal securities laws, and it is not the objective of this standard to alter or interpret that concept.

The Board did agree that clarity could be improved in some areas by inserting the word "material" to modify the word "misstatement." The Board added "material" to AU secs. 508.18A and B to be consistent with paragraph 4 of Auditing Standard No. 6. However, AU sec. 508.18C does not include "material" because that sentence

summarizes the SFAS No. 154 requirement for correcting a misstatement, which does not directly mention materiality.

Periods Covered by the Evaluation of Consistency

The new standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the new standard, when the auditor reports only on the current period, the auditor should evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor should evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented. In response to comments, the Board added this example to the final standard.

When a company uses retrospective application, as defined in SFAS No. 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. For example, consider a company that adopts a new

accounting standard in 2007 that requires retrospective application to 2006 and 2005. The financial statements for 2006 and 2005 will be consistent, as presented with 2007. However, the financial statements for the years 2006 and 2005 that were issued a year earlier will not reflect the retrospective application and hence will not be consistent with 2007 and will be different from the 2006 and 2005 financial statements that are presented with 2007. The new standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Paragraph 3 of the proposed standard described the financial statement periods covered by the evaluation of consistency. The third sentence of that paragraph was intended to be a clarification of the requirement in AU sec. 420.22 regarding the evaluation of two or more years. However, some commenters found the third sentence of paragraph 3 to be confusing and recommended retaining the language in AU sec. 420.22, unless the Board had intended to change the auditor's responsibilities for evaluating the consistency of GAAP. Because the Board wanted to be clear that the auditor's responsibilities had not changed, the Board decided to retain the original sentence from AU sec. 420.22, with some changes, instead of the proposed third sentence of paragraph 3. The inserted sentence, adapted from AU sec. 420.22, reads as follows (additions are in italics and deletions are in brackets):

When the [independent] auditor reports on two or more periods [years], he or she should evaluate [address the] consistency [of the application of accounting principles] between such periods [years] and the consistency of such periods [years] with the period [year] prior thereto if such prior period [year] is presented with the financial statements being reported upon.

The Board did not include the reference to "the application of accounting principles" because paragraph 3 also relates to the auditor's evaluation of a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. The Board also used the word "evaluate" because it describes the auditor's responsibilities consistently with the rest of the paragraph.

Two commenters suggested that the last sentence of proposed paragraph 3, which described the auditor's responsibility to evaluate whether the financial statements are consistent with previously issued financial statements for the same period, was confusing and unnecessary. These commenters suggested deleting the last sentence of paragraph 3. In addition, one commenter suggested that paragraph 3 of the proposed standard could be clarified by including the explanatory language from the proposing release regarding retrospective application under SFAS No. 154. As discussed above, the new standard is intended to clarify that the auditor's evaluation of consistency should include an evaluation of previously issued financial statements for the relevant periods. Accordingly, the Board believed that the final sentence of paragraph 3 is necessary. However, the Board agreed that including the suggested explanatory language from the proposing release regarding retrospective application would clarify the paragraph and has added that language as a footnote to paragraph 3.

Reference to Application of Accounting Principles

Consistent with the discussion above related to paragraph 3 of the proposed standard, the Board also removed the reference to "application of accounting principles" from the first paragraph of Auditing Standard No. 6. Because the auditor's evaluation of consistency under this standard includes errors not involving an accounting principle, the

consistency evaluation is broader than that described under the second standard of reporting. Accordingly, the Board also removed the reference to the second standard of reporting from paragraph 2 of Auditing Standard No. 6.

Change in Accounting Principle

The new standard requires the auditor to evaluate a change in accounting principle^{16/} that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the company justifies that the alternative accounting principle is preferable,^{17/} as required by SFAS No. 154.^{18/} Under the amendments to AU sec. 508, if the four criteria are met,^{19/} the auditor would recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the

^{16/} The proposed and final standards use the definition of a change in accounting principle found in SFAS No. 154, paragraph 2c.

^{17/} In certain circumstances, SEC rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. See Rule 10-01(b)(6) of Regulation S-X, 17 CFR 210.10-01(b)(6).

^{18/} Under SFAS No. 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See SFAS No. 154, paragraph 14.

^{19/} The auditor has substantially the same responsibility for evaluating a change in accounting principle as under AU sec. 431, Adequacy of Disclosure in Financial Statements, and paragraph .50 of AU sec. 508, Reports on Audited Financial Statements. The language in Auditing Standard No. 6 has, however, been updated to be consistent with SFAS No. 154.

change and a reference to the issuer's note disclosure describing the change. If those criteria are not met, the auditor would issue a qualified or adverse opinion.^{20/}

Some commenters recommended that the Board reconsider whether it was necessary for the auditor to recognize in the audit report changes that result when a company is required to adopt a newly issued accounting standard. They indicated that the significance of a company's discretionary change in accounting principle may be diluted if the auditor recognizes both discretionary changes and those changes in accounting principles required by a newly-issued standard in the report. Another commenter suggested that the auditor should not be required to include an explanatory paragraph in the audit report when changes in accounting principle have been applied retrospectively because, in such cases, the financial statements included in the filing will appear consistent. As noted above, the Board believes that it is important for investors to be informed when the prior year financial statements presented with the current year are different from previously issued financial statements. In addition, the Board believes that the different language in the auditor's report for discretionary changes and those required by a newly-issued standard provides sufficient notification to investors of the general nature of the change. Therefore, the Board adopted the requirement as proposed.^{21/}

^{20/} This responsibility is substantially unchanged from AU sec. 508.51.

^{21/} In addition, one commenter suggested that the standard include an example of a change in the method of applying an accounting principle. The final standard, like the proposed standard, notes that under SFAS No. 154 a change in the method of applying an accounting principle is also a change in accounting principle. While the Board believes that it is helpful for the standard to reference the accounting requirement, it also believes that it is not appropriate for the auditing standard to provide accounting guidance.

One commenter suggested that the proposed standard deleted useful information about a change in accounting principle that also involves a change in an estimate. The proposed standard did not carry forward the requirement of AU sec. 420.13 that the auditor should recognize in his or her report a change in accounting principle that is inseparable from a change in estimate. After considering this comment, the Board concluded that the requirement in AU sec. 420.13 does result in useful information being included in the auditor's report. Accordingly, the Board updated the language in AU sec. 420 to reflect the term used in SFAS 154, and included the requirement in Auditing Standard No. 6.^{22/}

Some commenters asked the Board to clarify the reporting requirement related to a change in reporting entity. According to AU sec. 420.08, a change in reporting entity resulting from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that the auditor include an explanatory paragraph in the auditor's report. Under the proposed standard, the auditor may have been required to report on, for example, the disposition of a subsidiary or business unit because SFAS No. 154 (and its predecessor, APB Opinion No. 20) did not specifically exempt such a transaction from the definition of a change in reporting entity. Generally, dispositions or spin-offs have specific disclosure requirements in the accounting standards and the Board did not intend to change practice and require the auditor to report on these events through an explanatory paragraph. Accordingly, the Board carried forward the requirement from AU sec. 420.08 regarding a

^{22/} The new standard uses the term "change in accounting estimate effected by a change in accounting principle," which is defined in SFAS No. 154 as "a change in

transaction or event. In addition, the Board also added a reference to paragraph 2f in SFAS No. 154, which describes a change in reporting entity, as suggested by some commenters.

In response to comments, the Board also modified paragraph 8 of the proposed standard, which provided direction for reporting a change in accounting principle. Some commenters noted that the proposed conforming amendments to AU sec. 508.17 had a more clearly stated version of the number of years that the auditor is required to include an explanatory paragraph related to a change in principle than did footnote 5 to paragraph 8. After considering the commenters' recommendation that the language in the footnote be changed, the Board decided that the footnote was not necessary because paragraph 8 referred the auditor directly to the reporting requirements in AU sec. 508. The Board therefore removed footnote 5 from the final standard.

Correction of a Material Misstatement in Previously Issued Financial Statements

Under Auditing Standard No. 6, the correction of a material misstatement in previously issued financial statements (*i.e.*, a "restatement") is recognized in the auditor's report through the addition of an explanatory paragraph. Under the conforming amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to

accounting estimate that is inseparable from the effect of a related change in accounting principle."

prior-period financial statements resulting from changes in accounting principle.

Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

One commenter suggested that the proposed standard did not clearly explain whether corrections of an error not involving a principle would require recognition in the auditor's report. Unlike the previous requirement, the proposed standard did not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."^{23/} Rather, the proposed standard required recognition in the auditor's report of any correction of a material misstatement, whether or not the error involved a principle. The Board reconsidered the language and concluded that the requirement as proposed was sufficiently clear. The new standard aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements.

Some commenters suggested that it would not improve clarity to have the auditor's report include a statement that the financial statements were restated "to correct a material misstatement." They noted that SFAS No. 154 already defines a restatement as the revision of previously issued financial statements to reflect the correction of an error. The Board decided to retain the reporting requirement as proposed because it clearly distinguishes corrections of misstatements from changes in accounting principle. Also, the required reporting language regarding restatements is more informative because

^{23/} This distinction previously was in paragraphs .12 and .16 of AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles.

it does not rely entirely on the user's knowledge of the definition of "restatement" in the accounting standard.^{24/}

One commenter also recommended that the auditor's explanatory paragraph about the correction of a misstatement should contain additional information. The commenter recommended that the explanatory paragraph include a statement that (1) the previously issued auditor's report should not be relied on because the previously issued financial statements were materially misstated, and (2) the previously issued report is replaced by the auditor's report on the restated financial statements.

The Board believes that the recommended additional language is not necessary because existing PCAOB standards and rules of the SEC are sufficient to inform users about misstatements in previously issued financial statements. Specifically, AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report, requires the auditor to take specific action when he or she concludes that information discovered after the financial statements have been issued would have affected his or her report if the company had not reflected the information in the financial statements and people are currently relying or are likely to rely on the financial statements and auditor's report. According to AU sec. 561.06, the auditor should advise the company to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to

^{24/} Two commenters suggested that the standard include the explanation from the release that the term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards. The Board agreed and has included that explanation in the final standard.

persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.^{25/}

A U.S. public company that is not a foreign private issuer under SEC rules also is required to file a Form 8-K current report, if it concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.^{26/} If the auditor has notified the issuer that action should be taken to prevent future reliance on a previously issued audit report, the company also must disclose that information in the Form 8-K.

Changes in Classification

Auditing Standard No. 6 does not require the auditor's report to recognize a change in classification^{27/} in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.^{28/} Accordingly, the new standard clarifies that the auditor should evaluate

^{25/} AU sec. 561.06 also requires that if the effect on the financial statements or auditor's report can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. If issuance of the financial statements with an auditor's report for a later period is imminent, a company is permitted to disclose the revision to the financial statements instead of reissuing earlier statements. When the effect on the financial statements cannot be determined without a prolonged investigation, appropriate disclosure would consist of notification that the financial statements and auditor's report should not be relied on and that revised financial statements and auditor's report will be issued upon completion of an investigation.

^{26/} See Securities Exchange Act Rule 13a-11, 17 CFR 240.13a-11.

^{27/} AU sec. 420.17 also did not require recognition of a change in financial statement classification in the auditor's report.

^{28/} SFAS No. 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the new standard address the auditor's responsibilities for changes in classification, which is an

a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be both a restatement and reclassification. Therefore, the auditor should evaluate these matters as part of the evaluation of corrections of misstatements. Under Auditing Standard No. 6, a classification change that is also a change in accounting principle should be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement should be reported on by the auditor as a restatement.

Some commenters recommended slight revisions to the first sentence of paragraph 11 to clarify the auditor's responsibilities. The first sentence stated that changes in classification in previously issued financial statements do not require recognition in the auditor's report. This seemed to conflict with the second sentence which required the auditor to review a material change in classification and related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. The Board agreed with the comments and modified the first sentence to state that a change in classification does not require audit report recognition unless the change represents the correction of a material misstatement or a change in accounting principle. Additionally, in the proposed standard, the Board used the word "review" to describe the auditor's responsibility when there has been a

element of the presentation and disclosure financial statement assertion under the

material change in financial statement classification. The Board concluded that the word "evaluate" better describes the auditor's responsibilities in this area and is more consistent with the other requirements in Auditing Standard No. 6. Accordingly, the Board replaced "review" with "evaluate."

Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board amended its interim standards to remove the GAAP hierarchy from the auditing standards. These amendments do not change the principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Commenters strongly supported removing the GAAP hierarchy from the auditing standards and stated that it was appropriate for the GAAP hierarchy to be contained in the accounting standards. However, one commenter observed that the proposed amendments contain significant differences from the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") proposed amendment to AU sec. 411 of the ASB's standards.^{29/}

auditing standards. See, e.g., paragraph .08 of AU sec. 326, Evidential Matter.

^{29/} In addition, this commenter suggested that U.S. auditing standard-setters should work together to achieve consistency on core auditing standards that are used by almost all auditors of U.S. entities. This commenter also suggested that if the Board continues issuing its own standards for audits of public companies, it should adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA standards. The Board is considering these comments as it seeks to make continuous improvements to its standard-setting and other programs.

The Board believes that the amendments to AU sec. 411 are consistent with the Board's objective of removing the GAAP hierarchy from the auditing standards, and retaining, or providing, direction necessary for audits of public companies. The significant differences between the ASB's amendments to its AU sec. 411 and the Board's amendments primarily are related to sources of GAAP for governmental entities and direction on the application of accounting principles, which the Board did not believe was appropriate for inclusion in the proposed amendments. In addition, the Board deleted references to Rule 203 of the AICPA's Code of Professional Conduct. Rule 203 prohibits auditors from expressing an opinion on financial statements that do not conform to GAAP unless the auditor can demonstrate that due to unusual circumstances the financial statements would have been misleading without departing from GAAP. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 203. Consistent with that action, the proposed amendments did not include a reference to Rule 203.

Section-by-Section Description of Amendments to the Interim Auditing Standards

In addition to proposing an auditing standard on evaluating consistency of financial statements, the Board also proposed amendments to other interim auditing standards and related interpretations. The following sections describe key aspects and elements of the amendments to the standards and interpretations, comments received, and changes incorporated in the final amendments.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 410.02 which discussed the meaning of "generally accepted accounting principles" and included other matters that are addressed

elsewhere in the standards. However, some commenters suggested that, to improve clarity, AU sec. 410 should retain the sentence in existing AU sec. 410.02 which states that the "first standard is construed not to require a statement of fact by the auditor but an opinion."

The Board agreed that, when viewed alone, the first standard of reporting, contained in AU sec. 410.01, does not provide a complete description of the auditor's responsibilities related to fair presentation in conformity with GAAP. However, the first standard of reporting combined with the fourth standard clearly indicates that the auditor is providing a statement of an opinion and not a statement of fact. The fourth standard of reporting provides that the auditor's report shall contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. To emphasize that the first and fourth reporting standards must be read together, the Board is including the fourth standard of reporting in the final amendment to AU sec. 410. However, as proposed, the prior statement on the meaning of "generally accepted accounting principles" has been deleted from AU sec. 410.02.

AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 411.02, which was a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15, which described the application of the GAAP hierarchy. The Board proposed to replace the description of GAAP in AU 411.02, with a statement that GAAP refers "to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission."

However, commenters had concerns about the proposal. One commenter noted that the SEC might allow companies to file financial statement prepared in conformity with international financial reporting standards ("IFRS") but not recognize the International Accounting Standards Board, which issues IFRS, as a standard-setting body. Another commenter suggested that to avoid potential confusion by users, the Board should acknowledge that there are other sources of GAAP for entities other than public companies.

In response to these comments, the Board decided to modify its proposed amendment of AU 411. It deleted AU sec. 411.02, which described GAAP, and revised AU sec. 411.01 to indicate that the auditor should look to the requirements of the SEC for the company under audit to identify the accounting principles that are applicable to that company. This change should also clarify that the standard is focused only on the accounting principles that may be used for purposes of the federal securities laws. Other accounting principles may apply to financial statements prepared for other purposes or by entities that are not issuers. The Board also modified AU 411.01 to better emphasize that standard's focus on the meaning of the phrase "present fairly."

Finally, as proposed, the Board eliminated AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 has been superseded by Auditing Standard No. 6, Evaluating Consistency of Financial Statements. However, some commenters suggested that parts of AU sec. 420 should have been incorporated into Auditing Standard No. 6. Commenters suggested that guidance on the objective of the consistency standard and the relationship

of consistency and comparability, matters that may not affect consistency, and changes expected to have a material future effect provided useful direction.

The Board believes that it is unnecessary to include the preceding direction. The proposed standard clarified that the auditor's report should recognize only those matters that require recognition under the existing auditing standards—i.e., a change in accounting principle or the correction of a material misstatement. The Board does not believe it is necessary to list in a standard those matters that do not require recognition in the auditor's report. Also, the Board believes that paragraph 1 clearly describes the objective of the standard. Paragraph 2 makes it clear that the standard considers comparability to be between periods for the company under audit.

AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and therefore has been eliminated.

AU sec. 431.04 is an application of the AICPA's Code of Professional Conduct regarding the disclosure of confidential client information. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 301. Consistent with that action, the proposed amendments would eliminate AU sec. 431.04.

Some commenters expressed concerns that the proposed elimination of AU sec. 431.04 would change the auditor's obligations, or reflected Board policy, regarding the

use of confidential client information in connection with evaluating the adequacy of financial statement disclosures. Those commenters generally recognized the limited nature of AU sec. 431.04 and acknowledged that, since in 2003 the Board did not adopt Rule 301, removing a portion of the interim standards based on that rule was a conforming amendment. However, they were concerned that the Board's action might be construed as minimizing the auditor's responsibilities for maintaining the confidentiality of client information.

The Board is aware that many auditors have legal or professional obligations to maintain the confidentiality of client information. These requirements arise from the rules of state licensing authorities,^{30/} the rules of professional organizations such as the AICPA and the International Federation of Accountants, and the laws of some foreign jurisdictions. The Board's decision to omit Rule 301 from its interim standards was based on a determination that incorporation of that rule was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of the Act. It did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. Similarly, in amending AU sec. 431, the Board seeks neither to modify nor to detract from existing confidentiality requirements.

Interpretations of the Auditing Standards in AU 400 Sections

The auditing interpretation in AU sec. 9420.52-.54 has been incorporated into Auditing Standard No. 6 and therefore has been eliminated, as proposed. The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec.

^{30/} For example, confidentiality requirements are included in the provisions of the Uniform Accountancy Act, which has been enacted in some form by many states.

9420 are addressed by the accounting standards and therefore also have been eliminated as proposed.^{31/}

AU sec. 508, Reports on Audited Financial Statements

In general, the Board has adopted the amendments as proposed. The amendments have conformed this interim auditing standard to Auditing Standard No. 6 on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, AU sec. 508.16 now specifically identifies the matters related to consistency of the company's financial statements that should be recognized in the auditor's report. Similarly, AU sec. 508.17A provides the requirements for evaluating consistency, that also is in paragraph 7 of Auditing Standard No. 6. AU secs. 508.17B and C, and AU sec. 508.18A provide separate requirements for reporting on changes in accounting principles and restatements, as discussed previously.

In addition, the amendments eliminate AU sec. 508.14-.15. Those paragraphs were an application of AICPA Ethics Rule 203, which, as previously noted, was not adopted as an interim standard by the Board.^{32/}

^{31/} One commenter suggested that some of the auditing interpretations should be retained because the guidance is still relevant. The Board considered the view of this commenter but decided to eliminate the interpretations because other auditing standards provided the necessary direction regarding the matter addressed in the interpretation, the interpretation dealt with items not requiring recognition in the auditor's report, or the interpretation was related to an accounting consideration of the company.

^{32/} One commenter expressed concern about deleting these paragraphs and suggested that, if the Board's intent was to delete all reference to the AICPA Code of Professional Conduct from the Board's interim standards, the Board should indicate the professional ethics that auditors should follow when conducting audits according to PCAOB standards. The Board's Rules 3500T and 3600T describe the Board's interim ethics and independence standards, respectively. These standards include certain provisions from the AICPA's Code of Professional Conduct. In addition, the Board has adopted ethics and independence rules concerning independence, tax services, and

Finally, in light of the definitions in SFAS No. 154, the amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that may result from either a correction of a misstatement or a change in accounting principle.^{33/}

References to APB Opinion No. 20

In addition, the Board has adopted other amendments to update references to APB Opinion No. 20, which was superseded by SFAS No. 154. Accordingly the Board amended AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report, footnote 3 to paragraph .06, to reference paragraphs 25 and 26 of SFAS No. 154. For AU sec. 328, Auditing Fair Value Measurements and Disclosures, footnote 4 to paragraph .19, the Board referenced paragraph 20 of SFAS No. 157, Fair Value Measurements, which states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This replaces a reference to the preferability requirement in SFAS No. 157 because that requirement does not apply to a change in a

contingent fees. See PCAOB Release No. 2005-014 (July 26, 2005). State law and membership organizations may impose additional requirements.

^{33/} Some commenters suggested that certain other changes were needed to AU sec. 508 or that certain amendments were not necessary. For example, some commenters suggested eliminating AU sec. 508.57 and retaining the original terminology in AU secs. 508.73 - .74. The Board decided that some of the suggested changes would change existing practice, such as the elimination of AU sec. 508.57, and were outside the scope of this project. For the others, the Board concluded that the amendments were consistent with the direction in Auditing Standard No. 6. In addition, one commenter believed that there were inconsistencies between the proposed amendments to AU sec. 508 and Staff Questions and Answers, Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor. However, the Board reviewed the Staff Questions and Answers and did not agree that there were inconsistencies with the proposed amendments to AU sec. 508.

company's method for determining fair value. Paragraph 20 is the accounting guidance applicable to a company's change in method for determining fair value.

Effective Date

The standard and amendments will be effective 60 days after approval by the SEC.

III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rule; or
- (b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

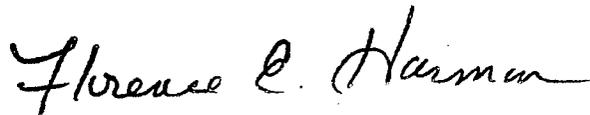
- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB 2008-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Florence Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB 2008-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob/shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2008-01 and should be submitted on or before **[insert 21 days from publication in the Federal Register]**.

By the Commission.



Florence E. Harmon
Acting Secretary

*Commissioner Walter -
not participating*

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

**[Release Nos. 34- 58264; IC-28345; IA-2763 File No. S7-22-08]
RIN 3235-AJ45**

Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices

AGENCY: Securities and Exchange Commission.

ACTION: Proposed guidance; request for comment.

SUMMARY: The Securities and Exchange Commission is publishing for comment this proposed guidance to boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with respect to overseeing the trading of investment company portfolio securities. The guidance focuses on the role of an investment company board in overseeing the best execution obligations of the investment adviser hired to invest in securities and other instruments on the investment company's behalf. In this respect, we address the conflicts of interest that may exist when an investment adviser uses an investment company's brokerage commissions to purchase services other than execution, such as the purchase of brokerage and research services through client commission arrangements. The Commission also is requesting comment on whether to propose that advisers be subject to new disclosure requirements concerning the use of client commission arrangements to investment company shareholders and other investment advisory clients.

DATES: Comments should be received on or before October 1, 2008.

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>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number **S7-22-08** on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Please follow the instructions provided for submitting comments.

Paper comments:

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

All submissions should refer to File Number **S7-22-08**. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, 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: Matthew N. Goldin, Senior Counsel, Karen L. Rossotto, Advisor to the Director, or Thomas R. Smith, Jr., Senior Advisor to the Director, Office of the Director, at 202-551-6720, Division of Investment

Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-0506.

I. INTRODUCTION AND SUMMARY

Many investment advisers, in connection with trades placed on behalf of their registered investment company, or “fund,” clients, receive brokerage and research services in reliance on the safe harbor provided under section 28(e)¹ of the Securities Exchange Act of 1934 (“Exchange Act”).² In recent years, changes in client commission practices, evolving technologies, and marketplace developments have transformed the brokerage and investment management industries and securities trading practices. In recognition of changing market conditions and current industry practices, in July 2006, we issued an interpretive release that provided guidance to investment advisers with respect to, among other things, the scope of the safe harbor provided under section 28(e) when advisers use brokerage commissions to purchase brokerage and research services for their managed accounts.³ In addition to providing guidance to investment advisers on their use of soft dollars, we believe it is important to provide guidance to fund boards of directors concerning their responsibilities to oversee the adviser’s satisfaction of its best execution obligations, including the adviser’s use of fund brokerage commissions and the overall transaction costs that the fund incurs when the fund buys or sells portfolio

¹ 15 U.S.C. 78bb(e). For a discussion of the section 28(e) safe harbor, see *infra* Section III.C. Whereas section 28(e) refers to a money manager as a “person . . . [who] exercise[s] . . . investment discretion with respect to an account,” we refer to money managers to funds in this Release as “investment advisers.”

² 15 U.S.C. 78a.

³ Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) [71 FR 41978 (July 24, 2006)] (“2006 Release”).

securities.⁴ As we have stated previously, transaction costs are a concern for fund investors for two reasons.⁵ First, for many funds, the amount of transaction costs incurred may be substantial.⁶ Second, fund advisers are subject to a number of potential conflicts of interest in conducting portfolio transactions on behalf of clients that are funds.⁷ Fund brokerage commissions, which are paid out of fund assets, may, for example, be used to obtain brokerage and research services under section 28(e) of the Exchange Act that might otherwise be paid for directly by the fund's investment adviser.

We recognize that conflicts of interest are inherent when an investment adviser manages money on behalf of multiple clients. As discussed in Section II of this Release, conflicts are also inherent in the external management structure of funds. Investment advisers are required to disclose material conflicts of interest to their clients, and those conflicts should be managed appropriately. Fund directors play a pivotal role in

⁴ See infra Section III (discussing fund directors' obligations with respect to overseeing advisers' trading of fund portfolio securities). Broadly defined, a fund's transaction costs include all of its costs that are associated with trading portfolio securities. Transaction costs may include, among other things, commissions, spreads, market impact costs, and opportunity costs. Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Release No. 26313 (Dec. 18, 2003) [68 FR 74820 (Dec. 24, 2003)] ("Concept Release"), at Section II.A. For purposes of this Release, the use of the term "securities" includes all instruments that an investment company may invest in under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Investment Company Act").

⁵ See Concept Release at Section I. However, we are aware that the interests of a fund's adviser and the fund's investors generally are aligned when an adviser places fund trades because advisers typically seek to minimize transaction costs due to the fact that such costs may detract from the fund's performance.

⁶ For example, one study estimates that the average annual trading cost for a sample of 1706 U.S. equity funds during the period 1995-2005 was almost 20 percent higher than the average expense ratio for those funds. These estimates include the effect of commissions, spreads, and market impact costs. Roger M. Edelen, Richard Evans & Gregory Kadlec, Scale Effects in Mutual Fund Performance: The Role of Trading Costs (working paper dated March 17, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367.

⁷ See Concept Release at Section I.

overseeing conflicts of interest investment advisers face when they have funds as clients. As explained in further detail in Section III of this Release, fund transaction costs may not be readily apparent to investors. It is imperative that the fund's directors both understand and scrutinize the payment of transaction costs by the fund⁸ and determine that payment of transaction costs is in the best interests of the fund and the fund's shareholders.⁹ Although directors are not required or expected to monitor each trade, they should monitor the adviser's trading practices and the manner in which the adviser fulfills its obligation to seek best execution when trading fund portfolio securities.¹⁰ In doing so, the fund's board should demand, and the fund's adviser must provide, all information needed by the fund's board to complete this review process.¹¹ Without sufficient oversight by the fund's board, transaction costs might inappropriately include payment for services that benefit the fund's adviser at the expense of the fund and that the board believes should be paid directly by the adviser rather than with fund assets.

⁸ See *id.* See also *infra* Section II at note 26 and accompanying text (discussing the external management structure of most funds).

⁹ See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)], at nn.7 & 12 (“Mutual funds are formed as corporations or business trusts under state law and, like other corporations and trusts, must be operated for the benefit of their shareholders. . . . Under state law, directors are generally responsible for the oversight of all of the operations of a mutual fund.”).

¹⁰ The directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices. See 2006 Release at n.6 (citing Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act, Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 FR 16012 (Mar. 10, 1981)]). See also 2 TAMAR FRANKEL, REGULATION OF MONEY MANAGERS 67 (1978) (“The directors should examine the adviser's practices in placing portfolio transactions with broker dealers and the use of the brokerage business for the benefit of the adviser or its affiliates, and ensure that there are no violations [] of the law. . . .”) (citing *Lutz v. Boas*, 39 Del. Ch. 585, 171 A.2d 381 (1961) and *William J. Nutt, A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 181 (1971)).

¹¹ See Concept Release at Section I.

We have received requests from fund directors for guidance on our view of their responsibilities in overseeing the activities of the investment advisers that trade their funds' portfolio securities. These requests include inquiries as to how directors may properly fulfill their responsibilities with respect to overseeing an adviser's satisfaction of its best execution obligations, including the adviser's trade execution practices and the adviser's use of fund brokerage commissions.¹² Today we are proposing guidance with respect to information a fund board should request that an investment adviser provide to enable fund directors to determine that the adviser is fulfilling its fiduciary obligations to the fund and using the fund's assets in the best interest of the fund. Our proposed guidance also is intended to assist the board in directing the adviser as to how fund assets should be used.¹³

Our proposed guidance would not impose any new or additional requirements. Rather, it is intended to assist fund directors in approaching and fulfilling their responsibilities of overseeing and monitoring the fund adviser's satisfaction of its best execution obligations and the conflicts of interest that may exist when advisers trade the securities of their clients that are funds.¹⁴ In developing this proposed guidance, we have taken into account the wide variety of funds and advisers in terms of size, asset classes, complexity, and operations. We have also considered the changing market environment

¹² In connection with these requests for guidance, fund directors have informed us that fund boards are spending increasing amounts of time on trading practices in light of the growing complexity in this area.

¹³ At the July 12, 2006 open meeting at which the Commission considered the 2006 Release, several of the Commissioners specifically noted that guidance for fund boards was a critical element in protecting investors against abuses in this area. An electronic link to an archived webcast of the open meeting is available at <http://www.connectlive.com/events/secopenmeetings>.

¹⁴ See infra Section III. See also 2006 Release at Section II.A.

in the brokerage and investment management industries.¹⁵ We feel that with rapidly evolving market conditions and trading practices, it is appropriate to give guidance at this time. For these reasons, we are proposing guidance for fund directors to consider in performing their responsibilities and in determining what is appropriate in light of their fund's particular circumstances.

Our intention in this proposed guidance is to assist boards. We wish to provide guidance that is relevant, useful, and beneficial to fund directors in fulfilling their responsibilities to act in the best interest of investors in this area. We request comment on all aspects of our proposed guidance to help us in achieving this goal. In addition, as the evolving nature of brokerage practices greatly influences how directors approach their oversight responsibilities in this area, we specifically request comment on the current state of the brokerage and investment management industries and its effect on advisers' trading of fund portfolio securities.

II. SUMMARY OF LAW REGARDING FIDUCIARY RESPONSIBILITIES OF INVESTMENT COMPANY DIRECTORS

In fulfilling their responsibilities to a fund that they oversee, fund directors should understand the nature and source of their legal obligations to the fund and the fund's shareholders. Because funds are generally formed as corporations, business trusts, or partnerships¹⁶ under state law, fund directors and trustees, like other corporate directors, are subject to a "duty of care" and a "duty of loyalty" under state and common law

¹⁵ In light of the advancements in the market and the continuously evolving technology influencing industry practices, the Commission staff talked with a variety of investment advisers and industry representatives, including independent fund directors and directors' counsel, to help ensure that our proposed guidance today reflects actual market practices and is based on factual industry experience.

¹⁶ See, e.g., A. Joseph Warburton, Should Mutual Funds Be Corporations: A Legal & Econometric Analysis, 33 IOWA J. CORP. L. 745, 748-49 (2008).

fiduciary principles,¹⁷ as well as the obligations imposed on them under the Investment Company Act.¹⁸

A director's duty of care generally requires a fund director to perform his or her oversight responsibilities with the care of an ordinarily prudent person in a like position under similar circumstances.¹⁹ The duty of care thus establishes the degree of attention and consideration required of a director in matters related to the fund he or she oversees. As such, a director's duty of care incorporates a duty to be informed, requiring that a director be reasonably informed about an issue before making a decision relating to that issue.²⁰ To be reasonably informed about an issue, a director must inform him or herself of all material information regarding that issue reasonably available to him or her.²¹ In fulfilling these obligations, a fund director may rely on written and oral reports provided by management, auditors, fund counsel, the fund's chief compliance officer ("CCO"), and other experts and committees of the board when making decisions, so long as the director reasonably believes that the reports are reliable and competent with respect to the relevant matters.²²

¹⁷ See, e.g., MD. CODE ANN., CORPS. AND ASS'NS § 2-405.1(a) (2008) (requiring a director to perform his duties: "(1) In good faith; (2) In a manner he reasonably believes to be in the best interests of the corporation; and (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.").

¹⁸ 15 U.S.C. 80a. See *supra* note 4.

¹⁹ See, e.g., MODEL BUS. CORP. ACT ANN. § 8.30(b) (3d ed. 2002); MD. CODE ANN., CORPS. AND ASS'NS § 2-405.1(a)(3) (2008).

²⁰ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (explaining that, although directors are assumed to have been informed in making a business decision, when the burden of proving that a board was insufficiently informed is met, the board will have been found to have breached its duty of care).

²¹ See *id.* at 872 (discussing the standard for determining whether a director's business judgment is informed).

²² See, e.g., *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125, 130 (1963) (explaining that, under general principles of the common law, a director is entitled to rely

A director's duty of loyalty requires him or her to act in the best interests of the fund and the fund's shareholders.²³ The duty of loyalty encompasses a director's obligations to avoid conflicts of interest with the fund and the fund's shareholders, not to put his or her personal interests before the interests of the fund and the fund's shareholders, and not to profit from his or her position as a fiduciary.²⁴

In addition to statutory and common law obligations, fund directors are also subject to specific fiduciary obligations relating to the special nature of funds under the Investment Company Act.²⁵ Unlike typical operating companies, funds ordinarily do not

on corporate summaries, reports, and records so long as he or she has not "recklessly reposed confidence in an obviously untrustworthy employee, [] refused or neglected cavalierly to perform his duty as a director, or [] ignored either willfully or through inattention obvious danger signs of employee wrongdoing." A director should be satisfied not only that the person providing the report or opinion is doing so about a matter within his or her knowledge or expertise and has an appropriate basis for the opinion, but also that the scope of the report bears on the matter being decided. See Van Gorkom, 488 A.2d at 875. In addition, to fulfill the duty of care, a director needs a well-informed decision-making process. This process may include, among other things, asking for and reviewing regular financial and other reports, questioning managers and outside experts about the meaning and implications of reports, and making inquiries when there are specific causes for concern. Id.

²³ See, e.g., Strougo v. Scudder, Stevens and Clark, Inc., 964 F. Supp. 783, 801 (S.D.N.Y. 1997) (citing MD. CODE ANN., CORPS. AND ASSN'S § 2-405.1(a)(1) (requiring corporate directors to perform their duties in "good faith") and JAMES J. HANKS, JR., MARYLAND CORPORATION LAW § 6.6(b) (1995-1 Supp.) (explaining that a director's duty to act in 'good faith' is generally synonymous with the duty of loyalty or the duty of fair dealing)). See also Pepper v. Litton, 308 U.S. 295, 310-311 (1939) (stating that a fiduciary "cannot serve himself first and his cestuis second").

²⁴ See, e.g., Guth v. Loft, Inc., 5 A. 2d 503, 510 (Del. Ch. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests"); see also Pepper, 308 U.S. at 310-311 (stating that a fiduciary "cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements."). See also FED. REGULATION OF SEC. COMM., AM. BAR ASS'N, FUND DIRECTOR'S GUIDEBOOK 98 (3d ed. 2006) ("Simply put, directors should not use their position for personal profit, gain, or other personal advantage.").

²⁵ See, e.g., Strougo, 964 F. Supp. at 798 (holding that a fund shareholder has a private right of action under section 36(a) of the Investment Company Act against the independent directors of a fund for breach of fiduciary duty involving personal misconduct). See also

have any employees that are truly their own, but rather are generally formed and managed by a separately owned and operated sponsor, commonly an investment adviser.²⁶ This external management structure of most funds may at times create conflicts of interest for investment advisers with clients that are funds. When it enacted the Investment Company Act, Congress recognized the potential for abuse created by the unique structure of funds.²⁷ To protect fund shareholders, the Act requires that each registered fund be governed by a board of directors with the authority to supervise the fund's operations.²⁸ The Act further requires that at least 40 percent of a fund's board be independent in order to serve as "independent watchdogs" in monitoring the fund's managing organization.²⁹ A fund board has the responsibility, among other duties, to monitor the conflicts of interest facing the fund's investment adviser and determine how the conflicts should be managed to help ensure that the fund is being operated in the best interest of the fund's shareholders.³⁰

Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management 251 (May 1992) ("Protecting Investors").

²⁶ See Protecting Investors 251 n.3.

²⁷ See Investment Company Act section 1(b)(2) [15 U.S.C. 80a-1(b)(2)]; U.S. SEC. AND EXCH. COMM'N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC NO. 76-279, Part III (1939). See also Joseph F. Krupsky, The Role of Investment Company Directors, 32 BUS. LAW. 1733, 1737-40 (1977); William J. Nutt, A Study of Mutual Fund Independent Directors, 120 U. PA. L. REV. 179, 181 (1971).

²⁸ See S. REP. NO. 91-184, at 4902-03 (1969) ("The directors of a mutual fund, like directors of any other corporation will continue to have ... overall fiduciary duties as directors for the supervision of all of the affairs of the fund.").

²⁹ 15 U.S.C. 80a-10(a). See also Burks v. Lasker, 441 U.S. 471, 484-485 (1979) ("Congress' purpose in structuring the Act as it did is clear... it 'was designed to place the unaffiliated directors in the role of 'independent watchdogs.'") (quoting Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977)).

³⁰ See Tannenbaum, 552 F.2d at 406 (noting that the independent director requirements under the Investment Company Act, in particular, were designed to ensure that "mutual funds would operate in the interest of all classes of [funds'] securities holders, rather than for the benefit of investment advisers, directors or other special groups.").

III. BOARD OVERSIGHT OF INVESTMENT ADVISER TRADING PRACTICES

In overseeing the use of fund assets and in monitoring the conflicts of interest faced by a fund's investment adviser, a fund board must consider the investment adviser's practices when it trades the fund's portfolio securities.³¹ A fund's investment adviser is a fiduciary with respect to the fund and therefore must act in the fund's best interest.³² Lower transaction costs generally are in the mutual interest of a fund's adviser and the fund's investors, and advisers typically seek to minimize transaction costs when trading fund securities so as not to detract from the fund's performance. At times, however, there may be incentives for an investment adviser to compromise its fiduciary obligations to the fund in its trading activities in order to obtain certain benefits that serve its own interests or the interests of other clients. These conflicts of interest may exist, for

³¹ See 2006 Release at n.6 (citing Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act, Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 FR 16012 (Mar. 10, 1981)] ("The directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices.")). See also Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Release"), at Section II.A.2.b (requiring that a fund's board approve the policies and procedures of the fund's service providers, including its investment adviser; the approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal securities laws by the fund's service providers). We have stated that we expect that the adviser's compliance policies and procedures will address, to the extent that they are relevant, the adviser's trading practices. See Compliance Release at II.A.1.

³² Investment advisers are fiduciaries and have an obligation under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act") and state law to act in the best interest of their clients. See RESTATEMENT (SECOND) OF TRUSTS § 170(1) (2008) ("The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary"); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship . . .'" (quoting 2 LOSS, SECURITIES REGULATION 1412 (2d ed. 1961))); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (noting that the legislative history of the Advisers Act "leaves no doubt that Congress intended to impose enforceable fiduciary obligations" on investment advisers).

example, when an adviser executes trades through an affiliate, when it determines the allocation of trades among its clients, and when it trades securities between clients. In addition, the use of fund brokerage commissions to pay for research and brokerage services may give incentives for advisers to disregard their best execution obligations when directing orders to obtain brokerage commission services. It also may give incentives for advisers to trade the fund's securities in order to earn credits for fund brokerage commission services. In accordance with its fiduciary obligations and provisions of the Advisers Act, an adviser must make full and fair disclosure of these conflicts to a client and disclose how the adviser will manage each conflict before the adviser may engage in conduct that constitutes a conflict.³³

The fund's board, in providing its consent on the fund's behalf, should be sufficiently familiar with the adviser's trading practices to satisfy itself that the adviser is fulfilling its fiduciary obligations and is acting in the best interest of the fund. In some cases where the Commission has adopted exemptive rules that permit funds to engage in transactions otherwise prohibited by the Investment Company Act, the Commission has imposed conditions designed to address certain conflicts of interest faced by advisers by mandating that directors take particular action in evaluating those conflicts.³⁴ In other

³³ See Capital Gains, 375 U.S. at 191, 196-197 ("The Investment Advisers Act of 1940 reflects . . . a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which was not disinterested.").

³⁴ See, e.g., Investment Company Act rule 10f-3(c)(10) [17 CFR 270.10f-3(c)(10)] (fund boards must adopt procedures for purchases by the fund of securities from an affiliated underwriter and assess compliance on a quarterly basis); Investment Company Act rule 17a-7(e) [17 CFR 270.17a-7(e)] (fund boards must adopt procedures for purchases from and sales to affiliated funds and assess compliance on a quarterly basis); Investment Company Act rule 17a-8(a) [17 CFR 270.17a-8(a)] (fund boards must make certain determinations in evaluating mergers with affiliated funds); and Investment Company

cases, the Commission has determined that the conflicts relating to a particular practice are unmanageable and has therefore prohibited advisers' activities in that area altogether.³⁵

Two specific areas where conflicts may arise when an adviser trades a fund's portfolio securities concern the adviser's obligation to seek best execution and to otherwise use fund assets, including brokerage commissions, in the best interest of the fund. The following sections provide guidance on the types of information a fund board should seek in order to evaluate whether the adviser to its fund has fulfilled its obligations to the fund with respect to these concerns.

A. Board Oversight of an Investment Adviser's Duty to Seek Best Execution and Consideration of Transaction Costs

As a fiduciary to a client that is a fund, an investment adviser has the duty to seek best execution of securities transactions it conducts on the fund's behalf.³⁶ As we have stated previously, in seeking best execution, an investment adviser must seek to "execute securities transactions for clients in such a manner that the client's total cost or proceeds

Act rule 17e-1(b) [17 CFR 270.17e-1(b)] (fund boards must adopt procedures for brokerage transactions with affiliates and assess compliance on a quarterly basis).

³⁵ See, e.g., Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sep. 2, 2004) [69 FR 54728 (Sep. 9, 2004)], at Section VII.E (explaining that the Commission's adoption in 2004 of Investment Company Act rule 12b-1(h) [17 CFR 270.12b-1(h)], which, among other things, prohibits a fund from using brokerage commissions to pay for the distribution of the fund's shares, was based on a conclusion that the practice of trading brokerage business for sales of fund shares poses conflicts of interest that the Commission believed to be "largely unmanageable").

³⁶ See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004, 16011 (Apr. 30, 1986)] ("1986 Release"), at Section V (explaining that an investment adviser has the obligation to seek "best execution" of a client's transaction); Delaware Management Company, Inc., 43 S.E.C. 392 (1967); Arleen W. Hughes, 27 S.E.C. 629 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

in each transaction is the most favorable under the circumstances.”³⁷ In this regard, in seeking to maintain best execution on behalf of a client that is a fund, an adviser should consider factors beyond simply commission rates or spreads,³⁸ including “the full range and quality of a broker’s services in placing brokerage. . . .”³⁹ These might include, among other things, the value of research provided, execution capability, financial responsibility, and responsiveness to the adviser.⁴⁰

When trading portfolio securities of a client that is a fund, an adviser should consider factors related to minimizing the overall transaction costs incurred by the fund.⁴¹ Transaction costs consist of explicit costs that can be measured directly, such as brokerage commissions, fees paid to exchanges, and taxes paid, as well as implicit costs that are more difficult to quantify. Implicit costs, which may include, among other things, bid/ask spreads, the price impact of placing an order for trading in a security, and missed trade opportunity cost, may exceed greatly a transaction’s explicit costs.⁴² Price impact and opportunity cost can be influenced by a variety of factors – each of which

³⁷ 1986 Release at Section V.

³⁸ A fund may incur spread costs rather than commissions when a dealer trades with it on a principal basis. Spread costs are incurred indirectly when a fund either buys a security from a dealer at the “asked” price or higher or sells a security to a dealer at the “bid” price or lower. The difference between the bid price and the asked price is known as the “spread.” Spread costs include both an imputed commission on the trade as well as any market impact cost associated with the trade. Dealer spreads compensate broker-dealers for, among other things, maintaining a market’s trading infrastructure (i.e., price discovery and execution services), the broker-dealer’s cost of capital, and its assumption of market risk. Spreads may also reflect the impact of large orders on the price of a security. The proportion of these two components varies among different trades. Concept Release at Section II.A.2.

³⁹ 1986 Release at Section V.

⁴⁰ Id.

⁴¹ See id.

⁴² For a more detailed discussion of explicit and implicit transaction costs, see Concept Release at Section II.A.

should be considered by an investment adviser – such as the anonymity of the parties to the trade, the willingness of the intermediary to commit capital to facilitate the trade, and the speed and price of the execution. Investment advisers also can take into account the quality and utility of any research provided by the broker-dealer.⁴³

An aspect of an adviser's best execution process that directors should also consider is the adviser's decision whether to use an alternative trading system. Newer trading venues, such as "dark pools,"⁴⁴ and the use of advanced mathematical models or algorithmic trading systems, crossing networks, and other alternative trading systems, are increasingly prevalent.⁴⁵ Although the use of such trading venues may provide funds

⁴³ See 1986 Release at Section V ("A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided. . ."). For further discussion regarding evaluation of broker-dealer research services, see *infra* Section III.D.

⁴⁴ For purposes of this release, our references to the term "dark pools" refer to markets that do not display quotes, but rather execute trades internally without displaying liquidity to other participants. A number of markets combine non-displayed liquidity with display of quotes. A substantial portion of the trading volume of these markets may result from interaction of orders with their non-displayed liquidity. See, e.g., Elizabeth Cripps, Shedding Light on the Dark Liquidity Pools, FTMANDATE, May 2007, available at www.ftmandate.com/news/printpage.php/aid/1442/Shedding_light_on_the_dark_liquidity_pools.html.

⁴⁵ One recent report noted that although dark pools currently make up seven to ten percent of equities' share volume in the U.S., that percentage is steadily increasing. CELENT, LLC, DARK LIQUIDITY POOLS IN EUROPE, CANADA, AND JAPAN: A US PHENOMENON GOES ABROAD (2007). See also David Bogoslaw, Big Traders Dive Into Dark Pools, BUSINESS WEEK, Oct. 3, 2007, available at www.businessweek.com/investor/content/oct2007/pi2007102_394204.htm (noting that the Aite Group predicted in September 2007 that exchanges' market share of U.S. equity trading would continue to decline from the current 75 percent, before stabilizing at around 62 percent by 2011, with alternative trading systems, including dark pools, intensifying fragmentation of the marketplace).

certain benefits (such as potentially lower execution costs),⁴⁶ they can also raise challenges to funds in certain situations.⁴⁷

We ask for comment on how changes in the brokerage industry should affect a fund board's oversight of the trading practices of the fund's adviser. Is our discussion of the brokerage industry (as relevant to funds and their advisers) accurate? Are there other considerations with respect to the brokerage industry we should take into account?

We understand that investment advisers with clients that are funds employ a wide range of procedures when selecting broker-dealers for fund securities transactions.⁴⁸ In consideration of the wide variety of advisers in terms of size and operations, each adviser should determine what trading intermediary selection process is most appropriate for its circumstances.⁴⁹ However, as the Commission has stated previously, in its process for choosing trading intermediaries, an adviser should periodically and systematically evaluate the performance of broker-dealers handling its transactions.⁵⁰ In addition, the Commission has stated that an investment adviser should address its best execution

⁴⁶ Execution costs may be lower on alternative trading systems. See, e.g., Jennifer Conrad, Kevin Johnson & Sunil Wahal, *Institutional Trading and Alternative Trading Systems*, 70 J. OF FIN. ECON. 99 (2003).

⁴⁷ For example, we understand that an adviser managing a fund that invests in companies with smaller capitalizations and more illiquid securities may need an executing broker-dealer to have experience and access to a particular market or one with expertise in a certain geographical area or industry. Advisers to these types of funds have indicated that they must rely on a relatively large number of brokers – especially where markets in niche securities have not developed on newer trading venues – to provide the execution and research they need with respect to a particular asset class.

⁴⁸ See infra note 77 and accompanying text (discussing the “broker vote” process employed by many advisers to evaluate broker-dealers’ brokerage and research services).

⁴⁹ See Compliance Release at Section I.A.1 (explaining that, in mandating investment adviser compliance policies and procedures, we elected not to impose a single set of universally applicable required elements because advisers are too varied in their operations).

⁵⁰ See 1986 Release at Section V.

obligations in the compliance policies and procedures that advisers are required to adopt and implement under rule 206(4)-7 under the Advisers Act.⁵¹ Rule 38a-1 under the Investment Company Act requires that the policies and procedures of a fund adviser be approved by the fund board based on the board's finding that the policies and procedures are reasonably designed to prevent the adviser's violation of the Federal securities laws.⁵²

Fund directors should seek relevant data from the fund's investment adviser to assist them in evaluating the adviser's procedures regarding its best execution obligations. These data should typically include, but not be limited to: (i) the identification of broker-dealers to which the adviser has allocated fund trading and brokerage; (ii) the commission rates or spreads paid; (iii) the total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period; and (iv) the fund's portfolio turnover rates. Fund boards may also discuss related matters with the adviser, which may include the following, where applicable:

- The process for making trading decisions and the factors involved in the selection of execution venues and the selection of broker-dealers;

⁵¹ See Compliance Release at Section II.A.1. Rule 206(4)-7 under the Advisers Act [17 CFR 275.206(4)-7] requires an investment adviser to have written compliance policies and procedures in place that are reasonably designed to prevent it from violating the Advisers Act and rules the Commission has adopted under the Act. The rule does not enumerate specific elements that an adviser must include in its policies and procedures. However, the Commission has stated that it expects an adviser, in designing its policies and procedures, to identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular obligations, and then design policies and procedures that address those risks. See *id.*

⁵² 17 CFR 270.38a-1. See also Compliance Release at Section II.A.2.

- The means by which the investment adviser determines best execution and evaluates execution quality as well as how best execution is affected by the use of alternative trading systems;
- Who negotiates commission rates, how that negotiation is carried out, whether the amount of commissions agreed to depends on comparative data with respect to commission rates, and generally how transactions costs are measured;⁵³
- How the quality of “execution-only” trades – trades that do not include payment for any additional research or services beyond execution – is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);
- How the performance of the adviser’s traders is evaluated, as well as the aggregate performance of the firm’s traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser’s activities, including the trading intermediary selection process;⁵⁴

⁵³ Although we are not suggesting that firms need to do so, we understand that some firms have employed third-party vendors to assist them in measuring best execution through a transaction cost analysis using comparative data from across the industry. We also have been informed that not all companies use the same methodology to measure trading costs and that there are no commonly accepted standards as to how to measure price impact.

- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;
- The process for trading fixed-income securities and determining the costs of fixed income transactions;
- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and
- If there are international trading activities, how these trades are conducted and monitored.

We acknowledge that not all funds would require an evaluation of each of these factors by their boards. Different factors may be appropriate for different funds, depending on a fund's investment objective, trading practices, and personnel.

We also request comment regarding how boards should approach their obligations to oversee and evaluate the fund adviser's trading practices and procedures. Is there further information fund boards should request that the adviser provide to assist directors in their review?

Once the board receives from the adviser information with respect to the issues outlined above, fund directors should determine whether the adviser's trading practices are being conducted in the best interests of the fund and the fund's shareholders. If these interests are not being best served, the board should direct the adviser accordingly.

In addition, when an investment adviser seeks the fund board's approval of the adviser's compliance policies and procedures, directors should satisfy themselves that the

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Because sub-advisory arrangements take various forms, directors should have an understanding of the structure of these arrangements and whether the adviser is appropriately overseeing the trading activities of the sub-advisers.

adviser's policies and procedures are reasonably designed, adequate, and being effectively implemented to prevent violations of the Federal securities laws.⁵⁵ Directors may evaluate the adviser's compliance policies and procedures through updates from different sources, which may include the fund's or the adviser's CCO or other appropriate sources.⁵⁶

Furthermore, with the rapid development of increased options for trading venues, fund boards need to remain up to date in their familiarity with the evolving market in this area. We understand that fund directors approach educating themselves on industry developments in various ways.⁵⁷

B. Board Oversight of an Investment Adviser's Use of Fund Brokerage Commissions

When trading portfolio securities on behalf of clients that are funds, there are a number of ways in which an investment adviser may use a portion of fund brokerage

⁵⁵ 17 CFR 270.38a-1(a)(2)-(3) (requiring that each fund "[o]btain the approval of the fund's board of directors . . . of the fund's policies and procedures and those of each investment adviser . . . which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser. . ." and that each fund "review, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser . . ."). See also Compliance Release at Section II.A.2. & II.B.2.

⁵⁶ 17 CFR 270.38a-1(a)(4)(iii) (requiring that the fund designate a CCO who must, "no less than annually, provide a written report to the board that, at a minimum, addresses," among other things, "[t]he operation of the policies and procedures of the fund and each investment adviser. . ."). See also Compliance Release at Section II.C.2.

⁵⁷ Some ways we have observed that directors educate themselves on developments in this area include: (i) establishing a committee of the board to specialize in portfolio trading practices; (ii) requiring that the adviser form special committees to consider best execution and the use of client commissions and to provide reports to the board on the adviser's trading activities; (iii) requesting periodic summaries and analyses from officers of the adviser to explain the adviser's portfolio trading practices; (iv) attending trade association events, seminars and/or other education events relating to brokerage practices; (v) subscribing to third-party information providers or retaining experts to ensure that board members remain knowledgeable with respect to market developments; and (vi) periodically meeting with portfolio managers, business unit staff, trading personnel and other employees of the adviser.

commissions to benefit the fund beyond execution of the securities transaction. First, a fund adviser may use a portion of fund brokerage commissions to purchase research and/or research-related services in accordance with section 28(e) of the Exchange Act. The research may be “proprietary” research, produced by the broker-dealer executing the securities transaction or its affiliates,⁵⁸ or it may be “third-party research,” produced or provided by someone other than the executing broker-dealer.⁵⁹ Investment advisers also may purchase third-party research themselves using cash payments from their own account, or “hard dollars.” Furthermore, investment advisers may obtain proprietary and third-party research through a “client commission arrangement.” In a client commission arrangement, an investment adviser agrees with a broker-dealer effecting trades for the adviser’s client accounts that a portion of the commissions paid by the accounts will be credited to purchase research either from the executing broker or another broker, as directed by the adviser.⁶⁰

In addition to obtaining research and research-related services with fund brokerage commissions,⁶¹ an adviser may use fund brokerage commissions in other ways. For example, an adviser may utilize a commission recapture arrangement, whereby the

⁵⁸ See THOMAS P. LEMKE & GERALD T. LINS, *SOFT DOLLARS AND OTHER BROKERAGE ARRANGEMENTS* § 1.04[A] (2005). Proprietary research is often provided to an investment adviser partly as a *quid pro quo* for brokerage business given by the adviser to the broker producing the research. Alternatively, proprietary research may be provided without being expressly requested and considered part of the services obtained in exchange for “full service,” or “bundled,” commissions that include a sufficient amount of compensation to cover the cost of research. *Id.*

⁵⁹ See *id.*

⁶⁰ See 2006 Release at Section III (interpreting section 28(e) to permit the industry flexibility to structure arrangements that are consistent with the statute and best serve investors).

⁶¹ See *infra* note 70 (explaining that only commission-based trades (as opposed to mark-ups or mark-downs or spreads) are covered under the safe harbor in section 28(e) of the Exchange Act).

fund receives a portion, or rebate, of the brokerage commission (or spread) charged by the broker-dealer handling the trade. Additionally, an investment adviser may use fund brokerage to pay certain providers for services utilized by the fund through an expense reimbursement arrangement with a broker-dealer and/or its affiliates.⁶²

We specifically request comment on our discussion of the various uses of fund brokerage. Have we described the use of fund brokerage commissions and client commissions by advisers correctly? Are fund brokerage commissions used in ways that we have not addressed but should address in this proposed guidance?

Because fund brokerage commissions are fund assets, investment advisers have a conflict of interest when they use commissions to obtain research and related services that they would otherwise have to pay for themselves. Advisers therefore are subject to certain requirements when using fund brokerage in this manner. First, section 17(e)(1) of the Investment Company Act prohibits investment advisers to registered investment companies from using soft dollars to obtain research or services outside the confines of

⁶² In expense reimbursement arrangements, also referred to as “brokerage/service arrangements,” a broker-dealer typically agrees to pay a fund’s service provider fees (such as custodian fees or transfer agency fees) and, in exchange, the fund agrees to direct a minimum amount of brokerage business to the reimbursing broker. The fund adviser usually negotiates the terms of the contract with the service provider, and the fees charged under the contract are paid directly by the broker-dealer. Brokerage/service arrangements may be structurally similar to client commission arrangements. However, unlike client commission arrangements, where the receipt of a benefit by the investment adviser through the use of fund brokerage commissions gives rise to conflicts of interest, brokerage/service arrangements generally do not raise these concerns because they typically involve the use of fund brokerage commissions to obtain services that directly and exclusively benefit the fund. See Payment for Investment Company Services with Brokerage Commissions, Securities Act Release No. 7197 (July 21, 1995) [60 FR 38918 (July 28, 1995)] (“1995 Release”), at nn. 1-2 and accompanying text; see also 2006 Release at Section II.A, n.27.

the safe harbor provided by section 28(e) of the Exchange Act.⁶³ Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets,⁶⁴ although an investment adviser's use of soft dollars creates opportunities for the adviser to benefit in ways that may not be in the best interest of the fund. These conflicts of interest arise in a number of ways when investment advisers use fund assets in soft dollar programs. For example:

- The use of fund brokerage commissions to buy research may relieve an adviser of having to produce the research itself or having to pay for the research with "hard dollars" from its own resources;

⁶³ 15 U.S.C. 80a-17(e)(1). Section 17(e)(1) of the Investment Company Act generally makes it unlawful for any affiliated person of a registered investment company to receive any compensation (other than a regular salary or wages from the company) for the purchase or sale of any property to or for the investment company when that person is acting as an agent other than in the course of that person's business as a broker-dealer. Essentially, section 17(e)(1) may be violated if an affiliated person of a registered investment company, such as an adviser, receives compensation (other than a regular salary or wages from the company) for the purchase or sale of property to or from the investment company. Absent the protection of section 28(e), which provides a safe harbor from liability under other federal and state law, an investment adviser's receipt of compensation – including in the form of brokerage or research services – under a client commission arrangement for the purchase or sale of any property, including securities, for or to the investment company, may constitute a violation of section 17(e)(1). *See* U.S. v. Deutsch, 451 F.2d 98, 110-11 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972). If a fund adviser's client commission arrangement is not consistent with section 28(e), disclosure of the arrangement would not cure any section 17(e)(1) violation. *See* 2006 Release at n.31; 1986 Release at n.55.

⁶⁴ An adviser's obligation to act in the best interest of its client imposes a duty on the adviser not to profit at the expense of the client without the client's consent. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. a, § 216 (1959). Also, section 206 of the Advisers Act establishes federal fiduciary standards governing the conduct of investment advisers. Under sections 206(1) and (2), in particular, an adviser must discharge its duties in the best interest of its clients, and must fully disclose a conflict of interest with a client, before engaging in conduct that constitutes a conflict. *See Transamerica*, 444 U.S. at 17.

- The use of soft dollars may give an adviser an incentive to compromise its fiduciary obligations and to trade the fund's portfolio in order to earn soft dollar credits;
- The availability of soft dollar benefits that an adviser may receive from fund brokerage commissions creates an incentive for an adviser to use broker-dealers on the basis of their research services provided to the adviser rather than the quality of execution provided in connection with fund transactions;
- An adviser may seek to use fund brokerage commissions to obtain research that benefits the adviser's other clients, including clients that do not generate brokerage commissions (such as fixed-income funds), those that are not otherwise paying more than the lowest available commission rate in exchange for soft dollar products or services (i.e., "paying up" in commission costs), or those from which the adviser receives the greatest amount of compensation for its advisory services;
- The use of soft dollars may disguise an adviser's true costs and enable an adviser to charge advisory fees that do not fully reflect the costs for providing the portfolio management services;⁶⁵
- The use of fund brokerage commissions to obtain research and other services may cause an adviser to avoid other uses of fund brokerage commissions that may be in the fund's best interest, such as establishing a commission recapture program

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See infra Section III.E (discussing the obligations of fund advisers and fund boards under section 15(c) of the Investment Company Act).

or fund expense reimbursement arrangement to offset expenses that are paid for with fund assets;⁶⁶ and

- In the case of “mixed-use” products – for example, research products or services obtained using soft dollars that may serve functions that are not related to the investment decision-making process, such as accounting or marketing – an adviser has a conflict when making an allocation determination between the research and non-research uses of the product as required to fulfill the requirements under section 28(e) of the Exchange Act.⁶⁷

When evaluating an adviser’s use of fund brokerage commissions in light of these conflicts, a fund board may determine that such use is in the best interests of the fund.⁶⁸

⁶⁶ Although these types of arrangements do not involve the conflicts posed by soft dollars, they do raise issues related to how a fund’s assets are being expended and other issues, such as disclosure. See Concept Release at Section VI.

⁶⁷ For a discussion of “mixed-use” items, see 1986 Release at Section II.B and 2006 Release at Section III.F. These releases stated, as an example of a product that may have a mixed use, management information services (which may integrate trading, execution, accounting, recordkeeping, and other administrative matters such as measuring the performance of accounts). In the 1986 Release, the Commission indicated that where a product has a mixed use, an investment adviser should make a reasonable allocation of the cost of the product according to its use, and should keep adequate books and records concerning the allocations. The Commission also stated: (i) that the allocation decision itself poses a conflict of interest for the investment adviser that should be disclosed to the client; and (ii) that an investment adviser may use client commissions pursuant to section 28(e) of the Exchange Act to pay for the portion of a service or specific component that assists the adviser in the investment decision-making process, but cannot use soft dollars to pay for that portion of a service that provides the adviser with administrative assistance. 1986 Release at Section II.B. The 2006 Release made clear that “brokerage” products and services, as defined in the release, may also require a mixed-use allocation. 2006 Release at nn.72-73. For a discussion of section 28(e) of the Exchange Act, see infra Section III.C.

⁶⁸ Fund boards are not required to approve brokerage and research services simply because they fall within the section 28(e) safe harbor. Rather, board determinations regarding the purchase of brokerage and research services with fund brokerage commissions should be made in accordance with the fund’s best interest. In this regard, section 28(e) contemplates that funds could enter into contracts to reduce or eliminate an adviser’s ability to rely on the safe harbor. See THOMAS P. LEMKE & GERALD T. LINS, *SOFT DOLLARS AND OTHER BROKERAGE ARRANGEMENTS* § 4.09 (2005) (“[T]he language of

C. Section 28(e) under the Securities Exchange Act of 1934

Section 28(e) of the Exchange Act provides a safe harbor that protects investment advisers from liability for a breach of fiduciary duty solely on the basis that the adviser caused an account over which it exercises investment discretion to pay more than the lowest commission rate in order to receive brokerage and research services provided by a broker-dealer, if the adviser determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.⁶⁹

As we have stated, section 17(e)(1) of the Investment Company Act, prohibits investment advisers to registered investment companies from obtaining brokerage and research services with fund brokerage commissions outside the section 28(e) safe harbor.⁷⁰

The 2006 Release provides guidance with respect to the appropriate framework for analyzing whether a particular service falls within the “brokerage and research

the safe harbor itself recognizes that the parties to an investment management relationship may by contract opt out of Section 28(e).”); see also Section 28(e) of the Exchange Act [15 U.S.C. 78bb(e)(1)] (stating that the safe harbor does not apply where “expressly provided by contract”).

⁶⁹ 15 U.S.C. 78bb(e)(1). When fixed commission rates were abolished in 1975, investment advisers and broker-dealers expressed concern that, if an investment adviser were to cause a client account to pay more than the lowest commission rate available for a particular transaction, then the adviser would be exposed to charges that it had breached its fiduciary duty owed to its client. Congress addressed this concern by enacting section 28(e). See 2006 Release at Section II.A.

⁷⁰ See supra note 63. It should be noted that section 28(e) of the Exchange Act does not encompass trades that are not executed on an agency basis, principal trades (with the exception of certain riskless principal transactions as described below), or other instruments traded net with no explicit commissions. See 2006 Release at n.27. However, the Commission has interpreted the term “commission” in section 28(e) as encompassing fees on certain riskless principal transactions that are reported under the trade reporting rules of the Financial Industry Regulatory Authority, or FINRA (as successor to the National Association of Securities Dealers, or NASD). See Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Release No. 45194 (Dec. 27, 2001) [67 FR 6 (Jan. 2, 2002)], at Section II.

services” safe harbor of section 28(e).⁷¹ A fund board should request that the fund adviser inform directors of the policies and procedures the adviser uses to ensure that the types of brokerage and research services the adviser obtains using fund brokerage commissions fall within the safe harbor and that the adviser has not engaged in excessive trading in light of the fund’s investment objectives. In turn, in approving the policies and procedures, a board should consider whether they are reasonably designed to ensure that the adviser’s use of fund brokerage commissions complies with the section 28(e) safe harbor, as well as all the federal securities laws.⁷²

In addition, as we stated in the 2006 Release, to rely on the section 28(e) safe harbor, an adviser must: (i) determine whether the product or service obtained is eligible research or brokerage under section 28(e); (ii) determine whether the eligible product actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities; and (iii) make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.⁷³ We also reaffirmed an investment adviser’s essential obligation under section 28(e) to make this good faith determination and that the burden in demonstrating this determination rests on the investment adviser.⁷⁴ An adviser should demonstrate to the board that it has met this burden.⁷⁵ We specifically request

⁷¹ See 2006 Release at Section III.

⁷² See supra note 52 and accompanying text (discussing a fund board’s obligation to approve an adviser’s compliance policies and procedures).

⁷³ See 2006 Release at Section III.B.

⁷⁴ See id.

⁷⁵ See 2006 Release at n.150 and accompanying text (citing HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, Securities Reform Act of 1975 (H.R. 4111), H.R. REP. NO. 94-123, at 95 (1975) (“It is, of course, expected that money managers paying brokers an

comment on our proposed guidance in this regard. We also request examples of effective practices fund boards employ when evaluating whether an adviser has made the good faith determination required under section 28(e).

D. An Investment Adviser's General Fiduciary Obligations to Clients that Are Funds When Using Soft Dollars

As we have stated, although a fund adviser may satisfy the requirements for using client commissions to pay for brokerage and research services under the section 28(e) safe harbor, a fund's directors still should evaluate the adviser's use of fund brokerage commissions to purchase research and services in order to determine whether the adviser is acting in the best interest of the fund. If a fund board determines that the adviser's use of brokerage commissions is not in the best interest of the fund, the board should prohibit or limit the use of fund brokerage commissions and direct the adviser accordingly.⁷⁶

In this regard, directors need to understand the procedures that the fund's investment adviser employs to address any potential conflicts of interest and ensure that fund commissions are being used appropriately. For example, to try to address concerns that a broker-dealer may be chosen by an adviser for reasons other than the quality of the broker-dealer's execution (including the brokerage and research services it provides), some advisers, particularly larger ones, may use an internal process referred to as a "broker vote" or "broker tolls," whereby the adviser's investment professionals, typically the portfolio managers and investment analysts, assess the value of the research and

amount [of commissions] which is based upon the quality and reliability of the broker's services including the availability and value of research, would stand ready and be required to demonstrate that such expenditures were bona fide."); see also 1986 Release at Section IV.B.3 (explaining that, among the responsibilities of the disinterested directors of a fund may be to monitor of the adviser's soft dollar arrangements).

⁷⁶

See supra note 68 and accompanying text.

services different broker-dealers provide to determine which broker-dealer's research and other services the adviser should purchase.⁷⁷

To assist the board in understanding the adviser's policies and procedures regarding the use of fund brokerage commissions to obtain brokerage and research services, the board should request that the adviser inform the directors as to such matters as the following:

- How does the adviser determine the total amount of research to be obtained and how will the research actually be obtained? In particular:
 - How does the adviser determine the amount to be spent using hard versus soft dollars?
 - How does the adviser determine amounts to be spent on proprietary versus third-party research arrangements?
 - What types of research products and services will the adviser seek to obtain and how will this research be beneficial to the fund?
 - How does the adviser determine amounts to be used in commission recapture programs and expense reimbursement programs?
- What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program? Is a broker vote process or some other mechanism used?

⁷⁷ Advisers have informed us that, although many employ a broker vote, the actual process of determining which brokers to use varies among firms, as do the factors upon which each firm's voting system is based. Often a system of rating or allocating points is used to set targets for each broker, with the better-rated brokers receiving additional orders. Other firms have substantially less formal broker-selection processes.

- Do any alternative trading venues that are used produce soft dollar credits? If so, how much?
- How does the adviser determine that the use of soft dollars is within the section 28(e) safe harbor? In particular:
 - Is the product or service obtained eligible brokerage or research, as defined under section 28(e)?
 - Does the product or service provide lawful and appropriate assistance to the adviser in carrying out its investment decision-making responsibilities?
 - Is the amount of commissions paid reasonable (based upon a good faith determination) in light of the value of brokerage and research services provided by the broker-dealer?
- How does soft dollar usage compare to the adviser's total commission budget?
- How are soft dollar products and services allocated among the adviser's clients? Are the commissions paid for certain trades in fund portfolio securities similar to commissions paid for transactions in similar securities, or of similar sizes, by the fund and the adviser's other clients (including clients that are not funds)? Are other clients paying lower commissions that do not include a soft dollar component? If so, does the adviser adequately explain the discrepancy in commission rates and provide the board data sufficient to satisfy the board that the fund is not subsidizing the research needs of the adviser's other client? To what extent are the products and services purchased through soft dollar arrangements used for the benefit of fixed-income or other funds that generally do not pay brokerage commissions?

- What is the process for assessing the value of the products or services purchased with soft dollars?
- What is the process used to evaluate the portion of a mixed use product or service that can be paid for under section 28(e)?⁷⁸
- To what extent does the adviser use client commission arrangements? What effect do these arrangements have on how the adviser selects a broker-dealer to complete a particular transaction? How does the adviser explain that the use of client commission arrangements benefits the fund?⁷⁹

We request comment on the information boards should receive to facilitate their review of an adviser's use of soft dollars.⁸⁰ Should boards request any further information from advisers in this regard? Should boards employ any specific alternative approaches or analyses when reviewing an adviser's soft dollar usage? Is further

⁷⁸ As we stated in the 2006 Release, in allocating costs for a particular product or service, a money manager should make a good faith, fact-based analysis of how it and its employees use the product or service. It may be reasonable for an investment adviser to infer relative costs from relative benefits to the firm or its clients. Relevant factors might include, for example, the amount of time the product or service is used for eligible purposes versus non-eligible purposes, the relative utility (measured by objective metrics) to the firm of the eligible versus non-eligible uses, and the extent to which the product is redundant with other products employed by the firm for the same purpose. See 2006 Release at Section III.F, n.148.

⁷⁹ We believe that the availability of electronic methods to order, track, and analyze securities trading may make it easier to determine whether client commission arrangements benefit a fund. With electronic trading, advisers and fund boards may be able to determine the costs associated with trade execution, as well as the expense of research paid for with fund brokerage commissions, with greater certainty. Also, to the extent that they incorporate transparency mechanisms such as the invoicing of costs for particular research products and services, the use of certain client commission arrangements may enable fund boards to more clearly determine the actual amount of commission dollars used to pay for research and those used to pay for execution.

⁸⁰ The staff has outlined some of the specific information fund boards have reviewed with respect to soft dollar arrangements. See Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Office of Compliance, Inspections and Examinations (Sept. 1998), available at <http://www.sec.gov/news/studies/softdollar.htm> ("1998 Staff Report"), at Appendix G.

guidance needed with respect to how a board should approach reviewing an adviser's soft dollar usage?

As with the adviser's trading practices, after receiving appropriate input and information from the adviser, if the board believes that the fund's brokerage commissions could be used differently so as to provide greater benefits to the fund, the board should direct the adviser accordingly. For example, the adviser should explain to the board that the value the fund receives from the brokerage and research services purchased with fund brokerage commissions is appropriate, and whether the services are inappropriately benefiting another of the adviser's clients at the fund's expense. In directing the adviser, the board also should consider such matters as: (i) whether it is appropriate for the adviser to refrain from purchasing research services in connection with certain types of trades, depending on market conditions; (ii) whether it is appropriate for the adviser to use fund brokerage commissions to receive brokerage and research services on some or all trades; (iii) whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and (iv) whether some combination of these alternatives may be in the best interest of the fund.

In addition, fund boards should inquire as to how the adviser's compliance policies and procedures with respect to soft dollars are determined and monitored.⁸¹ In deciding whether to approve these policies and procedures, directors should consider, and the investment adviser should explain, how the policies and procedures eliminate or

⁸¹ The Commission has stated that, in addition to an adviser's general best execution obligations, the compliance policies and procedures advisers are required to adopt and implement under rule 206(4)-7 of the Advisers Act should address the adviser's uses of client brokerage to obtain research and other services. See Compliance Release at Section II.

otherwise mitigate the conflicts of interest that exist when an adviser trades portfolio securities on the fund's behalf.⁸² Furthermore, the value of research obtained through the use of soft dollars is a factor a fund board should consider when determining whether an investment adviser has fulfilled its best execution obligations.⁸³ The conflicts of interest inherent in soft dollar arrangements require boards to pay particular attention to investment advisers' activities in this regard to ensure that fund assets are being used appropriately on behalf of the fund.⁸⁴

We request comment on our proposed guidance in regard to how a fund board should approach its review of an adviser's use of soft dollars and the adviser's applicable policies and procedures to ensure that the conflicts of interest inherent in these transactions are being managed.

E. Section 15(c) under the Investment Company Act

In addition to their oversight and monitoring responsibilities with respect to portfolio trading and the conflicts of interest associated with soft dollar programs, fund directors have an obligation to review the adviser's compensation. This requirement stems from the requirement in section 15(c) of the Investment Company Act that the independent members of the board review the fund's investment advisory contract on an

⁸² In this regard, fund boards may look to, among other sources, the fund's CCO to provide assistance with evaluating any potential conflicts of interest with respect to the adviser's brokerage practices and determining how those conflicts should be addressed. See Compliance Release at Section II.A.2.b.

⁸³ See 1986 Release at Section V. An adviser should consider the full range and quality of the broker's services, including the value of research provided, in assessing whether a broker will provide best execution.

⁸⁴ As suggested above, failure by an investment adviser to disclose material conflicts of interest to its clients may constitute fraud within the meaning of sections 206(1) and (2) of the Advisers Act. See supra note 64. See also *Capital Gains*, 375 U.S. at 191-193, 200-01 (noting that "suppression of information material to an evaluation of the disinterestedness of an investment adviser" may operate "as a deceit on purchasers.").

annual basis.⁸⁵ A fund board's review of the adviser's compensation under section 15(c) should incorporate consideration of soft dollar benefits that the adviser receives from fund brokerage.⁸⁶ In considering the advisory contract for approval, fund boards are required under section 15(c) to request and evaluate such information as may reasonably be necessary to evaluate the terms of the contract, and the adviser to the fund has the obligation to furnish to the board the information necessary to review the contract.⁸⁷

Although fund boards typically review the use of fund brokerage by the adviser (including the adviser's use of soft dollars) during the contract review process, Commission examinations show wide variations in board practices in this area.⁸⁸ In many cases, fund boards are provided with Part II of the adviser's Form ADV. While

⁸⁵ 15 U.S.C. 80a-15(c). Section 15(c) makes it unlawful for an investment company to enter into or renew an investment advisory contract unless it is approved by a majority of the company's disinterested directors.

⁸⁶ See 2006 Release; 1986 Release. In connection with the board's section 15(c) review of the advisory contract, section 36(b) of the Investment Company Act imposes a fiduciary duty on fund advisers with respect to their receipt of compensation for services or payments of a material nature from the fund or its shareholders. 15 U.S.C. 80a-36(b). In determining whether an adviser has breached its obligations under section 36(b), the seminal case of Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982), suggests that all of the facts and circumstances surrounding the adviser's relationship with the fund are appropriate for director consideration in approving the advisory contract. To the extent an adviser receives benefits from the use of soft dollars that are of "sufficient substance," these benefits should be disclosed and considered by the fund's board of directors. Id. at 932-933 (stating that "estimates of... 'fall-out' and 'float benefits' which, while not precise, could be a factor of sufficient substance to give the Funds' trustees a sound basis for negotiating a lower Manager's fee.").

⁸⁷ Section 15(a)(1) of the Investment Company Act, which makes it unlawful for any person to serve as an investment adviser of a registered investment company except pursuant to a written contract which has been approved by a majority vote of shareholders and which "precisely describes all compensation" to be paid under that contract, also should be considered with regard to soft dollar arrangements. 15 U.S.C. 80a-15(a)(1). See 1986 Release at n.40.

⁸⁸ See 1998 Staff Report at 36. Examinations conducted since the 1998 Staff Report continue to document wide variations in the fund board review process. For example, our inspection staff has observed that, in certain cases, a fund board has not obtained the information necessary to evaluate soft dollar arrangements in the context of the board's section 15(c) review.

Form ADV provides important information regarding the investment adviser, the Form ADV disclosure requirement was not designed for the purpose of providing fund directors with all of the information needed to help them satisfy board obligations under section 15(c) of the Investment Company Act. In order to fulfill their obligations in connection with the section 15(c) review process, fund boards often seek additional information on soft dollars. However, the types of additional information a board may require may vary depending on factors such as: (i) the scope and nature of the soft dollar program; (ii) the level of clarity and utility of the materials provided; (iii) the board's confidence in the adviser's relevant policies and procedures; and (iv) the adviser's compliance record. For example, information directors seek may range from simple reports on the cost of third-party soft dollar services to detailed reports on all fund portfolio securities transactions, including transaction volumes, soft dollar credits, services provided, and broker reviews.

To assist fund boards in carrying out their responsibilities under section 15(c), we believe it is appropriate for fund boards to request certain information regarding the adviser's use of fund brokerage, including soft dollar arrangements. Specifically, fund directors should require investment advisers, at a minimum, to provide them with information regarding the adviser's brokerage policies, and how a fund's brokerage commissions, and, in particular, the adviser's use of soft dollar commissions, were allocated, at least on an annual basis. Fund directors, in turn, should consider this information when they evaluate the terms of the advisory contract for the fund. Fund directors should, for example, consider whether the adviser properly accounts for use of fund brokerage commissions to purchase research that primarily or solely benefits

another client of the adviser. We specifically ask for comment on the information that boards should request and that the adviser should provide in connection with the board's review of the advisory contract under section 15(c).

IV. DISCLOSURE TO OTHER ADVISORY CLIENTS AND FUND INVESTORS

Our proposed guidance is designed to provide fund directors with information that will help them fulfill their oversight obligations with respect to the trading practices of the fund's investment adviser, including the adviser's use of soft dollars. The fact that the guidance is focused on fund boards should not be interpreted as an indication that the current level of soft dollar disclosure that is provided to other advisory clients and fund investors cannot be improved.⁸⁹ Accordingly, we solicit comment on whether we should propose additional disclosure requirements.

Currently, Part II of Form ADV, the adviser's firm brochure, must address the adviser's soft dollar practices. However, a 1998 report from our Office of Compliance Inspections and Examinations ("OCIE") observed that advisers' disclosure often failed to provide sufficient information for clients or prospective clients to understand the advisers' soft dollar practices and the conflicts those practices present.⁹⁰ In its report, OCIE stated that most advisers' descriptions of soft dollar practices were boilerplate, and

⁸⁹ We have considered enhancing soft dollar disclosure requirements in the past. For example, the Commission proposed a rule in 1995 that would have required an adviser to provide its clients with an annual report setting forth certain information about the adviser's use of client brokerage and the soft dollar services received by the adviser. The report would have included certain quantitative information about brokerage allocation and commissions paid. See Disclosure by Investment Advisers Regarding Soft Dollar Practices, Investment Advisers Act Release No. 1469 (Feb. 14, 1995) [60 FR 9750 (Feb. 21, 1995)].

⁹⁰ See 1998 Staff Report.

urged that we consider amending Form ADV to require better disclosure.⁹¹ We sought to address this concern in our proposed amendments to Part 2 of Form ADV.⁹² As currently proposed, Form ADV would require advisers to discuss the conflicts of interest inherent in an adviser's soft dollar practices and to describe the products and services acquired with soft dollars with enough specificity to permit clients to evaluate the conflicts of interest involved.⁹³

The guidance we are proposing today reflects the Commission's view of the critical role fund boards play in managing the adviser's conflicts of interest. We request general comment on our proposed guidance. In addition, we specifically request comment on whether: (i) further disclosure to fund investors of the information we suggest fund boards should consider would be helpful; (ii) any specific disclosure should be mandated to better assist investors in making informed investment decisions; and (iii) the public dissemination of particular information regarding a fund adviser's portfolio trading practices would have an adverse impact on the fund adviser's relationships with the broker-dealers that execute fund portfolio transactions.

⁹¹ Id.

⁹² See Amendments to Form ADV, Investment Advisers Act Release No. 2711 (March 3, 2008) [73 FR 13958 (March 14, 2008)]. As proposed, Item 12 of Part 2 would require an adviser that receives soft dollar products and services to disclose its practices and to discuss the conflicts of interest they create. Specifically, Part 2 would require an adviser to disclose to clients: (i) that it receives a benefit because it does not have to produce or pay for the products and services; (ii) that it has an incentive to select broker-dealers based on its interests instead of clients' interests in receiving best execution; (iii) whether or not it pays-up for soft dollar benefits; (iv) whether soft dollar benefits are used to service all of its accounts or just the accounts that paid for the benefits; and (v) the products and services it receives, describing them with enough specificity for clients to understand and evaluate possible conflicts of interest.

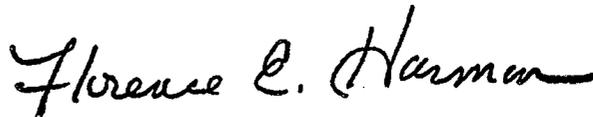
⁹³ Id.

We also request comment on whether we should again consider proposing to require investment advisers to provide their clients with customized information about how their individual brokerage is being used. If so, what types of information would be useful and in what detail? Should the information provided be different for institutional and non-institutional clients? Do institutional clients already require their advisers to provide information to them about soft dollars on a regular basis, and if so, what kind of information do they receive? What are the cost implications of requiring individual client reports?

V. SOLICITATION OF ADDITIONAL COMMENTS

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to fund board oversight of advisers' portfolio trading practices. Please be as specific as possible in your discussion and analysis of any additional issues.

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 30, 2008

*Commissioner Walter -
not participating*

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-58255; File No. S7-21-08]

RIN - 3235-AK20

Proposed Amendment to Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is publishing for comment proposed amendments to a rule under the Securities Exchange Act of 1934 ("Exchange Act") relating to municipal securities disclosure. The proposal would amend certain requirements regarding the information that the broker, dealer, or municipal securities dealer acting as an underwriter in a primary offering of municipal securities must reasonably determine that an issuer of municipal securities or an obligated person has undertaken, in a written agreement or contract for the benefit of holders of the issuer's municipal securities, to provide. Specifically, the amendments would require the broker, dealer, or municipal securities dealer to reasonably determine that the issuer or obligated person has agreed: (1) to provide the information covered by the written agreement to the Municipal Securities Rulemaking Board ("MSRB" or "Board"), instead of to multiple nationally recognized municipal securities information repositories ("NRMSIRs") and state information depositories ("SIDs"), as the rule currently provides, and (2) to provide such information in an electronic format and accompanied by identifying information as prescribed by the MSRB.

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DATES: Comments should be received on or before [insert date 45 days after date of publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-21-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File No. S7-21-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, 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: Martha Mahan Haines, Assistant Director and Chief, Office of Municipal Securities, at (202) 551-5681; Mary N. Simpkins, Senior Special Counsel, Office of Municipal Securities, at (202) 551-5683; Cyndi N. Rodriguez, Special Counsel, Office of Market Supervision, at (202) 551-5636; or Rahman J. Harrison, Special Counsel, Office of Market Supervision, at (202) 551-5663, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on a proposed amendment to Rule 15c2-12 under the Exchange Act.¹

I. Background

A. History of Rule 15c2-12

The Commission has long been concerned with improving the quality, timing, and dissemination of disclosure in the municipal securities markets. In an effort to improve the transparency of the municipal securities market, in 1989, the Commission adopted Rule 15c2-12² (“Rule” or “Rule 15c2-12”) and an accompanying interpretation modifying a previously published interpretation of the legal obligations of underwriters of municipal securities.³ As adopted in 1989, Rule 15c2-12 required, and still requires, underwriters participating in primary offerings of municipal securities of \$1,000,000 or more to obtain, review, and distribute to potential customers copies of the issuer’s official statement. Specifically, Rule 15c2-12 required, and still requires, an underwriter acting in a primary offering of municipal securities: (1) to obtain and review an official statement “deemed final” by an issuer of the securities, except for

¹ 17 CFR 240.15c2-12.

² 17 CFR 240.15c2-12.

³ See Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (July 10, 1989) (“1989 Adopting Release”).

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

While the availability of primary offering disclosure significantly improved following the adoption of Rule 15c2-12, there was a continuing concern about the adequacy of disclosure in the secondary market.⁴ To enhance the quality, timing, and dissemination of disclosure in the secondary municipal securities market, the Commission in 1994 adopted amendments to Rule 15c2-12.⁵ Among other things, the 1994 Amendments placed certain requirements on brokers,

⁴ In 1993, the Commission's Division of Market Regulation (n/k/a the Division of Trading and Markets) conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure ("1993 Staff Report"). Findings in the 1993 Staff Report highlighted the need for improved disclosure practices in both the primary and secondary municipal securities markets. The 1993 Staff Report found that investors need sufficient current information about issuers and significant obligors to better protect themselves from fraud and manipulation, to better evaluate offering prices, to decide which municipal securities to buy, and to decide when to sell. Moreover, the 1993 Staff Report found that the growing participation of individuals as both direct and indirect purchasers of municipal securities underscored the need for sound recommendations by brokers, dealers, and municipal securities dealers. See Securities and Exchange Commission, Division of Market Regulation (n/k/a Division of Trading and Markets), Staff Report on the Municipal Securities Market (September 1993) (available at <http://www.sec.gov/info/municipal.shtml>).

⁵ See Securities Exchange Act Release No. 34961 (November 10, 1994), 59 FR 59590 (November 17, 1994) ("1994 Amendments").

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

dealers, and municipal securities dealers (“Dealers” or, when used in connection with primary offerings, “Participating Underwriters”). In adopting the 1994 Amendments, the Commission intended “to deter fraud and manipulation in the municipal securities market” by prohibiting the underwriting and subsequent recommendation of transactions in municipal securities for which adequate information was not available on an ongoing basis.⁶

Specifically, under the 1994 Amendments, Participating Underwriters are prohibited, subject to certain exemptions, from purchasing or selling municipal securities covered by the Rule in a primary offering, unless the Participating Underwriter has reasonably determined that an issuer of municipal securities or an obligated person⁷ has undertaken in a written agreement or contract for the benefit of holders of such securities (“continuing disclosure agreement”) to provide specified annual information and event notices to certain information repositories. The information to be provided consists of: (1) certain annual financial and operating information and audited financial statements (“annual filings”);⁸ (2) notices of the occurrence of any of eleven specific events (“material event notices”);⁹ and (3) notices of the failure of an issuer or

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

⁶ See 1994 Amendments, supra note 5.

⁷ Obligated persons include persons, including the issuer, committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities to be sold in an offering. See 17 CFR 240.15c2-12(f)(10).

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

⁹ 17 CFR 240.15c2-12(b)(5)(i)(C). The following events, if material, require notice: (1) principal and interest payment delinquencies; (2) non-payment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of the security; (7) modifications to

other obligated person to make a submission required by a continuing disclosure agreement (“failure to file notices”).¹⁰ The 1994 Amendments require the Participating Underwriter to reasonably determine that an issuer of municipal securities or an obligated person has undertaken in the continuing disclosure agreement to provide: (1) annual filings to each NRMSIR; (2) material event notices and failure to file notices either to each NRMSIR or to the MSRB; and (3) in the case of states that established SIDs, all continuing disclosure documents to the appropriate SID. Finally, the 1994 Amendments revise the definition of “final official statement” to include a description of the issuer’s or obligated person’s continuing disclosure undertakings for the securities being offered, and of any instances in the previous five years in which the issuer or obligated person failed to comply, in all material respects, with undertakings in previous continuing disclosure agreements.

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

Since the adoption of Rule 15c2-12 in 1989 and its subsequent amendment in 1994, the size of the municipal securities market has grown considerably.¹¹ There were over \$2.6 trillion

rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities; and (11) rating changes.

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

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

¹¹ According to statistics assembled by the Securities Industry and Financial Markets Association (SIFMA), the amount of outstanding municipal securities grew from \$1.2616 trillion in 1996 to \$2.617.4 trillion at the end of 2007. See SIFMA “Outstanding U.S. Bond Market Debt” (available at http://www.sifma.org/research/pdf/Overall_Outstanding.pdf).

of municipal securities outstanding at the end of 2007.¹² Notably, at the end of 2007, retail investors held approximately 35% of outstanding municipal securities directly and up to another 36% indirectly through money market funds, mutual funds, and closed end funds.¹³ There is also substantial trading volume in the municipal securities market. According to the MSRB, more than \$6.6 trillion of long and short term municipal securities were traded in 2007 in more than 9-million transactions.¹⁴ Further, the municipal securities market is extremely diverse, with more than 50,000 state and local issuers of these securities.¹⁵

Currently, there are four NRMSIRs¹⁶ and three SIDs.¹⁷ Each of the NRMSIRs utilizes the information obtained from continuing disclosure documents to create proprietary information products that are primarily sold to and used by dealers, institutional investors and other market participants who subscribe to such products. With respect to the availability of municipal securities information to retail investors, each of the NRMSIRs also make continuing disclosure documents available for sale to non-subscribers.¹⁸

¹² See SIFMA "Outstanding U.S. Bond Market Debt" (available at http://www.sifma.org/research/pdf/Overall_Outstanding.pdf).

¹³ See SIFMA "Holders of U.S. Municipal Securities" (available at http://www.sifma.org/research/pdf/Holders_Municipal_Securities.pdf).

¹⁴ See MSRB's Real-Time Transaction Reporting Statistical Information, Monthly Summaries 2007 (available at http://www.msrb.org/msrb1/TRSweb/MarketStats/statistical_patterns_in_the_muni.htm).

¹⁵ See Securities Exchange Act Release No. 33741, *supra* note 5.

¹⁶ The four NRMSIRs are the Bloomberg Municipal Repository, DPC Data, Inc., Interactive Data Pricing and Reference Data, Inc., and Standard & Poor's Securities Evaluations, Inc.

¹⁷ The three SIDs are the Municipal Advisory Council of Michigan, the Municipal Advisory Council of Texas, and the Ohio Municipal Advisory Council.

¹⁸ See <http://www.bloomberg.com/markets/rates/municontacts.html> (Bloomberg Municipal Repository); <http://www.munifilings.com/help/help.cfm> (DPC Data, Inc.); http://www.interactivedata-prd.com/07company_info/about_us/MN/NRMSIR.shtml (Interactive Data Pricing and Reference Data, Inc.); and

Although the existing practice for the collection and availability of municipal securities disclosures has substantially improved the availability of information to the market, the Commission believes that improvements could achieve more efficient, effective, and wider availability of municipal securities information to market participants.¹⁹ Among other things, improvements in information availability may allow investors to obtain information more readily and may help them to make more informed investment decisions. Specifically, the Commission believes that municipal securities disclosure documents should be made more readily and more promptly available to the public and that all investors should have better access to important market information that may affect the price of a municipal security, such as information in financial statements and notices regarding defaults and changes in ratings, credit enhancement provider, and tax status.

Furthermore, the Commission believes that improved access to the information in continuing disclosure documents not only would provide the investing public with important information regarding municipal securities, both during offerings and on an ongoing basis, but

<http://www.disclosuredirectory.standardandpoors.com/> (Standard & Poor's Securities Evaluations, Inc.).

¹⁹ The Commission notes that the aspects of the Rule that relate to the provision of continuing disclosure documents to multiple locations (i.e., to each NRMSIR and SID) may have engendered certain inefficiencies in the current system. See 17 CFR 240.15c2-12(b)(5)(i)(A) through (D). For instance, there have been reports that NRMSIRs may not receive continuing disclosure documents concurrently, resulting in the uneven availability of documents from the various NRMSIRs for some period of time. There also have been reports of inconsistent document collections among NRMSIRs, possibly due to the failure of some issuers or obligated persons to provide continuing disclosure documents to each NRMSIR. Finally, there have been reports indicating possible weaknesses in document retrieval at the NRMSIRs. See, e.g., Troy L. Kilpatrick and Antonio Portuondo, Is This the Last Chance for the Muni Industry to Self-Regulate?, THE BOND BUYER, August 6, 2007, and comments made at the 2001 Municipal Market Roundtable - "Secondary Market Disclosure for the 21st Century" held November 14, 2001 ("2001 Roundtable"), and the 2000 Municipal Market Roundtable held October 12, 2000 (available at <http://www.sec.gov/info/municipal/roundtables/thirdmuniround.htm> and <http://www.sec.gov/info/municipal/roundtables/2000participants.htm>, respectively).

also would help fulfill the regulatory and information needs of municipal market participants, including Dealers, Participating Underwriters, mutual funds, and others. For example, many mutual funds include municipal securities in their portfolios that they routinely monitor for regulatory and other reasons.²⁰ They do so by reviewing annual filings, as well as material event notices and failure to file notices, obtained from NRMSIRs and SIDs.²¹ In addition, the MSRB requires Dealers to disclose to a customer at the time of trade all material facts about a transaction known by the Dealer.²² Further, the MSRB requires a Dealer to disclose material facts about a security when such facts are reasonably accessible to the market.²³ Accordingly, a Dealer is responsible for disclosing to a customer any material fact concerning a municipal security transaction made publicly available through sources such as NRMSIRs, the MSRB's Municipal Securities Information Library® ("MSIL"®) system,²⁴ the MSRB's Real-Time

²⁰ For example, Rule 2a-7 under the Investment Company Act of 1940 specifies the characteristics of investments that may be purchased and held by money market funds. Among other requirements, Rule 2a-7 requires a money market fund to limit its portfolio investments to those securities that the fund's board of directors determines present minimal credit risks (including factors in addition to any assigned rating). See Rule 2a-7(c)(3), 17 CFR 270.2a-7(c)(3).

²¹ See, e.g., the comments of Leslie Richards-Yellen, Principal, The Vanguard Group, at the 2001 Roundtable, supra note 19.

²² See MSRB "Interpretive Notice Regarding Rule G-17 on Disclosure of Material Facts" (March 20, 2002) (available at <http://www.msrb.org/msrb1/rules/notg17.htm>). See also Securities Exchange Act Release No. 45591 (March 18, 2002), 67 FR 13673 (March 25, 2002) (SR-MSRB-2002-01) (order approving MSRB's proposed interpretation of the duty to deal fairly set forth in MSRB Rule G-17).

²³ Id.

²⁴ Municipal Securities Information Library and MSIL are registered trademarks of the MSRB. The Official Statement and Advance Refunding Document ("OS/ARD") system of the MSIL system was initially approved by the Commission in 1991 and was amended in 2001 to establish the MSRB's current optional electronic system for underwriters to submit official statements and advance refunding documents. See Securities Exchange Act Release Nos. 29298 (June 13, 1991), 56 FR 28194 (June 19, 1991) (File No. SR-MSRB-90-2) (order approving MSRB's proposal to establish and operate the OS/ARD of the MSIL system, through which information collected pursuant to MSRB Rule G-36

Transaction Reporting System (“RTRS”), rating agency reports and other sources of information relating to the municipal securities transaction generally used by Dealers that effect transactions in the type of municipal securities at issue.²⁵ Dealers use the information contained in the continuing disclosure documents to carry out these obligations. Therefore, improving access to information in the continuing disclosure documents would help facilitate and simplify the process of gathering the necessary information to carry out their obligations. For these reasons, the Commission believes that municipal market participants should have more efficient access to information in continuing disclosure documents to satisfy their regulatory requirements and informational needs.

C. The MSRB’s Electronic Systems

In 2006, the Commission published for comment proposed amendments to Rule 15c2-12 in response to a petition from the MSRB²⁶ that would permit the MSRB to close its Continuing Disclosure Information Net (“CDINet”) system, thereby eliminating the MSRB as a location to which issuers could submit material event notices and failure to file notices.²⁷ In the 2006 Proposed Amendments, the Commission indicated its belief that, given the limited usage of the

would be made available electronically to market participants and information vendors) and 44643 (August 1, 2001), 66 FR 42243 (August 10, 2001) (File No. SR-MSRB-2001-03) (order approving MSRB’s proposal to amend the OS/ARD system to establish an optional procedure for electronic submissions of required materials under MSRB Rule G-36).

²⁵ See note 22, *supra*.

²⁶ See Letter from Diane G. Klinke, General Counsel, MSRB, to Jonathan G. Katz, Secretary, Commission, dated September 8, 2005 (“MSRB Petition”).

²⁷ See Securities Exchange Act Release No. 54863 (December 4, 2006), 71 FR 71109 (December 8, 2006) (“2006 Proposed Amendments”). According to the MSRB Petition, the CDINet system was designed to permit issuers to satisfy their undertakings to provide material event notices through a single submission to the MSRB, rather than through separate submissions to each of the NRMSIRs. The MSRB stated that relatively few issuers had opted to use the CDINet system, and, in recent years, usage of the CDINet system had diminished. See MSRB Petition, *supra* note 26.

MSRB's CDINet system, among other things, the proposed elimination of the provision in Rule 15c2-12 that allows the filing of material event notices with the MSRB was warranted.²⁸

The Commission recently approved the MSRB's proposed rule change, filed under Section 19(b) of the Exchange Act,²⁹ to establish a pilot program for an Internet-based public access portal ("pilot portal") for the consolidated availability of primary offering information about municipal securities that currently is made available in paper form, subject to copying charges, at the MSRB's public access facility, and electronically by paid subscription on a daily over-night basis and by purchase of annual back-log collections.³⁰ The MSRB is implementing the pilot portal as a service of its new Internet-based public access system, which it is designating as the Electronic Municipal Market Access ("EMMA") system, as a pilot facility within the MSIL system.

In the course of developing the primary offering information component of the EMMA system, the MSRB determined that it could incorporate in the EMMA system the collection and availability of continuing disclosure documents, thus eliminating the need for the Commission to adopt its proposed changes to Rule 15c2-12 to remove the MSRB as a repository of material event notices.³¹ As a result, the MSRB recently submitted to the Commission a proposed rule change, filed under Section 19(b) of the Exchange Act,³² to expand the EMMA system to

²⁸ See 2006 Proposed Amendments, supra note 27.

²⁹ 15 U.S.C. 78s(b).

³⁰ See Securities Exchange Act Release No. 57577 (March 28, 2008), 73 FR 18022 (April 2, 2008) (File No. SR-MSRB-2007-06) (order approving the pilot portal). Primary offering information consists of the official statement and the advance refunding document that Participating Underwriters are required to send to the MSRB under MSRB Rule G-36.

³¹ See Securities Exchange Act Release No. 58256 (July 30, 2008) (File No. MSRB-2008-05).

³² 15 U.S.C. 78s(b).

accommodate the collection and availability of annual filings, material event notices and failure to file notices.³³ While the MSRB still intends to propose to terminate its CDINet System, subject to Commission approval,³⁴ the MSRB's subsequent decision to file a proposed rule change to expand the EMMA system to accommodate annual filings, material event notices, and failure to file notices³⁵ has led the MSRB to consider whether to withdraw the MSRB Petition.³⁶ In light of the collection and availability of continuing disclosure documents and in conjunction with the Commission's proposal today to amend Rule 15c2-12, the Commission is considering whether to withdraw its 2006 Proposed Amendments.

Under the MSRB's proposed rule change -- filed under Section 19(b) of the Exchange Act³⁷ and under separate consideration by the Commission³⁸ -- the EMMA system would be expanded from the pilot program to allow for the electronic collection through the MSRB's Web site of continuing disclosure documents and related information received by the MSRB from issuers and obligated persons pursuant to undertakings under the Rule and for free public access to such information through MSRB web-based systems.³⁹ Information regarding the continuing

³³ See Securities Exchange Act Release No. 58256, supra note 31.

³⁴ Id.

³⁵ Id.

³⁶ Id.

³⁷ 15 U.S.C. 78s(b).

³⁸ The Commission is publishing for public comment this proposed rule change at the same time as it publishes these proposed amendments to Rule 15c2-12. Comments on the MSRB's proposed rule change should be directed to File No. SR-MSRB-2008-05.

³⁹ See Securities Exchange Act Release No. 58256, supra note 31.

disclosure documents would also be made available through a data stream by subscription for a fee.⁴⁰

II. Description of the Proposal

A. Proposed Amendments to Rule 15c2-12

The Commission is considering whether the development of a centralized system for the electronic collection and availability of information about outstanding municipal securities would improve the current paper-based system. Since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems that allow market participants and investors, both retail and institutional, easily, quickly, and inexpensively to obtain information through electronic means. The exponential growth of the Internet and the capacity it affords to investors, particularly retail investors, to obtain, compile and review information has likely helped to keep investors better informed. In addition to the Commission's EDGAR system, which contains filings by public companies required to file periodic reports and by mutual funds, the Commission has increasingly encouraged and, in some cases required, the use of the Internet and websites by public reporting companies and mutual funds to provide disclosures and communicate with investors.⁴¹

The Commission believes that, at present, information about municipal issuers and their securities that is accessible on the Internet may not be as consistently available or comprehensive

⁴⁰ The Commission notes that the MSRB would be required to file a proposed rule change with the Commission under Section 19(b) of the Exchange Act regarding any fees it proposes to establish for the subscription service.

⁴¹ See, e.g., Securities Exchange Act Release Nos. 52056 (July 19, 2005), 70 FR 44722 (August 3, 2005) (File No. S7-38-04) (adopting amendments to encourage and, in some cases, mandate the use of an Internet site in securities offering) and 56135 (July 26, 2007), 72 FR 42222 (August 1, 2007) (File No. S7-03-07) (adopting amendments to the proxy rules under the Exchange Act requiring issuers and other soliciting persons to post their proxy materials on an Internet Web site and providing shareholders with a notice of the Internet availability of the materials).

as information about other classes of issuers and their securities. This may be due, in part, to the lack of a central point of collection and availability of information in the municipal securities sector.⁴² Therefore, the Commission is proposing to amend Rule 15c2-12 to provide for a single centralized repository that receives submissions in an electronic format to encourage a more efficient and effective process for the collection and availability of continuing disclosure documents. In the Commission's view, a single repository that receives submissions in an electronic format could assist in facilitating and simplifying submissions of continuing disclosure documents under the Rule by enabling issuers and obligated persons to comply with their undertakings by submitting their continuing disclosure documents only to one repository, as opposed to multiple repositories.

The Commission also believes that having a centralized repository that receives submissions in an electronic format would provide ready and prompt access to continuing disclosure documents by investors and other municipal securities market participants. Rather than having to approach multiple locations, investors and other market participants would be able to go solely to one location to retrieve continuing disclosure documents, thereby allowing for a more convenient means to obtain such information. Moreover, the Commission believes that having one repository electronically collect and make available all continuing disclosure documents would increase the likelihood that investors and other market participants obtain complete information about a municipal security or its issuer, since the information would not be dispersed across multiple repositories. In addition, the Commission preliminarily expects that

⁴² Historically, there has been support for the concept of a central repository. For example, in response to the proposing release for Rule 15c2-12 in 1988, a majority of the comment letters supported a central repository and indicated a need to have a readily accessible central source of information about municipal bonds. See 1989 Adopting Release, supra note 3.

the consistent availability of such information from a single source could simplify compliance with regulatory requirements by Participating Underwriters and others, such as mutual funds and Dealers. Information vendors (including NRMSIRs and SIDs) and others also would have ready access from a single source to continuing disclosure documents for use in their value-added products.

The Commission notes that, when it adopted Rule 15c2-12 in 1989, it strongly supported the development of one or more central repositories for municipal disclosure documents.⁴³ In this regard, the Commission noted in the 1989 Adopting Release that “the creation of multiple repositories should be accompanied by the development of an information linkage among these repositories” so as to afford “the widest retrieval and dissemination of information in the secondary market.”⁴⁴ The Commission further stated that the “use of such repositories will substantially increase the availability of information on municipal issues and enhance the efficiency of the secondary trading market.”⁴⁵ In addition, the Commission stated when it adopted the 1994 Amendments that the “requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allay[ed] the anti-competitive concerns raised by the creation of a single repository.”⁴⁶

As noted earlier, the Commission has long been interested in improving the availability of disclosure in the municipal securities market. At the time the Commission adopted Rule 15c2-12 and amended it in 1994, disclosure documents were submitted in paper form. The

⁴³ See 1989 Adopting Release at 54 FR 28807, supra note 3. See also Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759 (March 17, 1994) (File No. S7-5-94) (proposing release for the 1994 Amendments) (“1994 Proposing Release”).

⁴⁴ See 1989 Adopting Release, supra note 3.

⁴⁵ Id.

⁴⁶ See 1994 Amendments, supra note 5.

Commission believed that, in such an environment where document retrieval would be handled manually, the establishment of one or more repositories could be beneficial in widening the retrieval and availability of information in the secondary market, since the public could obtain the disclosure documents from multiple locations. The Commission's objective of encouraging greater availability of municipal securities information remains unchanged. However, as indicated earlier, there have been significant inefficiencies in the current use of multiple repositories that likely have impacted the public's ability to retrieve continuing disclosure documents.⁴⁷ Although the Commission in the 1989 Adopting Release supported the development of an information linkage among the repositories, none was established to help broaden the availability of the disclosure information. Also, since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems, including the use of the Internet, to provide information quickly and inexpensively to market participants and investors. In this regard, the Commission preliminarily believes that the use of a single repository to receive, in an electronic format, and make available continuing disclosure documents, in an electronic format, would substantially and effectively increase the availability of municipal securities information about municipal issues and enhance the efficiency of the secondary trading market.

The Commission acknowledges that, if the proposed amendments were adopted to provide for a single repository, competition with respect to services provided by the existing NRMSIRs could decline, including a potential reduction in current services relating to municipal securities that are not within the ambit of Rule 15c2-12 or a potential narrowing of competing

⁴⁷ See note 19, *supra*.

information services regarding municipal securities.⁴⁸ The Commission, however, preliminarily believes that any potential effect on competition that could result from having a single repository would be justified by the more efficient and effective process for the collection and availability of continuing disclosure documents by a single repository. For instance, utilizing the Internet for the collection and availability of continuing disclosure documents would modernize the method of delivery of such documents to the single repository and make the documents more readily and easily accessible to investors and others. Moreover, in providing for a single repository for continuing disclosure documents that investors and others could easily access, the proposed amendments would foster the goals of the Exchange Act to protect investors and promote the public interest. For example, investors would be able to readily retrieve information from the central repository about municipal securities, and thus it would be easier for them to make more informed decisions in assessing whether to purchase, sell, or hold municipal securities. Similarly, commercial vendors could readily access the information to disseminate it or use it in whatever value-added products they may wish to provide.

As a result, the Commission preliminarily does not believe that having a single repository would have a significant adverse effect on the ability or willingness of private information vendors to compete to create and market value-added products. In fact, a single repository where documents are submitted in an electronic format could encourage the private information vendors to disseminate municipal securities information by reducing the cost of entry into the information services market. Vendors may need to make some adjustments to their infrastructure or facilities. However, some vendors could determine they no longer need to invest in the infrastructure and facilities necessary to collect and store continuing disclosure

⁴⁸ See also discussion in Sections V. and VI., infra.

documents, and new entrants into the market would not need to purchase the information from multiple locations, but rather could readily access such information from one centralized source. Thus, all vendors would have equal availability to the continuing disclosure documents and be able to compete in providing value-added services.

The Commission requests comment on whether it should amend Rule 15c2-12 as proposed in this release, or whether it is preferable to continue to have multiple sources for such information. The Commission requests comment on whether having one repository instead of multiple repositories for the submission of, and access to, continuing disclosure documents would improve access to secondary market disclosure for investors and municipal securities market participants. The Commission also requests comment on whether the availability of such information from a single source would simplify compliance with regulatory requirements by Participating Underwriters and others. The Commission seeks comment on any possible disadvantages in having only one repository responsible for the collection of, and access to, municipal securities information. Furthermore, the Commission requests comment whether it should contemplate alternative ways of improving the efficiency of the current structure, including the use of the existing NRMSIRs, instead of amending the Rule to provide for only one repository. In this regard, the Commission seeks comment concerning whether instead Rule 15c2-12 should be amended to require Participating Underwriters to reasonably determine that the continuing disclosure agreements provide solely for the electronic submission of such documents to each of the NRMSIRs. Commenters should provide reasons why submitting documents, electronically or otherwise, to multiple NRMSIRs, rather than to a single repository, would be preferable.

If the Commission should determine to amend the Rule to refer to one repository, the Commission also is proposing to revise Rule 15c2-12 to delete all references to NRMSIRs and instead to insert references to the MSRB. Established pursuant to an act of Congress⁴⁹ as a self-regulatory organization (“SRO”) for brokers, dealers and municipal securities dealers engaged in transactions in municipal securities, the MSRB is subject to Commission oversight, as provided by the Exchange Act. As an SRO, the MSRB is required to file its rules and changes to those rules with the Commission for notice and comment and Commission review under Section 19(b) of the Exchange Act.⁵⁰ Pursuant to Section 15B(b)(2)(C) of the Exchange Act, the MSRB’s rules are required to be designed, in part, “to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, ... to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.”⁵¹ The MSRB’s existing RTRS and MSIL systems, and the primary offering information component of the EMMA system that has been approved by the Commission (relating to the submission of official statements and advance refunding documents),⁵² were subject to notice and comment and Commission review. Similarly, the MSRB’s proposal to establish a continuing disclosure component within the EMMA system, as well as any future changes to that component, would be subject to Commission review under

⁴⁹ 15 U.S.C. 78o-4.

⁵⁰ 15 U.S.C. 78s(b).

⁵¹ 15 U.S.C. 78o-4(b)(2)(C).

⁵² See Securities Exchange Act Release No. 57577, *supra* note 30.

Section 19(b) of the Exchange Act.⁵³ Further, the Commission believes that, in addition to being subject to Commission oversight as an SRO, the MSRB is both familiar with the complexities of municipal securities and the municipal securities market and has experience in developing and maintaining electronic information systems for that market.⁵⁴ Collectively, these factors lead the Commission to propose to amend Rule 15c2-12 to provide that the MSRB be the centralized location for collecting (in an electronic format) and making information about municipal securities available to the public at no cost.

The Commission previously stated that it would specifically consider the competitive implications of the MSRB becoming a repository.⁵⁵ In addition, the Commission stated that, if the Commission were to conclude that the MSRB's status as a repository might have adverse competitive implications, it would consider whether it should take any action to address these effects.⁵⁶ As noted above, the Commission recognizes that competition with respect to certain information services regarding municipal securities that are provided by the existing NRMSIRs could decline should the MSRB become the central repository. However, the Commission believes that the reasons it provided above regarding the competitive implications with respect to having a single repository similarly would apply if the MSRB were the sole repository. The Commission does not believe that there are competitive implications that would uniquely apply

⁵³ See Securities Exchange Act Release No. 58256, supra note 31.

⁵⁴ For example, the MSRB is experienced with operating CDINet, the MSIL system, and the RTRS system.

⁵⁵ Specifically, the Commission stated that it would consider the competitive implications of an MSRB request for NRMSIR status. See Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333 (June 7, 1990) (File No. SR-MSRB-89-9). See also 1994 Proposing Release and 1994 Amendments, supra notes 43 and 5, respectively. Although the MSRB is not seeking NRMSIR status, the MSRB essentially would become a repository if the proposed amendments were adopted.

⁵⁶ See Securities Exchange Act Release No. 28081, supra note 55.

to the MSRB in its capacity as the sole repository, as opposed to any other entity that could be the sole repository. In fact, the Commission believes that, if the MSRB were the sole repository, its status as an SRO would provide an additional level of Commission oversight, as any changes to its rules relating to continuing disclosure documents would have to be filed for Commission consideration as a proposed rule change under Section 19(b) of the Exchange Act.

Accordingly, similar to the discussion above, the Commission believes that any competitive impact that could result from the MSRB's status as the sole repository would be justified by the benefits that such status could provide. The Commission believes that one of the benefits in having the MSRB be the sole repository would be its ability to provide a ready source of continuing disclosure documents to all investors, broker-dealers and information vendors who wish to use that information for their products. Private vendors could utilize the MSRB in its capacity as a repository as a means to collect information from the continuing disclosure documents to create value-added products for their customers. As noted earlier, vendors may need to make some adjustments to their infrastructure or facilities in using the MSRB's services as a repository of continuing disclosure documents. However, some vendors could determine they no longer need to incur the cost of obtaining and storing continuing disclosure documents, and new entrants into the information services market would not need to purchase the information from multiple locations. Thus, all vendors would have equal availability to these public documents and would be able to develop whatever services they choose.

The Commission requests comment concerning whether the MSRB should serve as the sole repository of continuing disclosure documents or whether another entity, such as a private vendor, should serve as the sole repository, instead of the MSRB. If commenters believe another entity should be the sole repository, commenters should provide reasons for their viewpoint. The

Commission seeks comment on whether the MSRB would be an appropriate operator of a centralized repository for the collection and availability of continuing disclosure information about municipal securities, and whether there is a more appropriate location or means through which such information could be made readily available to the public without charge.

Commenters are also asked to address whether the MSRB's status as an SRO would be an advantage or disadvantage to its serving as the sole repository. In addition, the Commission requests comment on whether having the MSRB serve as the sole repository would encourage or discourage competition between the MSRB and private vendors, or others.

If the Commission were to amend the Rule to provide for the MSRB to serve as the sole repository, the Commission would amend Rule 15c2-12(b)(5), which sets forth the undertakings to which Participating Underwriters must reasonably determine that issuers or other obligated persons have contractually agreed to provide in connection with primary offerings subject to the Rule. The proposed amendments would revise subparagraphs (b)(5)(i)(A) through (D) of Rule 15c2-12 to require Participating Underwriters to reasonably determine that the issuer or obligated person has agreed at the time of a primary offering: (1) to provide the continuing disclosure documents directly to the MSRB instead of to each NRMSIR and appropriate SID, and (2) to provide the continuing disclosure documents in an electronic format and accompanied by identifying information as prescribed by the MSRB. Specifically, the Commission proposes to amend Rule 15c2-12(b)(5)(i)(A) through (D) by deleting references in each of those provisions to NRMSIR and SID and adding language to require Participating Underwriters to reasonably

determine that issuers or obligated persons have undertaken to provide continuing disclosure documents to the MSRB in an electronic format as prescribed by the MSRB.⁵⁷

The Rule requires that Participating Underwriters reasonably determine that the information undertaken to be provided, in addition to being submitted to the NRMSIRs, or, in some cases, to the MSRB, must be submitted to a SID, if an appropriate SID has been established by that state.⁵⁸ The Commission adopted an exemption from paragraph (b)(5) of the Rule that, among other things, contains conditions on limited undertakings relating to making financial information or operating data available upon request or at least annually to a SID, and providing material event notices to each NRMSIR or the MSRB, and to a SID.⁵⁹ Because the Commission is now proposing to amend the Rule to provide for a single repository for the electronic collection and availability of continuing disclosure documents that the Commission believes would efficiently and effectively improve disclosure in the municipal securities market, the Commission believes that it is no longer necessary to specifically require in the Rule that Participating Underwriters reasonably determine that issuers and obligated persons have contractually agreed to provide continuing disclosure documents to the SIDs. The Commission, therefore, is proposing to delete references to the SIDs in the Rule. As discussed further below, the Commission, however, notes that there may be an obligation to provide such documents to a SID, if required by applicable state law, which also could be beneficial in improving disclosure in the municipal securities market.

⁵⁷ The Commission notes that the MSRB would be required to file a proposed rule change with the Commission under Section 19(b) of the Exchange Act regarding the electronic format it proposes to use.

⁵⁸ 17 CFR 240.15c2-12(b)(5)(i)(A) through (D).

⁵⁹ 17 CFR 240.15c2-12(d)(2)(ii)(A) and (B).

Specifically, the Commission is proposing to delete references to the SIDs in Rule 15c2-12(b)(5)(i)(A) through (D). Under these proposed amendments, Participating Underwriters no longer would need to reasonably determine that issuers or obligated persons have agreed in the continuing disclosure agreements to provide continuing disclosure documents to the appropriate SID, if any. The proposed amendments, however, would not affect the legal obligations of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that are required under the appropriate state law. In addition, the proposed amendments would have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to any effective date of the proposed amendments to the Rule to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that may be required under the appropriate state law.

The Commission requests comment on whether the reference to the SIDs should be deleted in the Rule. The Commission requests comment on the impact of deleting the references to the SIDs in the Rule, including the impact of the proposed deletion on the obligations of Participating Underwriters, issuers and obligated persons. The Commission also requests comment on the effect of the proposed deletion on SIDs and their role in the collection and disclosure of continuing disclosure documents.

The proposed amendments also would revise Rule 15c2-12(d)(2)(ii), which is part of an exemptive provision from Rule 15c2-12(b)(5). The exemption in Rule 15c2-12(d)(2) currently provides that paragraph (b)(5) of the Rule, which relates to the submission of continuing disclosure documents pursuant to continuing disclosure agreements, does not apply to a primary

offering if three conditions are met: (1) the issuer or the obligated person has less than \$10 million of debt outstanding;⁶⁰ (2) the issuer or obligated person has undertaken in a written agreement or contract (“limited undertaking”) to provide: (i) financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, including financial information and operating data which is customarily prepared by such obligated person and is publicly available, upon request to any person or at least annually to the appropriate SID,⁶¹ and (ii) material event notices to each NRMSIR or the MSRB, as well as the appropriate SID;⁶² and (3) the final official statement identifies by name, address and telephone numbers the persons from which the foregoing information, data and notices can be obtained. The proposed amendments would revise the limited undertaking set forth in 15c2-12(d)(2)(ii)(A) and (B) by deleting references to the NRMSIRs and SIDs and solely referencing the MSRB. Accordingly, under the proposed amendment to Rule 15c2-12(d)(2)(ii), a Participating Underwriter would be exempt from their obligations under paragraph (b)(5) of the Rule as long as an issuer or obligated person has agreed in its limited undertaking to provide financial information, operating data and material event notices to the MSRB in an electronic format as prescribed by the MSRB, and the exemption’s other conditions are satisfied. In conjunction with this proposed change, the Commission also would amend the provision of the exemption relating to the limited undertaking to provide that

⁶⁰ 17 CFR 240.15c2-12(d)(2)(i).

⁶¹ 17 CFR 240.15c2-12(d)(2)(ii)(A).

⁶² 17 CFR 240.15c2-12(d)(2)(ii)(B).

the type of financial information or operating data described in Rule 15c2-12(d)(2)(ii)(A) regarding each obligated person be submitted at least annually to the MSRB.⁶³

With respect to the proposed electronic submission of continuing disclosure documents, the Commission believes that this method would better enable the information to be promptly posted and made available to the public without charge. Electronic submission also would eliminate the need for manual handling of paper documents, which can be a less efficient and more costly process. For instance, the submission of paper documents would require the repository to manually review, sort and store such documents. There is also a potential for a less complete record of continuing disclosure documents at the repository if such documents are submitted in paper to the repository and, for instance, are misplaced or misfiled. As discussed below, the Commission believes that submissions in an electronic format should not be very burdensome on issuers or other obligated persons, since many continuing disclosure documents already are being created in an electronic format and, as a result, are readily transmitted by electronic means.⁶⁴

⁶³ Similar to the earlier discussion regarding the deletion of references to the SIDs in Rule 15c2-12(b)(5)(i), the proposed amendments to Rule 15c2-12(d)(2)(ii)(A) and (B) would not affect the legal obligations of issuers and obligated persons to provide financial information, operating data and material event notices, along with any other submissions, to the appropriate SID, if any, that are required under the appropriate state law. Furthermore, the proposed amendments to Rule 15c2-12(d)(2)(ii)(A) and (B) would have no effect on the obligations of issuers and obligated persons under outstanding limited undertakings entered into prior to any effective date of the proposed amendments to the Rule to submit financial information, operating data and material event notices to the appropriate SID, if any, as stated in their existing limited undertakings, nor on their obligation to make other submissions that may be required under the appropriate state law.

⁶⁴ In addition, the availability of audited financial statements and other financial and statistical data in an electronic format by issuers subject to the Rule could encourage the establishment of the necessary taxonomies and permit states and local governments to make use of XBRL in the future, should they wish to do so.

The Commission requests comment on the proposed amendment to provide continuing disclosure documents in an electronic format. The Commission requests comment on whether submitting continuing disclosure documents in an electronic format would increase the efficiency of submission and availability of continuing disclosure documents, and whether submitting the documents in an electronic format would facilitate wider availability of the information. The Commission also requests comment on alternative methods of providing secondary market disclosure, including whether commenters instead believe that the NRMSIRs should establish new comprehensive electronic systems for the submission of such documents. Furthermore, the Commission requests comment concerning whether the proposed amendments to Rule 15c2-12 should allow for the submission of paper documents and, if so, whether any conditions should be imposed in connection with paper submissions. Comments are also requested on whether the proposed amendments to Rule 15c2-12 should allow for the availability of paper copies upon request from the central repository.

To enable the continuing disclosure documents to be identified and retrieved accurately, the Commission is proposing new subparagraph (b)(5)(iv) of Rule 15c2-12 to require Participating Underwriters to reasonably determine that the issuer or obligated person has undertaken in writing to accompany all documents submitted to the MSRB with identifying information as prescribed by the MSRB. Similarly, the Commission is proposing a conforming change in subparagraph (d)(2)(ii)(C) of Rule 15c2-12 relating to the limited undertaking set forth in Rule 15c2-12(d)(2)(ii) to provide that all documents provided to the MSRB would be required to be accompanied by identifying information as prescribed by the MSRB.⁶⁵

⁶⁵ The Commission notes that the MSRB would be required to file a proposed rule change with the Commission pursuant to Section 19(b) of the Exchange Act regarding any such identifying information that it wished to specify.

The Commission believes that providing identifying information with each submitted document would permit the repository to sort and categorize the document efficiently and accurately. The Commission also anticipates that including in each submission the basic information needed to accurately identify the document would facilitate the ability of investors, market participants, and others to reliably search for and locate relevant disclosure documents. Furthermore, the Commission preliminarily expects that there would be a minimal burden on Participating Underwriters to comply with the proposed new subparagraph (b)(5)(iv) of Rule 15c2-12 since it would only require that the Participating Underwriters reasonably determine that issuers and obligated persons have contractually agreed to one additional provision relating to the identifying information, while there would be a significant benefit to investors and other municipal market participants to easily retrieve the information. Indeed, issuers and other obligated persons that choose to submit continuing disclosure documents through some existing dissemination agents and document delivery services already are supplying identifying information with their submissions.⁶⁶

The Commission requests comment on the proposed amendments to the Rule regarding supplying identifying information as prescribed by the MSRB. The Commission also requests comment on alternative methods that would assist investors and municipal market participants in locating specific information about a municipal security that is submitted under the Rule.

In addition, because the Commission is proposing to amend the Rule to reference the MSRB as the sole repository, the Commission proposes to make a similar change to Rule 15c2-

⁶⁶ The commitment by an issuer to provide identifying information would exist only if it were included in a continuing disclosure agreement. As a result, issuers submitting continuing disclosure documents pursuant to the terms of undertakings entered into prior to the effective date of the proposed amendments that did not require identifying information could submit documents without supplying identifying information.

12(b)(4)(ii), which currently refers to a NRMSIR with respect to the time period in which the Participating Underwriter must send the final official statement to any potential customer. Specifically, under Rule 15c2-12(b)(4), from the time the final official statement becomes available until the earlier of: (1) ninety days from the end of the underwriting period, or (2) the time when the official statement is available to any person from a NRMSIR, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in a primary offering is required to send to any potential customer, upon request, the final official statement. The Commission proposes to amend the language in Rule 15c2-12(b)(4)(ii) to refer to the MSRB instead of to a NRMSIR. Accordingly, Participating Underwriters would have the time period from when the final official statement becomes available until the earlier of: (1) ninety days from the end of the underwriting period, or (2) the time when the official statement is available to any person from the MSRB, but in no case less than twenty-five days following the end of the underwriting period, to send the final official statement to a potential customer, upon request. The Commission requests comment on this proposed change to Rule 15c2-12(b)(4)(ii), including whether Participating Underwriters or others would encounter problems complying with this provision as a result of the proposed revision.

Finally, the Commission proposes to make similar changes in Rule 15c2-12(f)(3) and (f)(9), which define the terms “final official statement” and “annual financial information,” respectively. Rule 15c2-12(f)(3) defines the term “final official statement” to mean a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter and that sets forth information concerning, among other things, financial information or operating data concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons

material to an evaluation of the offering. Rule 15c2-12(f)(9) defines the term “annual financial information” to mean financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Both definitions allow for financial information or operating data to be set forth in the document or set of documents, or be included by specific reference to documents previously provided to each NRMSIR, and to a SID, if any, or filed with the Commission. The Commission is proposing amendments to Rule 15c2-12(f)(3) and (f)(9) to replace references to a NRMSIR and SID, with references to the MSRB’s Internet Web site. Accordingly, the proposed amendments to paragraphs (f)(3) and (f)(9) of the Rule would allow issuers to reference financial information or operating data set forth in specified documents available to the public from the MSRB’s Internet Web site (or filed with the Commission) as part of the final official statements and annual financial information, instead of referencing specific documents previously provided to each NRMSIR and SID. The Commission requests comment on the proposed changes to the definitions of “final official statement” and “annual financial information” contained in Rule 15c2-12.

B. Submissions Required by Existing Undertakings

The proposed amendments to Rule 15c2-12 would only impact continuing disclosure agreements that are entered into in connection with primary offerings occurring on or after the effective date of these proposed amendments, if they were adopted by the Commission. In

accordance with the proposed amendments, Participating Underwriters would have to reasonably determine that a continuing disclosure agreement specifically referenced the MSRB as the sole repository to receive and make available the issuer's or obligated person's continuing disclosure documents. The Commission understands, however, that existing undertakings by issuers and obligated persons that were entered into prior to the effective date of these proposed amendments may specify in their continuing disclosure agreements that continuing disclosure documents be submitted to the current NRMSIRs in existence at the time a submission is made.

The Commission believes that, if the proposed amendments to Rule 15c2-12 were adopted, it would be more efficient and effective to implement a sole repository expeditiously. Towards this end, the Commission wishes to create a mechanism by which issuers or obligated persons could comply with their existing undertakings by submitting the continuing disclosure documents to one location, thereby providing investors and municipal market participants with prompt and easy access to continuing disclosure documents at no charge.

One approach that the Commission could consider to address this situation would be to direct its staff to withdraw all "no action" letters recognizing existing NRMSIRs⁶⁷ and for the Commission to designate the MSRB as the only NRMSIR. As a result, continuing disclosure documents that are provided pursuant to existing continuing disclosure agreements -- *i.e.*, those agreements entered into prior to the effective date of the proposed amendments which typically reference the NRMSIRs as the location to which a submission should be made -- would be

⁶⁷ See Letters from Brandon Becker, Director, Division of Market Regulation (n/k/a Division of Trading and Markets), Commission, to: Michael R. Bloomberg, President, Bloomberg L.P., dated June 26, 1995, and Aaron L. Kaplow, Vice President, Kenny S&P Information Services, dated June 26, 1995; and Letters from Robert L.D. Colby, Deputy Director, Division of Market Regulation (n/k/a Division of Trading and Markets), Commission, to: Peter J. Schmitt, President, DPC Data, Inc., dated June 23, 1997, and John King, Chief Operating Officer, Interactive Data, dated December 21, 1999.

provided to the MSRB in its capacity as the sole NRMSIR.⁶⁸ Providing all submissions – for both past and future offerings - to the same location preliminarily would be expected to be less confusing to, and could simplify the submission process for, issuers and other obligated persons subject to continuing disclosure agreements, as well as to investors and others who wish to obtain such information.

The Commission requests comment relating to the potential withdrawal of the “no action” letters provided to the NRMSIRs and having one NRMSIR-- the MSRB -- be the sole NRMSIR for those continuing disclosure agreements entered into prior to any Commission adoption of the proposed amendments to Rule 15c2-12. The Commission requests comment on the effect of the potential withdrawal of the “no action” letters on Participating Underwriters, issuers, NRMSIRs, investors and others. The Commission requests comment on possible alternative methods of transitioning from the current system of sending documents to multiple NRMSIRs. The Commission requests comment on whether there are any transition issues with respect to the proposed amendments, such as whether there would be any conflicts with respect to terms in existing continuing disclosure agreements. The Commission seeks comment on whether there are concerns that the NRMSIRs would not retain the historical continuing disclosure documents and whether commenters anticipate any problems in obtaining such documents from the current NRMSIRs, if they were no longer recognized as such. If commenters foresee any such problems, they should suggest alternative approaches for the

⁶⁸ Issuers or obligated persons with existing limited undertakings under Rule 15c2-12(d)(2)(ii)(B) that reference the MSRB rather than the NRMSIRs as the location to submit material event notices would not be affected by this proposed approach because they would continue to submit such notices to the MSRB as stated in their limited undertaking. However, issuers or obligated persons with existing limited undertakings that reference the NRMSIRs as the location to submit material event notices would provide such notices to the MSRB in its capacity as the sole NRMSIR.

retention of and access to historical information. The Commission also seeks comment on any issues or problems that could arise if investors seek to obtain and compare information from multiple repositories -- e.g., historical continuing disclosure documents from the NRMSIRs and current continuing disclosure documents from the MSRB-- and whether there are any alternative methods that would allow them to obtain complete information about municipal securities, including obtaining historical information.

The Commission seeks comment on any other transition issues in connection with the proposed amendments to Rule 15c2-12. In this regard, the Commission seeks comment on whether it would be appropriate to immediately move to an electronic form of submission if the Commission were to approve the proposed amendments to the Rule or whether there would be a need to maintain the option of submitting documents in paper form either as a temporary option during a transition period or as a permanent option. Finally, with respect to the transition to a sole repository for continuing disclosure documents, the Commission requests comment on whether commenters foresee any differences that could occur between the existing structure of multiple NRMSIRs and one repository regarding the scope, quantity, and continuity of information.

III. Request for Comments

The Commission seeks comment on all aspects of the proposed amendments to the Rule. In addition to the comments requested throughout the proposing release, comment is requested on whether the proposed amendments would further the Commission's goal of enhancing investors' prompt and efficient access to important information regarding municipal issuers, and whether the proposed amendments would improve the access to the information. Further, the Commission seeks comment regarding whether the proposed amendments would simplify the

ability of municipal issuers and other obligated persons to provide annual filings, material event notices, and failure to file notices. In addition, the Commission requests comment regarding the impact of the proposed amendments on Participating Underwriters and Dealers, as well as on the NRMSIRs and SIDs. The Commission requests comment on the impact on investors, vendors and others that may be affected by the proposed amendments. Further, the Commission requests comment on whether there are alternative approaches to improving the public's access to information about municipal securities that the Commission should consider. For example, the Commission seeks comment on possible alternatives including: whether the Commission should retain the current process of collecting and making available continuing disclosure documents through the existing NRMSIRs and, if so, whether the NRMSIRs should only accept submissions in an electronic format and allow for electronic access to them; whether the Commission should open the process and allow any other person or entity be the sole repository for the collection and availability of continuing disclosure documents, rather than proposing to amend the Rule to establish the MSRB as the sole repository. In addition, the Commission seeks comment on the operation of a system of continuing disclosure by the MSRB as opposed to another entity, such as a private vendor that is not an SRO. In this regard, the Commission requests comment on whether it is appropriate for an SRO, such as the MSRB, to function in the capacity as the sole information repository under the Rule. Finally, the Commission requests comment on the advantages and disadvantages of having one repository instead of having multiple NRMSIRs.

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments to the Rule contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995

("PRA").⁶⁹ In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission has submitted revisions to the currently approved collection of information titled "Municipal Securities Disclosure" (17 CFR 240.15c2-12) (OMB Control No. 3235-0372) to OMB. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

A. Summary of Collection of Information

Currently, under paragraph (b) of Rule 15c2-12, a Participating Underwriter is required: (1) to obtain and review an official statement "deemed final" by an issuer of the securities, except for the omission of specified information, prior to making a bid, purchase, offer, or sale of municipal securities; (2) in non-competitively bid offerings, to send, upon request, a copy of the most recent preliminary official statement (if one exists) to potential customers; (3) to send, upon request, a copy of the final official statement to potential customers for a specified period of time; (4) to contract with the issuer to receive, within a specified time, sufficient copies of the final official statement to comply with the Rule's delivery requirement, and the requirements of the rules of the MSRB; and (5) before purchasing or selling municipal securities in connection with an offering, to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of holders of such municipal securities, to provide annual filings, material event notices, and failure to file notices (i.e., continuing disclosure documents) to each NRMSIR (or, alternatively, to the MSRB in the case of material event notices and failure to file notices).⁷⁰ Under the proposed amendments to the Rule, Participating Underwriters would be required to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide continuing disclosure documents to

⁶⁹ 44 U.S.C. 3501 et. seq.

⁷⁰ 17 CFR 240.15c2-12(b).

the MSRB, in an electronic format and accompanied by identifying information, in each case as prescribed by the MSRB. The proposed amendments to the Rule would not substantively change any of the current obligations of Participating Underwriters, except to the extent that Participating Underwriters would have to reasonably determine that the issuer or obligated person has agreed in the continuing disclosure agreement to provide continuing disclosure documents to a single repository instead of to multiple NRMSIRs.

The proposed amendments also would revise Rule 15c2-12(d)(2)(ii), which is part of an exemptive provision from Rule 15c2-12(b)(5). The exemption in Rule 15c2-12(d)(2) currently provides that paragraph (b)(5) of the Rule, which relates to the submission of continuing disclosure documents pursuant to continuing disclosure agreements, does not apply to a primary offering if three conditions are met: (1) the issuer or the obligated person has less than \$10 million of debt outstanding;⁷¹ (2) the issuer or obligated person has undertaken in a written agreement or contract to provide: (i) financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, including financial information and operating data which is customarily prepared by such obligated person and is publicly available, upon request to any person or at least annually to the appropriate SID,⁷² and (ii) material event notices to each NRMSIR or the MSRB, as well as the appropriate SID;⁷³ and (3) the final official statement identifies by name, address and telephone number the persons from which the foregoing information, data and notices can be obtained. The proposed amendments would revise the limited undertaking set forth in 15c2-12(d)(2)(ii)(A) and (B) by deleting references to the NRMSIRs and SIDs and

⁷¹ 17 CFR 240.15c2-12(d)(2)(i).

⁷² 17 CFR 240.15c2-12(d)(2)(ii)(A).

⁷³ 17 CFR 240.15c2-12(d)(2)(ii)(B).

solely referencing the MSRB. Accordingly, under the proposed amendment to Rule 15c2-12(d)(2)(ii), a Participating Underwriter would be exempt from its obligations under paragraph (b)(5) of the Rule as long as an issuer or obligated person has agreed in its limited undertaking to provide financial information, operating data and material event notices to the MSRB in an electronic format as prescribed by the MSRB, and the exemption's other conditions are satisfied. In conjunction with this proposed change, the Commission also would amend the provision of the exemption relating to the limited undertaking to provide that the type of financial information or operating data described in Rule 15c2-12(d)(2)(ii)(A) regarding each obligated person be submitted at least annually to the MSRB.

B. Proposed Use of Information

The proposed amendments to the Rule would provide for a single repository that receives submissions in an electronic format to encourage a more efficient and effective process for the collection and availability of continuing disclosure documents. The proposed amendments to Rule 15c2-12 are intended to improve the availability of continuing disclosure documents that provide current information about municipal issuers and their securities. The proposed amendments would enable investors and other municipal securities market participants to have ready and prompt access to the continuing disclosure documents of municipal securities issuers. This information could be used by retail and institutional investors; underwriters of municipal securities; other market participants, including broker-dealers and municipal securities dealers; municipal securities issuers; vendors of information regarding municipal securities; the MSRB and its staff; Commission staff; and the public generally.

C. Respondents

In 2006, the Commission submitted a request to OMB for extension and approval of the collection of information associated with the existing Rule (“2006 PRA Submission”). OMB approved the extension of the 2006 PRA Submission on March 29, 2007. The current paperwork collection associated with Rule 15c2-12 applies to broker-dealers, issuers of municipal securities, and the NRMSIRs.⁷⁴ Currently, there are four NRMSIRs. The proposal would require that a Participating Underwriter in a primary offering of municipal securities reasonably determine that the issuer or an obligated person has undertaken in a continuing disclosure agreement to submit specified continuing disclosure documents to the MSRB in an electronic format and accompanied by identifying information, as prescribed by the MSRB. In the 2006 PRA Submission, the Commission estimated that the respondents impacted by the paperwork collection associated with the current Rule would consist of: 500 broker-dealers, 10,000 issuers, and four NRMSIRs.⁷⁵ Commission staff expects that there would be a reduction in the number of broker-dealers included in the current paperwork collection associated with the Rule, based on current information it obtained, as described below. Commission staff expects that there would be no change from the current paperwork collection associated with the Rule in the number of respondents that are issuers. The only other change in the number of respondents from the current paperwork collection would be that, in lieu of the four existing NRMSIRs, there would be a single repository.

D. Total Annual Reporting and Recordkeeping Burden

In the 2006 PRA Submission, the Commission included estimates for the hourly burdens that the Rule would impose upon broker-dealers, issuers of municipal securities, and the NRMSIRs. Commission staff has relied on these estimates and on updated information its staff

⁷⁴ NRMSIRs currently collect, index, store, retrieve and disseminate disclosure documents.

⁷⁵ See 2006 PRA Submission.

has obtained to prepare the analysis discussed below for each of the aforementioned entities and to compare current paperwork burdens associated with the Rule to paperwork burdens associated with the Rule as proposed to be amended.

Commission staff estimates the aggregate information collection burden for the amended Rule to consist of the following:

1. Broker-Dealers

Under the 2006 PRA Submission, the Commission estimated that the Rule imposes a paperwork collection burden for 500 broker-dealers.⁷⁶ In addition, the Commission estimated that it would require each of these broker-dealers an average burden of one hour per year to comply with the Rule.⁷⁷ This burden accounted for the time it would take a broker-dealer to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of holders of such municipal securities, to provide annual filings, material event notices, and failure to file notices (i.e., continuing disclosure documents) to each NRMSIR (or, alternatively, to the MSRB in the case of material event notices and failure to file notices).

Based on information provided to Commission staff by MSRB staff in a telephone conversation on April 11, 2008, Commission staff estimates that currently 200 to 250 broker-dealers potentially could serve as Participating Underwriters in an offering of municipal securities. Therefore, Commission staff estimates that, under the proposed amendments, the maximum number of broker-dealer respondents would be 250. This estimate represents a reduction of 250 broker-dealers from the current paperwork collection associated with the

⁷⁶ Id.

⁷⁷ Id.

Rule.⁷⁸ Commission staff believes that this estimated reduction in the number of broker-dealer respondents could be attributed in part to the fact that it may have been over-inclusive in estimating the number of broker-dealer respondents in the past. Further, both large and small broker-dealer firms increasingly have consolidated their operations during the past several years and some firms have left the municipal securities business, which also could account for a reduction in the number of broker-dealer respondents. Moreover, in connection with developing the proposed amendments, Commission staff has attempted to obtain more current information with respect to the number of respondents that would be subject to a paperwork collection. The proposed amendments, however, would not alter the paperwork burden of broker-dealers from that of the current Rule. Accordingly, Commission staff estimates that 250 broker-dealers would incur an estimated average burden of one hour per year to comply with the Rule, as proposed to be amended.

Commission staff estimates that a broker-dealer would incur a one-time paperwork burden to have its internal compliance attorney prepare and issue a notice advising its employees who work on primary offerings of municipal securities about the proposed revisions to Rule 15c2-12, if they are adopted by the Commission. Commission staff estimates that it would take the internal compliance attorney approximately 30 minutes to prepare a notice describing the broker-dealer's obligations in light of the proposed amendments to Rule. Commission staff believes that the task of preparing and issuing a notice advising the broker-dealer's employees about the proposed amendments is consistent with the type of compliance work that a broker-

⁷⁸ 500 (number of broker-dealer respondents in 2006 PRA Submission) – 250 (maximum estimate of broker-dealers impacted by the proposed amendments to the Rule) = 250 (broker-dealers). In order to provide an estimate for the paperwork burden that would not be under-inclusive, Commission staff elected to use the higher end of the estimate for the total number of broker-dealers impacted by the proposed amendments.

dealer typically handles internally. Accordingly, Commission staff estimates that 250 broker-dealers would each incur a one-time, first-year burden of 30 minutes to prepare and issue a notice to its employees regarding the broker dealer's obligations under the proposed amendments.

Therefore, under the proposed amendments, the total burden on these respondents would be 375 hours for the first year⁷⁹ and 250 hours for each subsequent year.⁸⁰

2. Issuers

The Commission believes that issuers prepare annual filings and material event notices as a usual and customary practice in the municipal securities market. Issuers' undertakings regarding the submission of annual filings, material event notices, and failure to file notices that are set forth in continuing disclosure agreements contemplated by the existing Rule, as well as the proposed amendments to the Rule, impose a paperwork burden on issuers of municipal securities.

In the 2006 PRA Submission, the Commission estimated that Rule 15c2-12 imposed a total paperwork burden of 5,000 hours on 10,000 issuers in any given year.⁸¹ In determining the paperwork burden for issuers under the 2006 PRA Submission, the Commission estimated that each issuer would submit each year one annual filing that describes its finances and operations. Thus, under the 2006 PRA Submission, the Commission estimated that issuers would prepare

⁷⁹ (250 (maximum estimate of broker-dealers impacted by the proposed amendments to the Rule) x 1 hour) + (250 (maximum estimate of broker-dealers impacted by the proposed amendments to the Rule) x .5 hour (estimate for one-time burden to issue notice regarding broker-dealer's obligations under the proposed amendments to the Rule)) = 375 hours.

⁸⁰ 250 (maximum estimate of broker-dealers impacted by the proposed amendments to the Rule) x 1 hour = 250 hours.

⁸¹ See 2006 PRA Submission.

approximately 10,000 packages of annual filings yearly and that it would take each issuer 30 minutes to do so, for a total burden of 5,000 hours.⁸² However, based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February 2008, Commission staff estimates that, in connection with the proposed amendments, 10,000 municipal issuers with continuing disclosure agreements would prepare approximately 12,000 to 15,000 annual filings yearly.⁸³

Issuers could submit continuing disclosure documents directly to the single repository or could do so indirectly through a designated agent. Based on telephone conversations with industry sources in May 2008, Commission staff estimates that approximately 30% of issuers today utilize the services of a designated agent to submit disclosure documents to NRMSIRS. An issuer would engage the services of a designated agent as a matter of convenience to advise it of the timing and type of continuing disclosure documents to be submitted to the repository. Commission staff does not believe that the percentage of issuers that rely on the services of a designated agent would change appreciably as a result of the proposed amendments because the proposed amendments simply would revise the location to which continuing disclosure documents would be submitted.

In the 2006 PRA Submission, the Commission estimated that the process for an issuer to submit the annual filings to each of the four NRMSIRs would require approximately 30

⁸² 10,000 (annual filings) x 30 minutes = 5,000 hours.

⁸³ The revision in the number of annual filings from the 10,000 annual filings included in the 2006 PRA Submission to approximately 12,000 to 15,000 annual filings reflects current information provided to Commission staff by MSRB staff, which advised that some issuers submit more than one annual filing each year. Also, the estimate for the number of annual filings includes the submission of annual financial information or operating data described in Rule 15c2-12(d)(2)(ii)(A).

minutes.⁸⁴ Commission staff estimates that, under the proposed amendments, an issuer would take approximately 45 minutes to submit the same annual filings to a single repository in an electronic format and accompanied by identifying information. This estimate includes approximately 30 minutes to prepare the annual filing, which is consistent with the 2006 PRA Submission, plus a new burden of an additional 15 minutes to convert the information into an electronic format and add any identifying information that the repository may prescribe.⁸⁵ Therefore, under the proposed amendments, the total burden on issuers of municipal securities to submit 15,000 annual filings to the MSRB is estimated to be 11,250 hours.⁸⁶ This amount represents an increase of 6,250 hours from the 5,000 hours included in the 2006 PRA Submission.⁸⁷

⁸⁴ See 2006 PRA Submission.

⁸⁵ This additional burden of 15 minutes may decrease over time as issuers become more efficient at converting continuing disclosure documents into an electronic format and preparing any identifying information that the repository may prescribe. Also, Commission staff estimates that, for the estimated 30% of issuers that utilize the services of a designated agent, the designated agent would convert the document into an electronic format (if the issuer has not already done so) and add the identifying information on the issuer's behalf and then submit the information to the MSRB. The additional paperwork burden of 15 minutes described above would remain the same whether or not an issuer utilizes a designated agent because the information would need to be converted into an electronic format and identifying information added, whether the issuer or the designated agent on the issuer's behalf performed these tasks. Commission staff has elected to use conservative estimates for purposes of this rulemaking but believes that ultimately the estimated additional paperwork burden of 15 minutes would be lower for those issuers that use designated agents that implement computer-to-computer interfaces with the MSRB.

⁸⁶ 15,000 (maximum estimate of annual filings) x 45 minutes = 11,250 hours. In order to provide an estimate for the paperwork burden that would not be under-inclusive, Commission staff elected to use the higher end of the estimate for the total number of annual filings estimated to be submitted each year.

⁸⁷ Under the proposed amendments, the increase in the annual paperwork burden for issuers with respect to the submission of annual filings is a result of the 15 minute increase in time it would require each issuer to submit annual filings, as well as Commission staff's revision of the estimate for the total number of annual filings submitted by issuers, which

In connection with developing the proposed amendments, the Commission has attempted to obtain more current information regarding the number of material event notices that potentially would be submitted annually to the proposed single repository. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February, 2008, it is estimated that, on an annual basis, the MSRB would receive approximately 50,000 to 60,000 notices of the occurrence of a material event.⁸⁸ Commission staff notes that this new estimate represents a substantial increase in the estimated number of material event notices that issuers would file relative to the number of material event notices included in the 2006 PRA Submission, and believes that the disparity could be due in part to the difficulty in obtaining an accurate, non-duplicative estimate of the number of paper documents filed with the various NRMSIRs, as well as Commission staff's decision to use conservative estimates for purposes of this rulemaking.

Under the 2006 PRA Submission, the Commission estimated that the process for an issuer to submit a material event notice to a NRMSIR would require approximately 30 minutes.⁸⁹ Commission staff estimates that, under the proposed amendments, providing this same information to the MSRB would require approximately 45 minutes. This estimate includes approximately 30 minutes to prepare the material event notice, which is consistent with the 2006 PRA Submission, plus a new burden of an additional 15 minutes to convert the information into

increased by 5,000 over the Commission's estimates in the 2006 PRA Submission. Issuers' burden under the 2006 PRA Submission is as follows: 10,000 annual filings x 30 minutes = 5,000 hours. Issuers' burden under the proposed amendments is as follows: 15,000 annual filings x 45 minutes = 11,250 hours. The difference in burden between the proposed amendments and the 2006 PRA Submission is as follows: 11,250 hours – 5,000 hours = 6,250 hours.

⁸⁸ This estimate for material event notices includes the submission of material event notices described in Rule 15c2-12(d)(2)(ii)(B).

⁸⁹ See 2006 PRA Submission.

an electronic format and add any identifying information that the repository may prescribe.⁹⁰

Therefore, under the proposed amendments, the total burden on issuers to submit material event notices to the MSRB would require 45,000 hours.⁹¹ This amount represents an increase of 44,250 hours from the 750 hours included in the 2006 PRA Submission.⁹²

Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February, 2008, Commission staff estimates that, on an annual basis, the MSRB would receive approximately 1,500 to 2,000 failure to file notices. Commission staff

⁹⁰ Commission staff notes that this additional burden of 15 minutes may decrease over time as issuers become more efficient at converting continuing disclosure documents into an electronic format and preparing any identifying information that the repository may prescribe, as set forth in the proposed amendments. Also, Commission staff estimates that, for the estimated 30% of issuers that utilize the services of a designated agent, the designated agent would convert the document into an electronic format (if the issuer has not already done so) and add the identifying information on the issuer's behalf and then submit the information to the MSRB. The additional paperwork burden of 15 minutes described above would remain the same whether or not an issuer utilizes a designated agent because the information would need to be converted into an electronic format and identifying information added, whether the issuer or the designated agent on the issuer's behalf performed these tasks. Commission staff has elected to use conservative estimates for purposes of this rulemaking but believes that ultimately the estimated additional paperwork burden of 15 minutes would be lower for those issuers that use designated agents that implement computer-to-computer interfaces with the MSRB.

⁹¹ 60,000 (maximum estimate of material event notices) x 45 minutes = 45,000 hours. In order to provide an estimate for the paperwork burden that would not be under-inclusive, Commission staff has elected to use the higher end of the estimate for the total number of material event notices estimated to be submitted each year.

⁹² Under the proposed amendments, the increase in the annual paperwork burden for issuers with respect to the submission of material event notices is a result of the 15 minute increase in time it would require each issuer to submit material event notices, as well as Commission staff's upward revision of its estimate for the total number of material event notices that issuers would submit, which is estimated to increase by 58,500 notices over the Commission's estimate in the 2006 PRA Submission, as noted earlier. See text accompanying note 88. Issuers' burden under the 2006 PRA Submission is as follows: 1,500 material event notices x 30 minutes = 750 hours. Issuers' burden under the proposed amendments is as follows: 60,000 material event notices x 45 minutes = 45,000 hours. The difference in burden between the proposed amendments and the 2006 PRA Submission is as follows: 45,000 hours – 750 hours = 44,250 hours.

estimates that the current process of preparing and submitting a failure to file notice to a NRMSIR would require approximately 15 minutes. Commission staff estimates that, under the proposed amendments, providing this same information to the MSRB would require approximately 30 minutes. This estimate includes approximately 15 minutes to prepare and submit the failure to file notice, plus an additional 15 minutes to convert the information into an electronic format and add any identifying information that the repository would prescribe.⁹³ Therefore, under the proposed amendments, the total burden on issuers to prepare and submit failure to file notices to the MSRB would be 1,000 hours.⁹⁴ Thus, the estimated 1,000 hours to prepare and submit failure to file notices to the MSRB represents a new paperwork burden of 1,000 hours.

Accordingly, under the proposed amendments, the total burden on issuers to submit annual filings, material event notices and failure to file notices to the MSRB would be 57,250

⁹³ Commission staff notes that this additional burden of 15 minutes may decrease over time as issuers become more efficient at converting continuing disclosure documents into an electronic format and preparing any identifying information that the repository may prescribe. Also, Commission staff estimates that, for the estimated 30% of issuers that utilize the services of a designated agent, the designated agent would convert the document into an electronic format (if the issuer has not already done so) and add the identifying information on the issuer's behalf and then submit the information to the MSRB. The additional paperwork burden of 15 minutes described above would remain the same whether or not an issuer utilizes a designated agent because the information would need to be converted into an electronic format and identifying information added, whether the issuer or the designated agent on the issuer's behalf performed these tasks. Commission staff has elected to use conservative estimates for purposes of this rulemaking but believes that ultimately the estimated additional paperwork burden of 15 minutes would be lower for those issuers that use designated agents that implement computer-to-computer interfaces with the MSRB.

⁹⁴ 2,000 (maximum estimate of failure to file notices) x 30 minutes = 1,000 hours.

hours.⁹⁵ This represents an increase in the total number of burden hours for issuers of 51,500 hours from the 5,750 hours included in the 2006 PRA Submission.

3. The MSRB

In the 2006 PRA Submission, the Commission estimated that the total burden on each NRMSIR of collecting, indexing, storing, retrieving and disseminating information requested by the public to be 29,400 hours and that the total burden on all four NRMSIRs was 117,600 hours (4 NRMSIRs x 29,400 hours). The proposed amendments contemplate that the MSRB would be the sole repository and would receive disclosure documents in an electronic, rather than paper, format. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February, 2008, Commission staff estimates that the burden to collect, index, store, retrieve, and make available the pertinent documents would be the number of hours that MSRB employees would be assigned to the system for collecting, storing, retrieving, and making available the documents. In a series of telephone conversations between MSRB staff and Commission staff in February, 2008, the MSRB advised that three full-time employees and one half-time employee would be assigned to these tasks and that each full-time employee would spend approximately 2,000 hours per year working on these tasks. Therefore, the total burden on the MSRB to collect, store, retrieve, and make available the disclosure documents covered by the proposed amendments would be 7,000 hours per year.⁹⁶ Thus, the total burden on the MSRB to collect, store, retrieve, and make available the disclosure

⁹⁵ 11,250 hours (estimated burden for issuers to submit annual filings) + 45,000 hours (estimated burden for issuers to submit material event notices) + 1,000 hours (estimated burden for issuers to submit failure to file notices) = 57,250 hours.

⁹⁶ 2,000 hours x 3.5 (3 full time employees and 1 half-time employee) = 7,000 hours.

documents covered by the proposed amendments would be 22,400 hours⁹⁷ less than the burden for each NRMSIR to collect, index, store, retrieve and make available disclosure documents under the 2006 PRA Submission, and 110,600 hours⁹⁸ less than the burden for all four NRMSIRs to collect, index, store, retrieve and make available disclosure documents as estimated in the 2006 PRA Submission. The difference in the burden hour estimate for the MSRB to collect, store, retrieve, and make available continuing disclosure documents under the proposed amendments in comparison to the burden on the NRMSIRs estimated in the 2006 PRA Submission could be attributed to the fact that the proposed amendments contemplate that the continuing disclosure documents would be collected, stored, retrieved and made available electronically, whereas the 2006 PRA Submission contemplated that these documents would be collected, stored, retrieved and made available in paper format. In part, the estimate in the 2006 PRA Submission was based on the expectation that the documents would be collected, stored, retrieved and made available in paper rather than electronic format, which would require more people to perform these tasks.

4. Annual Aggregate Burden for Proposed Amendments

Accordingly, Commission staff expects that the ongoing annual aggregate information collection burden for the proposed amendments to the Rule would be 64,500 hours.⁹⁹ The

⁹⁷ 29,400 hours (estimated burden for each NRMSIR in the 2006 PRA Submission) - 7,000 hours (estimated burden for MSRB under the proposed amendments) = 22,400 hours (estimated reduction from current Rule's burden).

⁹⁸ 117,600 hours (estimated burden for all four NRMSIRs in the 2006 PRA Submission) - 7,000 hours (estimated burden for MSRB under the proposed amendments) = 110,600 hours (estimated reduction from current Rule's burden).

⁹⁹ 250 hours (total estimated burden for broker-dealers) + 57,250 hours (total estimated burden for issuers) + 7,000 hours (total estimated burden for MSRB) = 64,500 hours. The initial first-year burden would be 64,625 hours: 375 hours (total estimated burden for broker-dealers in the first year) + 57,250 hours (total estimated burden for issuers) + 7,000 hours (total estimated burden for MSRB) = 64,625 hours.

current annual aggregate information collection burden for the Rule is 123,850 hours.¹⁰⁰

Therefore, if the Commission were to adopt the proposed amendments, the ongoing annual aggregate information collection burden for Rule 15c2-12 is estimated to be reduced by 59,350 hours.¹⁰¹

E. Total Annual Cost Burden

1. Issuers

The Commission expects that some issuers could be subject to some costs associated with the proposed electronic submission of annual filings, material event notices and failure to file notices, particularly if they (or their agent) currently submit paper copies of these documents to the NRMSIRs. It is likely, however, that many issuers of municipal securities currently have the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB. For issuers that currently have such capability, the start-up costs to provide continuing disclosure documents to the MSRB would be minimal because they already would possess the necessary resources internally. Some issuers may have the necessary computer equipment to transmit documents electronically to the MSRB, but may need to upgrade or obtain the software necessary to submit documents to the MSRB in the electronic format that it prescribes. For these issuers, the start-up costs would be the costs of upgrading or acquiring the necessary software. Issuers that presently do not provide their annual filings, material event notices and/or failure to file notices in an electronic format and that are currently sending paper copies of their documents

¹⁰⁰ See 2006 PRA Submission.

¹⁰¹ 123,850 hours (total burden under current Rule) – 64,500 hours (total burden under amended Rule) = 59,350 hours. In the first year, the aggregate burden would be reduced by 59,225 hours: 123,850 (total burden under current Rule) – 64,625 hours (total burden under amended Rule in the first year) = 59,225 hours.

to the NRMSIRs pursuant to their continuing disclosure agreements could incur some costs to obtain electronic copies of such documents if they are prepared by a third party (e.g. accountant or attorney) or, alternatively, to have a paper copy converted into an electronic format. These costs would vary depending on how the issuer elected to convert its continuing disclosure documents into an electronic format. An issuer could elect to have a third-party vendor transfer its paper continuing disclosure documents into the appropriate electronic format. An issuer also could decide to undertake the work internally, and its costs would vary depending on the issuer's current technology resources.

The cost for an issuer to have a third-party vendor transfer its paper continuing disclosure documents into an appropriate electronic format could vary depending on what resources are required to transfer the documents into the appropriate electronic format. One example of such a transfer would be the scanning of paper-based continuing disclosure documents into an electronic format. Based on information provided to Commission staff through limited inquiries to commercial vendors in February 2008, Commission staff estimates that the cost for an issuer to have a third-party vendor scan documents would be \$6 for the first page and \$2 for each page thereafter. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February, 2008, Commission staff estimates that material event and failure to file notices consist of one to two pages, while annual filings range from eight to ten pages to several hundred pages, but average about 30 pages in length. Accordingly, the approximate cost for an issuer to use a third party vendor to scan a material event notice or failure to file notice would be \$8 each, and the approximate cost to scan an average-sized annual financial statement would be \$64. Based on information provided to Commission staff by

MSRB staff in a series of telephone conversations in February 2008, Commission staff estimates that an issuer would submit one to five continuing disclosure documents annually.

Alternatively, an issuer that currently does not have the appropriate technology could elect to purchase the resources to electronically format the disclosure documents on its own.¹⁰² Based on information obtained by Commission staff through limited inquiries of commercial vendors in February 2008, Commission staff estimates that an issuer's initial cost to acquire these technology resources could range from \$750 to \$4,300.¹⁰³ Some issuers may have the necessary hardware to transmit documents electronically to the MSRB, but may need to upgrade or obtain the software necessary to submit documents to the MSRB in the electronic format that it prescribes. Based on information obtained by Commission staff through limited inquiries of commercial vendors in February 2008, Commission staff estimates that an issuer's cost to update or acquire this software could range from \$50 to \$300.¹⁰⁴

¹⁰² Generally, the technology resources necessary to transfer a paper document into an electronic format are a computer, scanner and possibly software to convert the scanned document into the appropriate electronic document format. Most scanners include a software package that is capable of converting scanned images into multiple electronic document formats. An issuer would only need to purchase software if the issuer (i) has a scanner that does not include a software package that is capable of converting scanned images into the appropriate electronic format, or (ii) purchases a scanner that does not include a software package capable of converting documents into the appropriate electronic format.

¹⁰³ Commission staff estimates the cost for an issuer to upgrade or acquire the necessary technology to transfer its paper continuing disclosure documents into an electronic format are based upon the following estimates for purchasing the necessary equipment from a commercial vendor: (i) an issuer's cost for a computer would range from \$500 to \$3,000; (ii) an issuer's cost for a scanner would range from \$200 to \$1,000; and (iii) an issuer's cost for software to submit documents in an electronic format would range from \$50 to \$300.

¹⁰⁴ Commission staff estimates the cost for an issuer to upgrade or acquire the software to submit documents in an electronic format would range from \$50 to \$300. Issuers that only need to upgrade existing software would incur costs closer to the lower end of this estimate, while those issuers that need to purchase completely new software packages would incur costs closer to the higher end of this estimate.

In addition, issuers without direct Internet access could incur some costs to obtain such access to submit the documents. However, Commission staff notes that Internet access is now broadly available to and utilized by businesses, governments, organizations and the public, and Commission staff expects that most issuers of municipal securities currently have Internet access. In the event that an issuer does not have Internet access, it would incur costs in obtaining such access, which Commission staff estimates to be approximately \$50 per month, based on its limited inquiries to Internet service providers. Otherwise, there are multiple free or low cost locations that an issuer could utilize, such as various commercial sites, which could help an issuer to avoid the costs of maintaining continuous Internet access solely to comply with the proposed amendments to the Rule.

Accordingly, Commission staff estimates that the costs to some issuers to submit continuing disclosure documents to a single repository in electronic format could include: (i) an approximate cost of \$8 per notice to use a third party vendor to scan a material event notice or failure to file notice, and an approximate cost of \$64 to use a third party vendor to scan an average-sized annual financial statement, (ii) an approximate cost ranging from \$750 and \$4,300 to acquire technology resources to convert continuing disclosure documents into an electronic format, (iii) \$50 to \$300 solely to upgrade or acquire the software to submit documents in an electronic format; and (iv) approximately \$50 per month to acquire Internet access.

For an issuer that does not have Internet access and elects to have a third party convert continuing disclosure documents into an electronic format (“Category 1”), the total maximum external cost such issuer would incur would be \$752 per year.¹⁰⁵ For an issuer that does not have

¹⁰⁵ [\$64 (cost to have third party convert annual filing into an electronic format) x 2 (maximum estimated number of annual filings filed per year per issuer)] + [\$8 (cost to have third party convert material event notice or failure to file notice into an electronic

Internet access and elects to acquire the technological resources to convert continuing disclosure documents into an electronic format internally (“Category 2”), the total maximum external cost such issuer would incur would be \$4,900 for the first year and \$600 per year thereafter.¹⁰⁶

Accordingly, Commission staff estimates that the total cost for issuers, if they all were classified as Category 1, would be \$7,520,000 per year, and that the total cost for issuers, if they all were classified as Category 2, would be \$49,000,000 for the first year and \$6,000,000 per year thereafter.¹⁰⁷

Alternatively, an issuer could elect to use the services of a designated agent to submit continuing disclosure documents to the MSRB. As noted above, Commission staff believes that approximately 30% of municipal issuers that submit continuing disclosure documents today rely on the services of a designated agent. Generally, when issuers utilize the services of a designated agent, they enter into a contract with the designated agent for a package of services, including the submission of continuing disclosure documents, for a single fee. Based on information provided

format) x 3 (maximum estimated number of material event or failure to file notices filed per year per issuer)] + [\$50 (estimated monthly Internet charge) x 12 months] = \$752. Commission staff estimates that an issuer would file one to five continuing disclosure documents per year. These documents generally consist of no more than two annual filings and three material event or failure to file notices.

¹⁰⁶ [\$4300 (maximum estimated one-time cost to acquire technology to convert continuing disclosure documents into an electronic format)] + [\$50 (estimated monthly Internet charge) x 12 months] = \$4900. After the initial year, issuers who acquire the technology to convert continuing disclosure documents into an electronic format internally would only have the cost of obtaining Internet access. \$50 (estimated monthly Internet charge) x 12 months = \$600.

¹⁰⁷ Total cost for Category 1: 10,000 issuers x \$752 (annual cost per issuer to have a third party convert continuing disclosure documents into an electronic format and for Internet access) = \$7,520,000. Total cost for Category 2: 10,000 issuers x \$4,900 (one-time cost to acquire technology to convert continuing disclosure documents into an electronic format and annual cost for Internet access) = \$49,000,000. 10,000 issuers x \$600 (annual cost per issuer for Internet access) = \$6,000,000. In order to provide an estimate of the total costs to issuers that would not be under-inclusive, Commission staff elected to use all 10,000 issuers for each Category’s estimate.

to Commission staff by industry sources in telephone conversations in May 2008, it is anticipated that five of the largest designated agents would submit documents electronically to the MSRB via a direct computer-to-computer interface. Based on information provided to Commission staff by MSRB staff during telephone conversations in May 2008, Commission staff estimates that the start-up cost for an entity to develop a direct computer-to-computer interface with the MSRB would range from approximately \$69,360 to \$138,720.¹⁰⁸ Thus, the maximum estimated total start-up cost of developing a direct computer-to-computer interface by each of the five designated agents for the submission of continuing disclosure documents to the MSRB would be \$693,600.

The Commission believes that, in light of the estimated cost to develop and implement a computer-to-computer interface with the MSRB, it is unlikely that issuers would elect to proceed with this approach given the availability of less expensive alternatives to submitting continuing disclosure documents electronically to the MSRB. However, some issuers could choose to submit their continuing disclosure documents to the MSRB through a designated agent. A designated agent could submit continuing disclosure documents along with identifying information to the MSRB on behalf of numerous issuers. Depending on its business model, a designated agent could submit continuing disclosure documents along with identifying information to the MSRB via the Internet or through a direct computer-to-computer interface. In either case, the issuer could incur a cost associated with the designated agent's electronic

¹⁰⁸ The MSRB estimated that it would take an entity approximately 240 to 480 hours of computer programming to develop the computer-to-computer interface with the MSRB. $\$289$ (hourly wage for a senior programmer) \times 240 hours = $\$69,360$. $\$289$ (hourly wage for a senior programmer) \times 480 hours = $\$138,720$. The $\$289$ per hour estimate for a senior programmer is from SIFMA's Office Salaries in the Securities Industry 2007, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

submission of the pertinent continuing disclosure document and any identifying information to the MSRB. Commission staff estimates that this cost could be approximately \$16 per continuing disclosure document.¹⁰⁹

2. MSRB

The MSRB would incur costs to develop the computer system to allow it to collect, store, process, retrieve, and make available continuing disclosure documents furnished to it by issuers of municipal securities. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February 2008, MSRB's start-up costs associated with developing the portal for continuing disclosure documents, including hardware, an additional hosting site, and software licensing and acquisition costs, would be approximately \$1,000,000. In addition, the MSRB indicated that the annual operating costs for this system, excluding salary and other costs related to employees, would be approximately \$350,000. Accordingly, Commission staff estimates that the total costs for the MSRB would be \$1,350,000 for the first year and \$350,000 per year thereafter, exclusive of salary and other costs related to employees.¹¹⁰

¹⁰⁹ For this estimate, Commission staff has included the cost of having the designated agent's compliance clerk submit electronically the pertinent continuing disclosure document and any identifying information to the MSRB. 15 minutes (.25 hours) (estimated time per document to gather identifying information) x \$62 (hourly wage for a compliance clerk) = \$15.50 (approximately \$16). The \$62 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2007, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

¹¹⁰ \$1,000,000 (cost to establish computer system) + \$350,000 (annual operation costs for computer system, excluding salary and other related costs for employees) = \$1,350,000 (first year cost to MSRB). After the first year, the only cost would be the annual operation cost of \$350,000. These costs do not include the salary and other overhead costs related to the employees who would maintain the system. MSRB staff advised Commission staff that the personnel costs associated with operating the portal for continuing disclosure documents would be approximately \$400,000 per year.

F. Retention Period of Recordkeeping Requirements

As an SRO subject to Rule 17a-1 under the Exchange Act,¹¹¹ if the proposed amendments to the Rule were adopted, the MSRB would be required to retain records of the collection of information for a period of not less than five years, the first two years in an easily accessible place. The proposed amendments to the Rule would contain no recordkeeping requirements for any other persons.

G. Collection of Information is Mandatory

Any collection of information pursuant to the proposed amendments to the Rule would be a mandatory collection of information.

H. Responses to Collection of Information Will Not Be Kept Confidential

The collection of information pursuant to the proposed amendments to the Rule would not be confidential and would be publicly available.

I. Request for Comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments regarding: (1) whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) the accuracy of the Commission's estimate of the burden of the revised collections of information; (3) whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) 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.

¹¹¹ 17 CFR 240.17a-1.

The Commission has submitted to OMB for approval the proposed revisions to the current collection of information titled "Municipal Securities Disclosure." 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-0609; with reference to File No. S7-21-08, and be submitted to the Securities and Exchange Commission, Public Reference Room, 100 F Street, NE, Washington, DC 20549. As OMB is required to make a decision concerning the collection 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. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, should refer to File No. S7-21-08, and be submitted to the Securities and Exchange Commission, Public Reference Room, 100 F Street, NE, Washington, DC 20549.

V. Costs and Benefits of Proposed Amendments to Rule 15c2-12

The Commission is considering the costs and benefits of the proposed amendments to Rule 15c2-12 discussed above. As discussed below, the Commission believes that there would be an overall reduction in costs based on the proposed amendments. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data regarding any such costs or benefits.

A. Benefits

Under the proposed amendments to the Rule, a Participating Underwriter would be prohibited from purchasing or selling municipal securities covered by the Rule in a primary

offering, unless it has reasonably determined that the issuer of a municipal security has undertaken in a continuing disclosure agreement to provide continuing disclosure documents to the MSRB.¹¹² The Commission believes that providing for a single repository that receives submissions in an electronic format, rather than multiple repositories, would encourage a more efficient and effective process for the collection and availability of continuing disclosure information. In the Commission's view, a single electronic point of collection and accessibility of continuing disclosure documents could assist issuers and obligated persons in complying with their undertakings. Submission of continuing disclosure documents only to one repository rather than multiple repositories would reduce the resources issuers and obligated persons need to devote to the process of gathering and submitting continuing disclosure documents. Because the proposed amendments would provide for the electronic submission and availability of continuing disclosure documents, the costs to issuers and obligated persons of gathering and submitting this information ultimately could be reduced because they no longer would have to gather and submit documents in a paper format. As described more fully in Section IV. above, Commission staff estimates that the ongoing annual information collection burden under the proposed amendments would be 64,500 hours.¹¹³ This is a reduction of 59,350 hours from the 2006 PRA

¹¹² Under the proposed amendments to paragraph (d)(2)(ii) of the Rule, a Participating Underwriter would be exempt from its obligations under paragraph (b)(5) of the Rule as long as an issuer or obligated person has agreed in its limited undertaking that the publicly available financial information or operating data described in paragraph (d)(2)(ii)(A) of the Rule would be submitted to the MSRB annually, instead of upon request to any person or at least annually to the appropriate SID, if any, and that the material event notices described in paragraph (d)(2)(ii)(B) of the Rule would be submitted to the MSRB, instead of to each NRMSIR or the MSRB and to the appropriate SID, if any, and as long as the other conditions of the exemption are met.

¹¹³ Commission staff estimates that the annual information collection burden under the proposed amendments in the first year would be 64,625 hours.

Submission.¹¹⁴ This overall reduction in the Rule's paperwork burden - and the costs associated with that burden - principally would benefit issuers or obligated persons:

The Commission also believes that having a single repository that receives and makes available submissions in an electronic format would provide ready and prompt access to this information by investors and municipal securities market participants. Investors and market participants would be able to go solely to one location to retrieve continuing disclosure documents rather than having to approach multiple locations, thereby allowing for a more convenient means to obtain such information. In addition, the Commission preliminarily believes that having one repository electronically collect and make available all continuing disclosure documents would increase the likelihood that investors and other market participants would obtain complete information.

The Commission expects that a single repository that receives submissions in an electronic format could simplify compliance with regulatory requirements by broker-dealers and others, such as mutual funds, by providing them with consistent availability of continuing disclosure documents from a single source. Information vendors (including NRMSIRs and SIDs) and others also would have ready access to all continuing disclosure documents that they in turn could use in their value-added products. The Commission also expects that having a single repository that receives submissions in an electronic format would make the information available to all users.

Under the current Rule, Commission staff estimates that the current annual paperwork cost for all four NRMSIRs to collect, index, store, retrieve and disseminate continuing disclosure

¹¹⁴ In the first year, this is a reduction of 59,225 from the 2006 PRA Submission.

information requested by the public to be approximately \$7.3 million.¹¹⁵ Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February 2008, the MSRB staff estimated that the MSRB's annual total costs to collect, index, store, retrieve and make available continuing disclosure information, would be \$1,350,000 for the first year and \$350,000 per year thereafter. Providing for a single repository could reduce the paperwork costs that NRMSIRs currently incur because they no longer would have to maintain personnel and other resources solely in connection with their status as a NRMSIR.

Finally, the Commission preliminarily believes that the proposed amendments could encourage the dissemination of information in the information services markets by providing easier access to continuing disclosure documents. As a result, there potentially could be an increase in the number of information vendors disseminating continuing disclosure documents and value-added products because the cost of entry into the municipal securities information services market could be reduced.

The Commission seeks comment on the anticipated benefits of the proposed amendments.

B. Costs

If the amendments to the Rule were adopted, the Commission would not expect broker-dealers to incur any additional recurring costs because the proposed amendments would not alter substantively the existing Rule's requirements for these entities, except with respect to the place to which issuers would agree to make filings. The proposed amendments would change the

¹¹⁵ 117,600 hours (total annual hourly burden for all four NRMSIRs from 2006 PRA Submission) x \$62 (hourly wage for a compliance clerk) = \$7.3 million. The \$62 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2007, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

location where the continuing disclosure documents of issuers or obligated persons would be submitted pursuant to continuing disclosure agreements. As noted above, Commission staff estimates that the annual information collection burden for each broker-dealer under the proposed amendments to the Rule would be one hour. This annual burden is identical to the burden that a broker-dealer has under the current Rule.¹¹⁶ Accordingly, Commission staff estimates that it would cost each broker-dealer \$270 annually to comply with the Rule.¹¹⁷

In addition, Commission staff estimates that a broker-dealer could have a one-time internal cost associated with having an in-house compliance attorney prepare and issue a memorandum advising the broker-dealer's employees who work on primary offerings of municipal securities about the proposed revisions to Rule 15c2-12, if they are adopted by the Commission. Commission staff estimates it would take internal counsel approximately 30 minutes to prepare this memorandum, for a cost of approximately \$135.¹¹⁸

The Commission believes that the ongoing obligations of broker-dealers under the Rule would be handled internally because compliance with these obligations is consistent with the type of work that a broker-dealer typically handles internally. The Commission does not believe that a broker-dealer would have any recurring external costs associated with the proposed amendments to the Rule. The Commission requests comment on any costs broker-dealers could incur under the proposed amendments.

¹¹⁶ See 2006 PRA Submission.

¹¹⁷ 1 hour (estimated annual information collection burden for each broker-dealer) x \$270 (hourly cost for a broker-dealer's internal compliance attorney) = \$270. The hourly rate for the compliance attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2007, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

¹¹⁸ See Section IV.D.1., supra.

Although Rule 15c2-12 relates to the obligations of broker-dealers, issuers or obligated persons indirectly could incur costs as a result of the proposed amendments. Pursuant to continuing disclosure agreements, issuers of municipal securities currently undertake to provide continuing disclosure documents to the NRMSIRs either directly or indirectly through an indenture trustee or a designated agent. In either case, some issuers could be subject to the costs associated with the proposed electronic filing of annual filings, material event notices and failure to file notices, particularly if they (or their agent) currently submit paper copies of these documents to the NRMSIRs. For those issuers that currently deliver their continuing disclosure documents electronically to the NRMSIRs, there should be minimal change in costs as a result of the proposed requirement that documents be submitted electronically.

Issuers that presently do not provide their annual filings, material event notices and/or failure to file notices in an electronic format and that are currently sending paper copies of their documents to the NRMSIRs pursuant to their continuing disclosure agreements could incur some costs to obtain electronic copies of such documents from the party who prepared them or, alternatively, to have a paper copy converted into an electronic format. These costs would vary depending on how the issuer elected to convert their continuing disclosure documents into an electronic format. An issuer could elect to have a third-party vendor transfer their paper continuing disclosure documents into the appropriate electronic format. An issuer also could decide to undertake the work internally, and its costs would vary depending on the issuer's current technology resources. An issuer also would need to have Internet access to submit documents electronically and would incur the costs of maintaining such service, if the issuer currently does not have Internet access, unless it relies on other sources of Internet access.

It is likely, however, that many issuers of municipal securities currently possess the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB. For issuers that currently have such capability, the start-up costs to provide continuing disclosure documents to the MSRB would be minimal because they already would have the necessary resources internally.

As described more fully in Section IV. above, Commission staff estimates that the costs to some issuers to submit continuing disclosure documents to a single repository in an electronic format may include: (i) an approximate cost of \$8 per notice to use a third party vendor to scan a material event notice or failure to file notice, and an approximate cost of \$64 to use a third party vendor to scan an average-sized annual financial statement; (ii) an approximate cost ranging from \$750 and \$4300 to acquire technology resources to convert continuing disclosure documents into an electronic format; (iii) \$50 to \$300 to upgrade or acquire the software to submit documents in an electronic format; (iv) approximately \$50 per month to acquire Internet access; and (v) an approximate cost of \$16 per continuing disclosure document to have a designated agent submit electronically continuing disclosure documents and identifying information to the MSRB. Also, as more fully described in Section IV. above, the total estimated cost of five designated agents developing computer-to-computer interfaces for the submission of documents to the MSRB would be \$693,600.

Issuers or obligated persons also would have to provide certain identifying information to the repository pursuant to their undertakings in continuing disclosure agreements. As described more fully in Section IV. above, Commission staff estimates that each issuer would submit one

to five continuing disclosure documents annually to the MSRB, for a maximum estimated annual labor cost of approximately \$232.50 per issuer.¹¹⁹

The Commission expects that the costs to issuers could vary somewhat, depending on the issuer's size. The Commission believes that any such difference would be attributable to the fact that larger issuers may tend to have more issuances of municipal securities; thus, larger issuers may tend to submit more documents than smaller issuers. Thus, the costs of submitting documents could be greater for larger issuers. The Commission requests comments on costs that issuers and obligated persons could incur as a result of the proposed amendments.

Further, the Commission does not anticipate that issuers would incur any costs associated with the need to revise the template for continuing disclosure agreements, if the proposed amendments are adopted. Commission staff contacted National Association of Bond Lawyers ("NABL") staff in April 2008 regarding the potential costs to issuers for bond lawyers to revise the provisions of continuing disclosure agreements that would be affected by the proposed amendments. According to NABL staff, the NABL members advised that the cost of revising the template for continuing disclosure agreements to reflect the proposed amendments would be insignificant and stated their belief that the costs would not be passed on to issuers.

As discussed in Section IV. above, the MSRB would incur costs to develop the computer system to allow it to collect, store, process, retrieve, and make available continuing disclosure

¹¹⁹ 5 (maximum estimated number of continuing disclosure filed per year per issuer) x \$62 (hourly wage for a compliance clerk) x 45 minutes (.75 hours) (average estimated time for compliance clerk to submit a continuing disclosure document electronically) = \$232.50. The \$62 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2007, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead. In order to provide an estimate of total costs for issuers that would not be under-inclusive, the Commission elected to use the higher end of the estimate of annual submissions of continuing disclosure documents.

documents furnished to it by issuers of municipal securities. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February 2008, MSRB's start-up costs associated with developing the portal for continuing disclosure documents, including hardware, an additional hosting site, and software licensing and acquisition costs, would be approximately \$1,000,000. Based on information provided to Commission staff by MSRB staff in a series of telephone conversations in February 2008, the MSRB staff estimated that the MSRB's ongoing costs of operating the system, including allocated costs associated with such items as office space and licensing fees, would be approximately \$1,350,000 for the first year and \$350,000 per year thereafter. In addition, MSRB staff advised Commission staff that the personnel costs associated with operating the portal for continuing disclosure documents would be approximately \$400,000 per year.¹²⁰

Some NRMSIRs and other vendors of municipal disclosure information could incur costs in transitioning their business models if the Commission were to adopt the proposal to establish a single repository for municipal disclosure documents. In fact, existing NRMSIRs could be adversely affected by the proposed amendments because the proposal contemplates a single repository. Any NRMSIR that currently provides municipal disclosure documents as its primary business model could face a significant decline in its business, and thus in income, as a result of the proposed amendments.¹²¹ In addition, to transition from multiple repositories to a single repository, the Commission is considering whether to direct its staff to withdraw the "no action"

¹²⁰ Based on information provided to Commission staff by MSRB staff in telephone conversations in May 2008, this amount represents the estimated personnel costs associated with the MSRB's having three and one-half persons devoted to operating the continuing disclosure portal.

¹²¹ See, e.g., Letter from Peter J. Schmitt, Chief Executive Officer, DPC Data, dated January 23, 2008, regarding SR-MSRB-2007-06, submitted to www.sec.gov/comments. ("DPC Data Letter").

letters issued to the NRMSIRs and to designate the MSRB as the NRMSIR. As a result, the NRMSIRs could experience an immediate decline in income with respect to those parts of their business that provide municipal disclosure documents to persons who request them. Also, NRMSIRs could have some costs if they continued to maintain historical continuing disclosure information that they have already received under existing continuing disclosure agreements. The Commission requests comment and empirical data on any anticipated costs that NRMSIRs could incur.

Finally, under the proposed amendments, Rule 15c2-12 no longer would refer to SIDs. The proposed amendments would not affect the legal obligations of issuers or obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that may be required under the appropriate state law. In addition, the proposed amendments would have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to any effective date of amendments to the Rule, if the Commission were to adopt such amendments, to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that may be required under the appropriate state law. Unlike NRMSIRs, SIDs are membership organizations and use information submitted to them in products for their members. While SIDs can charge fees for requested documents, the Commission believes, based on telephone conversations between Commission staff and representatives of SIDs in April 2008, that this is not a primary source of revenue for them. The Commission does not expect that SIDs would experience a decline in operations or incur any costs as a result of the proposed amendments, but seeks comment on any anticipated impact that the proposed amendments could have on SIDs.

C. Request for Comment on Costs and Benefits

To assist the Commission in evaluating the costs and benefits that could result from the proposed amendments to the Rule, the Commission requests comments on the potential costs and benefits identified in this proposal, as well as any other costs or benefits that could result from the proposed amendments to the Rule. Commenters should provide analysis and data to support their views on the costs and benefits. In particular, the Commission requests comment on the costs and benefits of the proposed amendments on broker-dealers, issuers, the MSRB, NRMSIRs and other vendors, as well as any costs on others, including market participants and investors.

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

Section 3(f) of the Exchange Act¹²² requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act¹²³ requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments to the Rule would revise subparagraph (b)(5) of Rule 15c2-12 to require Participating Underwriters to reasonably determine that the issuer or obligated person has agreed at the time of a primary offering: (1) to provide the continuing disclosure documents to the MSRB instead of to each NRMSIR and appropriate SID; and (2) to provide the continuing

¹²² 15 U.S.C. 78c(f).

¹²³ 15 U.S.C. 78w(a)(2).

disclosure documents in an electronic format and accompanied by identifying information as prescribed by the MSRB.

The Commission preliminarily believes that the proposed amendments to the Rule should help make the municipal securities disclosure process more efficient and help conserve resources for municipal security issuers, as well as investors and market participants. Under the current regulatory framework, issuers of municipal securities in their continuing disclosure agreements undertake to submit continuing disclosure documents to four separate NRMSIRs, and they submit such documents in paper or electronic form. The Commission anticipates that amending the Rule could promote the efficiency of the municipal disclosure process by reducing the resources municipal security issuers would need to devote to the process of submitting continuing disclosure documents.

As noted above, the Commission has long been interested in improving the timing and availability of disclosure in the municipal securities market. At the time the Commission adopted Rule 15c2-12 in 1989 and adopted the 1994 Amendments, disclosure documents were submitted in paper form. The Commission believed that, in such an environment where document retrieval would be handled manually, the establishment of one or more repositories could be beneficial in widening the retrieval and availability of information in the secondary market, since the public could obtain the disclosure documents from multiple locations. The Commission's objective of encouraging greater availability of municipal securities information remains unchanged.

However, there have been significant inefficiencies in the current use of multiple repositories that likely have affected the public's ability to retrieve continuing disclosure

documents.¹²⁴ In this regard, the Commission noted in the 1989 Adopting Release that “the creation of multiple repositories should be accompanied by the development of an information linkage among these repositories” so as to afford “the widest retrieval and dissemination of information in the secondary market.”¹²⁵ Although the Commission in the 1989 Adopting Release supported the development of an information linkage among the repositories, none was established to help broaden the availability of the disclosure information. Also, since the adoption of the 1994 Amendments, there have been significant advancements in technology and information systems, including the use of the Internet, to provide information quickly and inexpensively to market participants and investors. In this regard, the Commission preliminarily believes that the use of a single repository to receive, in an electronic format, and make available continuing disclosure documents in an electronic format would substantially and effectively increase the availability of municipal securities information about municipal issues and enhance the efficiency of the secondary trading market for these securities.

In addition, the Commission preliminarily believes that having a single repository for electronically submitted information would provide investors, market participants, and others with a more efficient and convenient means to obtain continuing disclosure documents and would help increase the likelihood that investors, market participants, and others would make more informed investment decisions regarding whether to buy, sell or hold municipal securities.

With respect to the Exchange Act goal of promoting competition, the Commission notes that, when it adopted Rule 15c2-12 in 1989, it strongly supported the development of one or

¹²⁴ See note 19, *supra*.

¹²⁵ See 1989 Adopting Release, *supra* note 3.

more central repositories for municipal disclosure documents.¹²⁶ The Commission “recognize[d] the benefits that may accrue from the creation of competing private repositories,” and indicated that “the creation of central sources for municipal offering documents is an important first step that may eventually encourage widespread use of repositories to disseminate annual reports and other current information about issuers to the secondary markets.”¹²⁷ Further, when it adopted the 1994 Amendments, the Commission stated that the “requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allay[ed] the anti-competitive concerns raised by the creation of a single repository.”¹²⁸

There have been significant advances in technology and information collection and delivery since that time, as discussed throughout this release, that indicate that having multiple repositories may not be necessary because the widespread availability and dissemination of information can be achieved through different, more efficient, means. Because the current environment differs markedly from the time when Rule 15c2-12 was adopted in 1989 and subsequently amended in 1994, the Commission believes that it is appropriate to propose an approach that utilizes the significant technological advances, such as the development and use of various electronic formats, that have occurred in the intervening years.

The Commission’s proposal to provide for the establishment of a single repository for continuing disclosure documents would help further the Exchange Act objective of promoting competition because information about municipal securities, provided in an electronic format, would be more widely available to market professionals, investors, information vendors, and

¹²⁶ See 1989 Adopting Release at 54 FR 28807, supra note 3. See also 1994 Proposing Release, supra note 43.

¹²⁷ See 1989 Adopting Release, supra note 3. See also 1994 Proposing Release, supra note 43.

¹²⁸ See 1994 Amendments, supra note 5.

others as a result of the proposed amendments. For example, the Commission believes competition among vendors could increase because vendors could utilize this information to provide value-added services to municipal market participants. The Commission's proposal also could promote competition in the purchase and sale of municipal securities because the greater availability of information as a result of the proposed amendments could instill greater investor confidence in the municipal securities market. Moreover, the greater availability of information also could encourage improvement in the completeness and timeliness of issuer disclosures and could foster interest in municipal securities by retail and institutional customers. As a result, more investors could be attracted to this market sector and broker-dealers could compete for their business.

The Commission acknowledges that, if the proposed amendments were adopted to provide for a single repository, they potentially could have an adverse impact on one or more existing NRMSIRs, especially if their business models depended on their status as a NRMSIR.¹²⁹ Moreover, NRMSIRs have received compensation for providing copies of continuing disclosure documents to persons who request them. Thus, one or more NRMSIRs possibly could be adversely affected by the proposal, if they no longer have available to them a steady flow of funds from providing for a fee copies of continuing disclosure documents to persons who request them. As a result of the proposed amendments, a NRMSIR could find that it would have to revise its current manner of doing business or face a significant downturn in its business

¹²⁹ In responding to the MSRB's proposed rule change to revise its MSIL system, one NRMSIR expressed concern about the MSRB's proposed competition with vendors to offer what it viewed as value-added features and services relating to disclosure documents. This NRMSIR stated that, if the MSRB were permitted to offer value-added content and features in connection with its proposed Internet-based portal for disclosure documents, it would inflict economic harm on existing data vendors. See DPC Data Letter, supra note 121.

operations. Vendors of information about municipal securities, other than NRMSIRs, also could be affected by the proposed amendments if the sole repository provides information electronically for no charge.

In addition, there would be just one repository, and not four NRMSIRs as is currently the case, if the Commission were to adopt the proposed Rule 15c2-12 amendments. Thus, the proposal could reduce competition with respect to services provided by NRMSIRs as information vendors. In addition to supplying municipal disclosure documents upon request, NRMSIRs also provide value-added market data services to municipal investors that incorporate continuing disclosure information. If NRMSIRs were adversely affected by the proposal to establish a single repository, it is possible that there could be a reduction in these value-added market data services relating to municipal securities or a loss of innovation in offering competing information services regarding municipal securities.

The Commission preliminarily does not believe that having a single repository would have a significant adverse effect on the ability or willingness of private information vendors to compete to create and market value-added data products. Commercial vendors could readily access the information made available by the repository to re-disseminate it or use it in whatever value-added products they may wish to provide. In fact, a single repository in which documents are submitted in an electronic format could encourage the private information vendors to disseminate municipal securities information by reducing the cost of entry into the information services market. Existing vendors could need to make some adjustments to their infrastructure or facilities. However, some vendors could determine that they no longer need to invest in the infrastructure and facilities necessary to collect and store continuing disclosure documents, and new entrants into the market would not need to obtain the information from multiple locations,

but rather could readily access such information from one centralized source. Thus, all vendors should be able to obtain easily continuing disclosure documents and should be able to compete in providing value-added services.

The Commission, therefore, preliminarily believes that any potential effect on competition that could result from the proposed amendments would be justified by the more efficient and effective process for the collection and availability of continuing disclosure documents. A single repository for the electronic collection and availability of these documents would foster the Exchange Act objective of promoting competition by simplifying the method of submission of continuing disclosure documents to one location and making the documents more readily accessible to investors and others by virtue of the documents being in an electronic format.

The Commission previously stated that it would specifically consider the competitive implications of the MSRB becoming a repository.¹³⁰ In addition, the Commission stated that if the Commission were to conclude that the MSRB's status as a repository might have adverse competitive implications, it would consider whether it should take any action to address these effects.¹³¹ As noted earlier, the Commission recognizes that competition with respect to certain information services regarding municipal securities that are provided by the existing NRMSIRs could decline should the MSRB become the central repository. The Commission believes that one of the benefits in having the MSRB be the sole repository would be its ability to provide a ready source of continuing disclosure documents to other information vendors who wish to use that information for their products. Private vendors could utilize the MSRB in its capacity as a

¹³⁰ See Securities Exchange Act Release No. 28081, supra note 55.

¹³¹ Id.

repository as a means to collect information from the continuing disclosure documents to create value-added products for their customers.

In addition, the Commission believes that the reasons it provided above regarding the competitive implications with respect to having a single repository similarly would apply if the MSRB were the sole repository. The Commission does not believe that there are competitive implications that would uniquely apply to the MSRB in its capacity as the sole repository as opposed to any another entity that could be the sole repository. In fact, the Commission believes that, if the MSRB were the sole repository, its status as an SRO would provide an additional level of Commission oversight, as changes to its rules relating to continuing disclosure documents would have to be filed for Commission consideration as a proposed rule change under Section 19(b) of the Exchange Act. Accordingly, the Commission believes that any competitive impact that could result from the MSRB's status as the sole repository would be justified by the benefits that such status could provide.

The Commission preliminarily believes that the proposed amendments could have a positive effect on capital formation by municipal securities issuers. The Rule is addressed to the obligations of broker-dealers participating in a primary offering of municipal securities (*i.e.*, Participating Underwriters). Because continuing disclosure documents would be submitted electronically to a single repository, investors and other market participants potentially could obtain information about these issuers more readily than they can today. They no longer would have to contact several NRMSIRs to make sure that they have obtained complete information about the municipal issuer. Easier access to continuing disclosure documents regarding municipal securities could provide investors and other market participants with more complete information about municipal issuers. Moreover, this ready availability of continuing disclosure

documents could encourage investors to consider purchasing new issuances of municipal securities because they could readily access information from a single repository and review that information in making an investment decision. As a result, the proposed amendments could help foster the Exchange Act goal of capital formation.

The Commission proposes to delete references to the SIDs in Rule 15c2-12. Since the Commission is now proposing to amend the Rule to provide for a single repository for the electronic collection and availability of continuing disclosure documents that the Commission believes would efficiently and effectively improve disclosure in the municipal securities market, the Commission believes that it is no longer necessary to require in the Rule that Participating Underwriters reasonably determine that issuers and obligated persons have contractually agreed to provide continuing disclosure documents to the SIDs.

The proposed amendments would not affect the legal obligations of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that are required under the appropriate state law. In addition, the proposed amendments would have no effect on the obligations of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to any effective date of the proposed amendments to the Rule to submit continuing disclosure documents to the appropriate SID, if any, as stated in their existing continuing disclosure agreements, nor on their obligation to make any other submissions that are required under the appropriate state law. The Commission preliminarily does not believe that its proposal to delete references to SIDs in Rule 15c2-12 would have any potential effect on efficiency, competition or capital formation.

Based on the analysis above, the Commission preliminarily believes that the proposed amendments to the Rule would not impose any burden on competition not necessary or

appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed amendments to the Rule would place a burden on competition, as well as the effect of the proposed amendments on efficiency, competition, and capital formation. The Commission specifically seeks comment on whether the proposed amendments would place a burden on competition or have an effect on efficiency, competition, and capital formation with respect to issuers, NRMSIRs or other vendors, the MSRB, broker-dealers, other market participants, investors, or others.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or “SBREFA,”¹³² the Commission must advise the OMB 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: (1) an annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of the proposed rule 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.

VIII. Regulatory Flexibility Act Certification

¹³² 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).

Section 603(a) of the Regulatory Flexibility Act¹³³ (“RFA”) requires the Commission to undertake an initial regulatory flexibility analysis of the proposed amendments to the Rule on small entities, unless the Commission certifies that the proposed amendments, if adopted, would not have a significant economic impact on a substantial number of small entities.¹³⁴

For purposes of Commission rulemaking in connection with the RFA, a broker-dealer is a small business if its total capital (net worth plus subordinated liabilities) on the last day of its most recent fiscal year was \$500,000 or less, and is not affiliated with any entity that is not a “small business.”¹³⁵ Some broker-dealers that would be subject to the proposed amendments meet these definitions of a “small business.” In addition, for purposes of Commission rulemaking in connection with the RFA, a “small business” may also include a municipal securities dealer that is a bank (including a separately identifiable department or division of a bank) which has total assets of less than \$10 million at all times during the preceding fiscal year; had an average monthly volume of municipal securities transactions in the preceding fiscal year of less than \$100,000; and is not affiliated with any entity that is not a “small business.”¹³⁶

The proposed amendments to the Rule would not substantively change any of the current obligations of broker-dealers or municipal securities dealers, except to the extent that they would have to reasonably determine that the issuer or obligated person has agreed in writing to provide continuing disclosure documents to a single repository instead of to multiple NRMSIRs. The paperwork burden for broker-dealers or municipal securities dealers would not be altered by the proposed amendments, except to the extent that the firm’s compliance attorney would need to

¹³³ 5 U.S.C. 603(a).

¹³⁴ 5 U.S.C. 605(b).

¹³⁵ 17 CFR 240.0-10(c).

¹³⁶ 17 CFR 240. 0-10(f).

prepare and issue a notice to members or a memorandum explaining the impact of the proposed amendments to pertinent personnel, if the proposal is adopted by the Commission.¹³⁷

For purposes of Commission rulemaking in connection with the RFA, an issuer or person, other than an investment company, is a “small business” or “small organization” if its “total assets on the last day of its most recent fiscal year were \$5 million or less.”¹³⁸ The Commission believes that at least three of the four NRMSIRs are part of large business entities that have assets in excess of \$5 million.¹³⁹ One of the current four NRMSIRs and possibly one or more vendors of continuing disclosure documents may be a “small business” for purposes of the RFA. As noted above, the proposed amendments could have a significant economic impact on the business model of one NRMSIR and possibly on the business models of one or more other vendors of municipal securities information. While the Commission acknowledges that the proposed amendments to the Rule could have a significant economic impact on certain vendors of municipal securities information, the Commission does not believe that the number of such vendors that could be affected by the proposed amendments represents a substantial number of small businesses.

In addition, the Commission believes that two of the three SIDS may be a “small business” or “small organization” for purposes of the RFA. The proposed amendments, however, would not affect any legal obligations issuers or obligated persons may have to provide continuing disclosure documents, along with any other submissions, to the appropriate SID, if any, that may be required under the appropriate state law.

¹³⁷ See Section IV.D.1., *supra*.

¹³⁸ 17 CFR 230.157. See also 17 CFR 240.0-10(a).

¹³⁹ Commission staff based this determination on its review of various public sources of financial information about these three NRMSIRs.

A “small governmental jurisdiction” is defined by the RFA to include “governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand.”¹⁴⁰ Since the Rule applies to primary offerings of municipal securities with an aggregate principal amount of at least \$1,000,000 or more, some issuances by small governmental jurisdictions would not be covered by the Rule. For those small issuers whose primary offerings of municipal securities are impacted by the Rule, the Commission notes that issuers of municipal securities currently are familiar with, and provide, pursuant to their continuing disclosure agreements, continuing disclosure documents. Under the proposal, issuers would submit, pursuant to their undertakings in continuing disclosure agreements, continuing disclosure documents to the MSRB in an electronic format and accompanied by identifying information, instead of to each of the four existing NRMSIRs. Accordingly, to the extent a small governmental jurisdiction has conducted a primary offering of municipal securities for which a Participating Underwriter has reasonably determined that the issuer has entered into a contractual undertaking covered by the Rule, its continuing disclosure documents would be submitted to one repository, instead of multiple ones as is the case today, and thus the small governmental jurisdiction would incur no significant additional economic impact as a result of the proposed amendments to the Rule. The Commission believes that many municipal issuers currently have the capability to convert paper documents to electronic documents. Those small governmental jurisdictions that: (i) do not have continuing disclosure information in an electronic format; or (ii) do not have the internal means to convert continuing disclosure information into an electronic format, would have to incur a cost to convert their paper documents into an electronic file.¹⁴¹

Although some small governmental jurisdictions could incur costs to submit documents

¹⁴⁰ 5 U.S.C. 601(5).

¹⁴¹ See Section V.B., *supra*.

electronically to a single repository, the Commission does not believe that these costs would result in a significant economic impact for a substantial number of small governmental jurisdictions.¹⁴²

In the Commission's view, the proposed amendments would not have a significant economic impact on a substantial number of small entities, including broker-dealers, municipal securities dealers, small governmental jurisdictions, NRMSIRs and other vendors of municipal disclosure documents, SIDs, or other small businesses or small organizations. For the above reasons, the Commission certifies that the proposed amendment to the Rule would not have a significant economic impact on a substantial number of small entities. The Commission requests comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities, including broker-dealers and municipal securities dealers, small governmental jurisdictions, NRMSIRs and other vendors of municipal disclosure documents, SIDS, or other small businesses or small organizations, and provide empirical data to support the extent of the impact.

IX. Statutory Authority

Pursuant to the Exchange Act, and particularly Sections 3(b), 15(c), 15B and 23(a)(1) thereof, 15 U.S.C. 78c(b), 78o(c), 78o-4, and 78w(a)(1), the Commission is proposing amendments to § 240.15c2-12 of Title 17 of the Code of Federal Regulations in the manner set forth below.

Text of Proposed Rule Amendments

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

¹⁴² Id.

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

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

1. The general authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.15c2-12 is amended by the following:

- A. Revise the text of paragraph (b)(4)(ii), the introductory text of paragraph (b)(5)(i), and paragraphs (b)(5)(i)(A) and (B);
- B. In the introductory text of paragraph (b)(5)(i)(C) and in paragraph (b)(5)(i)(D) remove the phrase “to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any,”;
- C. In paragraph (b)(5)(ii)(C) remove the phrase “, and to whom it will be provided”;
- D. Add new paragraph (b)(5)(iv);
- E. Revise the introductory text of paragraph (d)(2)(ii) and paragraphs (d)(2)(ii)(A) and (B);

F. Add new paragraph (d)(2)(ii)(C); and

G. Revise paragraphs (f)(3) and (f)(9).

The additions and revisions read as follows.

§ 240.15c2-12 Municipal securities disclosure.

* * * * *

(b) * * *

(4) * * *

(ii) The time when the official statement is available to any person from the Municipal Securities Rulemaking Board, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board, either directly or indirectly through an indenture trustee or a designated agent:

(A) Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated

person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

* * * * *

(iv) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board.

(c) * * *

(d) * * *

(1) * * *

(2) * * *

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board:

(A) At least annually, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official

statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(C) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board; and

* * * * *

(f) * * *

(3) The term final official statement means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents

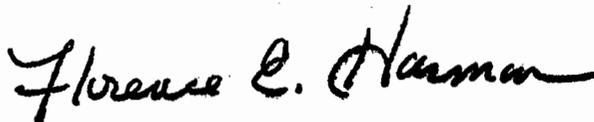
available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

* * * * *

(9) The term annual financial information means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

* * * * *

By the Commission.



Florence E. Harmon
Acting Secretary

Dated: July 30, 2008

*Commissioner Walter
not participating*

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58256; File No. SR-MSRB-2008-05)

July 30, 2008

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of Proposed Rule Change Relating to the Establishment of a Continuing Disclosure Service of the Electronic Municipal Market Access System (EMMA)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 29, 2008, the Municipal Securities Rulemaking Board ("MSRB") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

The MSRB is filing with the Commission a proposed rule change to establish a continuing disclosure service (the "continuing disclosure service") of the MSRB's Electronic Municipal Market Access system ("EMMA"). The continuing disclosure service would receive electronic submissions of, and would make publicly available on the Internet, continuing disclosure documents and related information from issuers, obligated persons and their agents pursuant to continuing disclosure undertakings entered into consistent with Exchange Act Rule 15c2-12. The MSRB requests approval of the continuing disclosure service to commence operation on the later of January 1, 2009 or

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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the effective date of any provisions of Rule 15c2-12 providing for the MSRB to serve as the sole central repository for all electronic continuing disclosure information provided pursuant to Rule 15c2-12.

The text of the proposed rule change is available on the MSRB's Web site at www.msrb.org/msrb1/sec.asp, at the MSRB's principal office, and at the Commission's Public Reference Room. If approved, the rule text for the continuing disclosure service of EMMA would be available on the MSRB's Web site at www.msrb.org/msrb1/rulesandforms under the heading Information Facilities.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, the MSRB included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The proposed rule change would establish, as a component of EMMA, the continuing disclosure service for the receipt of, and for making available to the public of, continuing disclosure documents and related information to be submitted by issuers, obligated persons and their agents pursuant to continuing disclosure undertakings entered

into consistent with Rule 15c2-12.³ As proposed, all continuing disclosure documents and related information would be submitted to the MSRB, free of charge, through an Internet-based electronic submitter interface or electronic computer-to-computer data connection, at the election of the submitter, and public access to the documents and information would be provided through the continuing disclosure service on the Internet (the “EMMA portal”) at no charge as well as through a paid real-time data stream subscription service.⁴

Under Rule 15c2-12(b)(5), an underwriter for a primary offering of municipal securities subject to the rule currently is prohibited from underwriting the offering unless the underwriter has determined that the issuer or an obligated person⁵ for whom financial information or operating data is presented in the final official statement has undertaken in writing to provide certain items of information to the marketplace.⁶ Rule 15c2-12(b)(5) provides that such items include: (A) annual financial information concerning obligated

³ EMMA was originally established, and began operation on March 31, 2008, as a complementary pilot facility of the MSRB’s existing Official Statement and Advance Refunding Document (OS/ARD) system of the Municipal Securities Information Library (MSIL) system. See Securities Exchange Act Release No. 57577 (March 28, 2008), 73 FR 18022 (April 2, 2008) (File No. SR-MSRB-2007-06) (approving operation of the EMMA pilot to provide free public access to the MSIL system collection of official statements and advance refunding documents and to the MSRB’s Real-Time Transaction Reporting System historical and real-time transaction price data) (the “Pilot Filing”).

⁴ The pilot EMMA portal currently is accessible at emma.msrb.org.

⁵ Rule 15c2-12(f)(10) defines “obligated person” as any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities sold in a primary offering (other than providers of bond insurance, letters of credit, or other liquidity facilities).

⁶ See also Rule 15c2-12(d)(2).

persons;⁷ (B) audited financial statements for obligated persons if available and if not included in the annual financial information; (C) notices of certain events, if material;⁸ and (D) notices of failures to provide annual financial information on or before the date specified in the written undertaking.⁹

⁷ Rule 15c2-12(f)(9) defines “annual financial information” as financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis.

⁸ Under Rule 15c2-12(b)(5)(C), such events currently consist of principal and interest payment delinquencies; non-payment related defaults; unscheduled draws on debt service reserves reflecting financial difficulties; unscheduled draws on credit enhancements reflecting financial difficulties; substitution of credit or liquidity providers, or their failure to perform; adverse tax opinions or events affecting the tax-exempt status of the security; modifications to rights of security holders; bond calls; defeasances; release, substitution, or sale of property securing repayment of the securities; and rating changes.

⁹ Under Rule 15c2-12(b)(5)(i), annual filings are to be sent to all existing nationally recognized municipal securities information repositories (“NRMSIRs”) and any applicable state information depositories (“SIDs”), while material event notices may be sent to all existing NRMSIRs or to the MSRB, as well as to any SIDs. The MSRB, which currently operates CDINet to process and disseminate notices of material events submitted to the MSRB, previously petitioned the Commission to amend Rule 15c2-12 to remove the MSRB as a recipient of material event notices due to the very limited level of submissions received by the MSRB, constituting a negligible percentage of material event notices currently provided to the marketplace. See Letter from Diane G. Klinke, General Counsel, MSRB, to Jonathan G. Katz, Secretary, Commission, dated September 8, 2005. The Commission has published proposed amendments to Rule 15c2-12 to this effect. See Exchange Act Release No. 54863 (December 4, 2006), 71 Fed. Reg. 71109 (December 8, 2006). In light of this proposed rule change, the MSRB is considering at this time whether to withdraw its petition. In addition, the MSRB intends, on a future date, to file a proposed rule change with the Commission for permission to discontinue CDINet in view of the establishment of EMMA’s continuing disclosure service.

As proposed, the continuing disclosure service would accept submissions of (i) continuing disclosure documents as described in Rule 15c2-12, and (ii) other disclosure documents specified in continuing disclosure undertakings entered into consistent with Rule 15c2-12 but not specifically described in Rule 15c2-12. In connection with documents submitted to the continuing disclosure service, the submitter would provide, at the time of submission, information necessary to accurately identify: (i) the category of information being provided; (ii) the period covered by any annual financial information, financial statements or other financial information or operating data; (iii) the issues or specific securities to which such document is related or otherwise material (including CUSIP number, issuer name, state, issue description/securities name, dated date, maturity date, and/or coupon rate); (iv) the name of any obligated person other than the issuer; (v) the name and date of the document; and (vi) contact information for the submitter. Submitters would be responsible for the accuracy and completeness of all documents and information submitted to EMMA.

The MSRB proposes that submissions to the continuing disclosure service be made as portable document format (PDF) files configured to permit documents to be saved, viewed, printed and retransmitted by electronic means. If the submitted file is a reproduction of the original document, the submitted file must maintain the graphical and textual integrity of the original document. In addition, starting in the first calendar quarter beginning at least nine months after approval by the Commission of this filing, such PDF files must be word-searchable (that is, allowing the user to search for specific terms used within the document through a search or find function available in most standard software packages), provided that diagrams, images and other non-textual

elements would not be required to be word-searchable due to current technical hurdles to uniformly producing such elements in word-searchable form without incurring undue costs. Although the MSRB would strongly encourage submitters to immediately begin making submissions as word-searchable PDF files (preferably as native PDF or PDF normal files, which generally produce smaller and more easily downloadable files as compared to scanned PDF files), implementation of this requirement would be deferred as noted above to provide issuers, obligated persons and their agents with sufficient time to adapt their processes and systems to provide for the routine creation or conversion of continuing disclosure documents as word-searchable PDF files.

All submissions to the continuing disclosure service pursuant to this proposal would be made through password protected accounts on EMMA by: (i) issuers, which may submit any documents with respect to their municipal securities; (ii) obligated persons, which may submit any documents with respect to any municipal securities for which they are obligated; and (iii) designated agents, which may be designated by issuers or obligated persons to make submissions on their behalf. Issuers and obligated persons would be permitted under the proposal to designate agents to submit documents and information on their behalf, and would be able to revoke the designation of any such agents, through the EMMA on-line account management utility. Such designated agents would be required to register to obtain password-protected accounts on EMMA in order to make submissions on behalf of the designating issuers or obligated persons. Any party identified in a continuing disclosure undertaking as a dissemination agent or other party responsible for disseminating continuing disclosure documents on behalf of an issuer or obligated person would be permitted to act as a designated agent for such issuer or

obligated person, without a designation being made by the issuer or obligated person as described above, if such party certifies through the EMMA on-line account management utility that it is authorized to disseminate continuing disclosure documents on behalf of the issuer or obligated person under the continuing disclosure undertaking. The issuer or obligated person, through the EMMA on-line account management utility, would be able to revoke the authority of such party to act as a designated agent.

As proposed, electronic submissions of continuing disclosure documents through the continuing disclosure service would be made by issuers, obligated persons and their agents, at no charge, through secured, password-protected interfaces. Continuing disclosure submitters would have a choice of making submissions to the proposed continuing disclosure service either through a Web-based electronic submission interface or through electronic computer-to-computer data connections with EMMA designed to receive submissions on a bulk or continuous basis.

All documents and information submitted through the continuing disclosure service pursuant to this proposed rule change would be available to the public for free through the EMMA portal on the Internet, with documents made available for the life of the securities as PDF files for viewing, printing and downloading.¹⁰ As proposed, the EMMA portal would provide on-line search functions to enable users to readily identify and access documents that relate to specific municipal securities based on a broad range of search parameters. In addition, the MSRB proposes that real-time data stream subscriptions to continuing disclosure documents submitted to EMMA would be made

¹⁰ The MSRB understands that software currently is generally available for free that permits users to save, view and print PDF files, as well as to conduct word searches in word-searchable PDF documents. The MSRB would provide links for downloading such software on the EMMA portal.

available for a fee.¹¹ The MSRB would not be responsible for the content of the information or documents submitted by submitters displayed on the EMMA portal or distributed to subscribers through the continuing disclosure subscription service.

The MSRB has designed EMMA, including the EMMA portal, as a scalable system with sufficient current capacity and the ability to add further capacity to meet foreseeable usage levels based on reasonable estimates of expected usage, and the MSRB would monitor usage levels in order to assure continued capacity in the future.

The MSRB may restrict or terminate malicious, illegal or abusive usage for such periods as may be necessary and appropriate to ensure continuous and efficient access to the EMMA portal and to maintain the integrity of EMMA and its operational components. Such usage may include, without limitation, usage intended to cause the EMMA portal to become inaccessible by other users, to cause the EMMA database or operational components to become corrupted or otherwise unusable, to alter the appearance or functionality of the EMMA portal, or to hyperlink to or otherwise use the EMMA portal or the information provided through the EMMA portal in furtherance of fraudulent or other illegal activities (such as, for example, creating any inference of MSRB complicity with or approval of such fraudulent or illegal activities or creating a false impression that information used to further such fraudulent or illegal activities has been obtained from the MSRB or EMMA). Measures taken by the MSRB in response to such unacceptable usage shall be designed to minimize any potentially negative impact on the ability to access the EMMA portal.

¹¹ Fees for subscriptions to the continuing disclosure collection would be established in a separate filing to be submitted to the Commission pursuant to Section 19(b)(2) of the Exchange Act prior to the commencement of operation of the continuing disclosure service, if approved by the Commission.

2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act,¹² which provides that the MSRB's rules shall:

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.

The MSRB believes that the proposed rule change is consistent with the Act. The continuing disclosure service would serve as an additional mechanism by which the MSRB works toward removing impediments to and helping to perfect the mechanisms of a free and open market in municipal securities. The continuing disclosure service would help make information useful for making investment decisions more easily available to all participants in the municipal securities market on an equal basis throughout the life of the securities without charge through a centralized, searchable Internet-based repository, thereby removing potential barriers to obtaining such information. Broad access to continuing disclosure documents through the continuing disclosure service should assist in preventing fraudulent and manipulative acts and practices by improving the opportunity for public investors to access material information about issuers and their securities.

¹² 15 U.S.C. 78o-4(b)(2)(C).

Furthermore, the continuing disclosure service should reduce the effort necessary for issuers and obligated persons to comply with their continuing disclosure undertakings by making submissions to a single venue¹³ using an electronic submission process, which should result in lower costs to issuers and savings to their citizens. Similarly, a single centralized and searchable venue for free public access to disclosure information should promote a more fair and efficient municipal securities market in which transactions are effected on the basis of material information available to all parties to such transactions, which should allow for fairer pricing of transactions based on a more complete understanding of the terms of the securities and the potential investment risks. Free access to this information – previously available in most cases only through paid subscription services or on a per-document fee basis – should reduce transaction costs for dealers and investors.

All of these factors serve to promote the statutory mandate of the MSRB to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The MSRB does not believe that the proposed rule change would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Documents and information provided through the continuing disclosure service would be available to all persons simultaneously. In addition to making the documents and information available for free on the EMMA portal to all members of the public, the MSRB would make such documents and information available by subscription on an

¹³ Some states may require issuers and/or obligated persons to submit disclosure information to state information depositories or other venues pursuant to state law.

equal and non-discriminatory basis without imposing restrictions on subscribers from, or imposing additional charges on subscribers for, re-disseminating such documents or otherwise offering value-added services and products based on such documents on terms determined by each subscriber.

The MSRB has considered carefully a commentator's concern regarding the MSRB's plans to develop EMMA,¹⁴ as well as expressions of interest from private enterprises in entering this market.¹⁵ One commentator on the Pilot Filing¹⁶ stated that the MSRB's intention to combine continuing disclosures with primary market disclosures and trade price data "breaks new ground among regulatory bodies in terms of value-added content available to the public at no charge," arguing that the MSRB would "effectively take over the business of providing value-added content."¹⁷ Another

¹⁴ See comments from Peter J. Schmitt, CEO, DPC DATA Inc. ("DPC"), dated January 23, 2008.

¹⁵ See letter from Philip C. Moyer, CEO, EDGAR Online, Inc. ("EDGAR Online"), to Ernesto A. Lanza, Senior Associate General Counsel, MSRB, dated December 17, 2007. In addition, the MSRB has received several inquiries through the pilot EMMA portal's feedback (emma.msrb.org/AboutEMMA/Feedback.aspx) and contact (emma.msrb.org/AboutEMMA/ContactUs.aspx) Web forms from members of the public seeking information on using EMMA documents and data, through the EMMA portal or subscription services, for the purposes of re-dissemination to their customers.

¹⁶ See footnote 3 *supra*.

¹⁷ See comments of DPC. DPC further stated, "There is precedent of other Self-Regulatory Organizations (SROs) offering such sophisticated value-added information to the market, but only on a fee basis." DPC also states that "the MSRB's sample pilot portal at www.msrb.org/msrb1/accessportal/SampleComprehensiveDisclosureDisplay.htm provides a glimpse of specific value-added features the MSRB intends to offer the public free of charge. Among these are nine-digit CUSIP searches, hyperlinks to bond issuers Web sites, an 'alerts' service to users of the portal, sophisticated document viewing options, links to other related documents in the portals disclosure archive, and subsequent event notifications that equate to custom

commentator on the Pilot Filing argued in favor of the creation of a “publicly accessible storage and dissemination system” for all filings in the municipal securities market, stating that the current municipal securities disclosure model “severely limits innovation and access” to disclosures and “locks up public documents in private hands while the proposed portal run by a public entity will encourage transparency in the municipal securities market and create a healthy ecosystem of information that will ultimately benefit both the investment community and the municipalities that seek access to public markets.”¹⁸

The MSRB believes that the availability of continuing disclosure documents through the EMMA portal and the continuing disclosure subscription service, without the imposition of limitations on or additional charges for redistribution of such documents to customers, clients or other end-users of the subscriber,¹⁹ would promote competition among private data vendors and other enterprises engaged in or interested in becoming engaged in information services by eliminating existing barriers to new entrants into the

research. These features and capabilities are well in excess of the system that the MSRB has pointed to as its model, the SEC’s own EDGAR.”

¹⁸ See letter from EDGAR Online. EDGAR Online further stated, “In spite of a great deal of work by the Municipal Issuers on their disclosures – a small group of companies control access for the entire market to the documents that are supposed to be public.... The rigid control of public information dissuades other information providers from trying to enter or innovate for this market. This means that there are few people working on improving ease of use, depth of analysis, thoroughness of information or more effective means of delivery.... The process of managing these documents consumes most of the resources of these few information providers and the time of investors. As a result, the information contained in these documents – risks and opportunities – are usually lost because there are few sources of good comparability and data.”

¹⁹ The MSRB notes that subscribers may be subject to proprietary rights of third parties in information provided by such third parties that is made available through the subscription.

market for municipal securities information services. Private enterprises would be able to obtain a complete collection of all continuing disclosure documents submitted by issuers, obligated persons and their agents as contemplated by Exchange Act Rule 15c2-12 from a single source using a single consistent indexing method since all such documents would be submitted to the continuing disclosure service and would be indexed as received using a single indexing logic. Currently, parties wishing to obtain a complete collection of continuing disclosure documents must consider whether continuing disclosure documents have been uniformly provided to all existing nationally recognized municipal securities information repositories as contemplated under Rule 15c2-12 and, if not, might need to undertake the effort and expense of obtaining continuing disclosure documents from two or more of the existing sources, which may have differing terms of use that may limit the ability to re-disseminate such documents.

Furthermore, the availability of all continuing disclosure documents in a defined electronic format in one venue should make document handling, storage and dissemination more efficient than under the current situation in which documents may exist in paper form as well as in various different electronic formats. The existence of a single consistent indexing logic to be used by the continuing disclosure service, and the inclusion of key indexing information on the EMMA portal and in the continuing disclosure subscription service, would relieve the burden that private information vendors would otherwise have of creating such an index. The standardized continuing disclosure document collection and indexing information provided through the continuing disclosure service would be available equally to existing information vendors and parties seeking to enter the market, thereby promoting competition among all such private

parties in a non-discriminatory manner with respect to the value-added services they may wish to offer based on the continuing disclosure document collection. Such parties would likely bear some initial burden of ensuring that their infrastructure and facilities are capable of receiving and processing the information provided through the continuing disclosure service, but the MSRB believes that such parties would realize savings from the efficiencies described above.

Thus, although the MSRB recognizes that the continuing disclosure service might require private enterprises to modify some aspects of the way they undertake their current business activities, the MSRB believes that the continuing disclosure service would promote, rather than hinder, further competition, growth and innovation in this area. The MSRB further believes that the operation by the MSRB of the continuing disclosure service would not result in the MSRB taking over the business of providing value-added content but instead serve as a basis on which private enterprises could themselves concentrate more of their resources on developing and marketing value-added services. The MSRB believes that much of the impact of the proposed rule change on commercial enterprises would result from the increased competition in the marketplace resulting from the entry of additional commercial enterprises in competition with such existing market participants with respect to value-added services, rather than from the operation of the continuing disclosure service as a source of the raw documents and related information to the public. The MSRB believes that the benefits realized by the investing public from the broader and easier availability of disclosure information about municipal securities that would be provided through the continuing disclosure service would justify any potentially negative impact on existing enterprises from the operation of EMMA.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In a notice published by the MSRB on January 31, 2008, the MSRB described its plan for implementing a continuing disclosure service that would be integrated into other services to be offered through EMMA (the "2008 Notice").²⁰ In particular, the MSRB stated its plan to institute the continuing disclosure service to accept submissions of continuing disclosure information in a designated electronic format directly from issuers, obligated persons and their designated agents acting on their behalf. EMMA's continuing disclosure service would be designed to accept such electronic submissions, including basic indexing information, either through a Web-based interface or by computer-to-computer upload or data stream. In addition to making continuing disclosures available through the EMMA portal, the MSRB would make such disclosures available through a paid real-time data stream subscription for re-dissemination or other use by subscribers. In publishing the 2008 Notice, the MSRB sought comment on certain basic elements relating to the incorporation into EMMA of continuing disclosure information provided by issuers and obligated persons under Rule 15c2-12, as discussed below. The 2008 Notice had been published by the MSRB following a series of other notices for comment (the "Prior Notices")²¹ and the filing with the Commission of the Pilot Filing in connection with the establishment of the MSRB's proposed centralized disclosure utility.

Several commentators on the Prior Notices discussed issues relating to continuing

²⁰ See MSRB Notice 2008-05 (January 31, 2008).

²¹ See MSRB Notice 2006-19 (July 27, 2006); MSRB Notice 2007-5 (January 25, 2007); MSRB Notice 2007-33 (November 15, 2007). Only those comments of the commentators on the Prior Notice and the Pilot Filing relating to the continuing disclosure service are discussed in this filing.

disclosure. These commentators stated that continuing disclosures should be made available on the same platform as other disclosures,²² with some commentators supporting the MSRB's willingness to establish a comprehensive disclosure system that included continuing disclosure.²³ The MSRB's plan to establish the continuing disclosure service as a component of EMMA would ensure that continuing disclosure documents would be made available to the public through the EMMA portal.

A commentator on the Pilot Filing suggested that, if the Commission were to make the MSRB the sole secondary market disclosure filing venue for issuers and obligated persons, the Commission would move "closer to the Tower Amendment danger zone."²⁴ As noted in section 3(b) of this filing, the MSRB believes that the continuing disclosure service is consistent with the MSRB's statutory mandate under Section 15B of the Act. In particular, the MSRB believes that the operation of the continuing disclosure service would in no way violate the restrictions placed on the MSRB's activities by the so-called Tower Amendment.²⁵ The MSRB believes that the proposed continuing

²² See letters from Leslie Norwood, Vice President and Assistant General Counsel, Bond Market Association (now known as Securities Industry and Financial Markets Association, or "SIFMA"), to Mr. Lanza, dated September 15, 2006; Thomas Sargant, President, Regional Municipal Operations Association, to Mr. Lanza, dated September 27, 2006; Gary P. Machak, Chairman, Municipal Advisory Council of Texas, to Mr. Lanza, dated September 14, 2006; Elizabeth R. Krentzman, General Counsel, Investment Company Institute ("ICI"), to Mr. Lanza, dated September 14, 2006; Ruth Brod, Consultant, TRB Associates, to Mr. Lanza, dated September 14, 2006; Terry L. Atkinson, Managing Director, UBS Securities LLC, to Mr. Lanza, dated September 15, 2006.

²³ See letters from Ms. Norwood, Managing Director and Associate General Counsel, SIFMA, to Mr. Lanza, dated December 14, 2007; S. Lauren Heyne, Chief Compliance Officer, R.W. Smith & Associates, Inc., to Mr. Lanza, dated December 17, 2007.

²⁴ See comments of DPC. See also footnote 14 *supra*.

²⁵ See Exchange Act Section 15B(d).

disclosure service is consistent with the MSRB's mandate under the Act to adopt rules that, among other things, protect investors and the public interest by providing a free centralized source of information for retail investors.

As discussed in greater detail in section 4 of this filing, this commentator also stated that the MSRB's intention to combine continuing disclosures with primary market disclosures and trade price data "breaks new ground among regulatory bodies in terms of value-added content available to the public at no charge," expressing the view that the MSRB would "effectively take over the business of providing value-added content."²⁶

Another commentator on the Pilot Filing argued in favor of the creation of a "publicly accessible storage and dissemination system" for all filings in the municipal securities market, stating that the current municipal securities disclosure model "severely limits innovation and access" to disclosures and "locks up public documents in private hands while the proposed portal run by a public entity will encourage transparency in the municipal securities market and create a healthy ecosystem of information that will ultimately benefit both the investment community and the municipalities that seek access to public markets."²⁷

As discussed in greater detail in section 4 of this filing, the MSRB believes that the operation by the MSRB of the continuing disclosure service would not result in the MSRB taking over the business of providing value-added content but instead serve as a basis on which private enterprises could themselves concentrate more of their resources on developing and marketing value-added services. The MSRB believes that much of the impact of the proposed rule change on commercial enterprises would result from the

²⁶ See comments of DPC.

²⁷ See letter from EDGAR Online. See also footnote 15 *supra*.

increased competition in the marketplace resulting from the entry of additional commercial enterprises in competition with such existing market participants with respect to value-added services, rather than from the operation of continuing disclosure service as a source of the raw documents and related information to the public. Although the MSRB recognizes that the continuing disclosure service might require private enterprises to modify some aspects of the way they undertake their current business activities, the MSRB believes that the continuing disclosure service would promote, rather than hinder, further competition, growth and innovation in this area.

Most commentators on the 2008 Notice were supportive of the MSRB's decision to begin planning for the continuing disclosure service,²⁸ although some commentators would not commit fully to support this process until reviewing possible Commission amendments to Rule 15c2-12 necessary for the development of the MSRB's continuing

²⁸ See letters from Rob Yolland, Chairman, National Federation of Municipal Analysts, to Mr. Lanza, dated March 10, 2008; Kathleen A. Aho, President, National Association of Independent Public Finance Advisors ("NAIPFA"), to Lynnette Hotchkiss, Executive Director, MSRB, dated March 10, 2008; Robert Donovan, Executive Director, Rhode Island Health and Educational Building Corporation, Stephen M. Fillebrown, Director of Research, Investor Relations and Compliance, NJ Health Care Facilities Financing Authority, and Charles A. Samuels and Meghan B. Burke, Mintz Levin Cohn Ferris Glovsky and Popeo PC, on behalf of National Association of Health and Educational Facilities Finance Authorities ("NAHEFFA"), to Mr. Lanza, dated March 3, 2008; Cristeena G. Naser, Senior Counsel, American Bankers Association, to Mr. Lanza, dated February 28, 2008; Rick Farrell, Executive Director, Council of Infrastructure Financing Authorities ("CIFA"), to Mr. Lanza, dated February 25, 2008; Jack Addams, Managing Director, First Southwest Company ("First Southwest"), to Mr. Lanza, dated February 25, 2008; Jeffrey L. Esser, Executive Director and CEO, Government Finance Officers Association ("GFOA"), Vernon L. Larson, President, National Association of State Auditors, Comptrollers and Treasurers ("NASACT"), & South Dakota State Treasurer, and Lynn Jenkins, President, National Association of State Treasurers ("NAST"), & Kansas State Treasurer, jointly, to Mr. Lanza, dated February 25, 2008; Heather Traeger, Assistant Counsel, ICI, to Mr. Lanza, dated February 25, 2008; Ms. Norwood, SIFMA, to Mr. Lanza, dated February 25, 2008.

disclosure service, as well as specific details relating to the implementation by the MSRB of the proposed continuing disclosure service.²⁹ Commentators representative of issuers encouraged the MSRB to work with the issuer community in developing the submission process.³⁰ The MSRB has participated in a series of meetings and demonstrations with issuer organizations to discuss the development of EMMA, including the continuing disclosure service. The MSRB would continue to work with the issuer community, as well as with the other relevant segments of the municipal securities marketplace, as development of the continuing disclosure service proceeds. In addition, the MSRB intends to work with issuer organizations to assist issuers in adapting to the process for submitting continuing disclosure documents to EMMA, including coordinated efforts targeted at issuers making submissions under continuing disclosure undertakings entered into prior to the continuing disclosure service becoming operational, with a view to ensuring that means for making submissions of continuing disclosure documents through EMMA are available for issuers that have not yet fully adapted to EMMA's all-electronic submission process.

One commentator asked whether periodic filings other than submissions of annual financial information, such as quarterly or monthly financial results, would be accepted.³¹ A second commentator sought clarification on whether continuing disclosure information for offerings sold prior to the launch of the continuing disclosure service would be

²⁹ See letters from CIFA; GFOA, NASACT and NAST; NAHEFFA; NAIPFA. GFOA, NASACT and NAST also stated, and NAHEFFA agreed, that "Rule 15c2-12 should only be changed to allow for electronic submission of disclosure documents to one central location, and that no other changes to the Rule should be made."

³⁰ See letters from CIFA; GFOA, NASACT and NAST; NAHEFFA.

³¹ See letter from NAHEFFA.

accepted and made publicly available.³² Another commentator asked whether historical documents would be included.³³

The MSRB understands that issuers and obligated persons have often sought to disseminate to the marketplace items of continuing disclosure that are in addition to the specific items of continuing disclosure described in Rule 15c2-12. Such additional items may include, but are not limited to, quarterly or monthly financial information and notices of other events. In some cases such additional items of disclosure may be specified under a continuing disclosure undertaking entered into consistent with Rule 15c2-12. The continuing disclosure documents to be made publicly available through the EMMA portal would consist of the specific items of continuing disclosure described in Rule 15c2-12 and any additional disclosure items as specifically set forth in a continuing disclosure undertaking.³⁴ Continuing disclosure documents would be made available for any issue for which such documents have been submitted to EMMA, regardless of whether the continuing disclosure undertaking was entered into before or after the establishment of the continuing disclosure service. EMMA would make available only those continuing disclosures submitted to EMMA on or after the launch of the continuing disclosure service.³⁵

³² See letter from J. Foster Clark, President, National Association of Bond Lawyers (“NABL”), to Mr. Lanza, dated February 25, 2008.

³³ See letter from First Southwest.

³⁴ The MSRB supports the dissemination of additional continuing disclosures beyond the baseline established by Rule 15c2-12 and may consider in the future the possible expansion of the continuing disclosure service to include additional voluntary secondary market disclosures, which would be the subject of future filings with the Commission.

³⁵ While EMMA would not include historical documents, the continuing disclosure documents that would be received by EMMA through the continuing disclosure

One commentator asked whether all continuing disclosure documents and information would be available for free on the EMMA portal or whether some portions would only be available to paid subscribers.³⁶ Other commentators sought clarification on the timing of information that would be provided through a subscription as compared to the time of posting the information on the EMMA portal.³⁷ As noted in this filing, all continuing disclosures received by the MSRB would be accessible for free on the EMMA portal and would also be available, simultaneously with posting on the EMMA portal, through a data-stream subscription for a fee. The subscription would not provide any documents or information in addition to what is made public through the EMMA Web site.

A commentator asked whether special software or other arrangements would be necessary for issuers, obligated persons and their agents to make submissions of continuing disclosure documents. This commentator also asked whether submitters would be provided with electronic confirmation that disclosure materials were received by the continuing disclosure service.³⁸ Continuing disclosure documents may be converted from other electronic formats to PDF using various free or commercially available software programs or plug-ins. In those cases where the original continuing disclosure document exists solely in paper format (which the MSRB believes is not common and should become increasingly rare), submitters may use the services of widely available commercial copying and document handling enterprises or may use existing or

service would constitute the most up-to-date disclosures made by or on behalf of submitting issuers and obligated persons applicable to their securities.

³⁶ See letter from NABL.

³⁷ See letters from NAHEFFA; First Southwest.

³⁸ See letter from NAHEFFA.

newly acquired scanning hardware. The Web-based data-entry process that would be established for on-line submissions to the continuing disclosure service would require no special software other than a Web browser. Similarly, on-line uploads of data files in extensible markup language (XML) do not require any special software but would require programming to create XML files and to provide a process for accurately populating the XML files with necessary data. Computer-to-computer connections, an optional means for submitting continuing disclosures expected to be used primarily by agents acting on behalf of multiple issuers and/or obligated persons, would require submitters to use commercially available products or to undertake programming (at the election of the submitter) to interface with an EMMA Web service. All submission methods would provide appropriate feedback to submitters for error correction and submission confirmation purposes, which may require some programming by submitters to ensure they realize the full benefit of such feedback.

The 2008 Notice sought comment on whether the continuing disclosure service should accept continuing disclosure submissions from a third party with respect to an issuer's securities only if the issuer has affirmatively designated that such third party is authorized to act as its agent, or whether submissions from any registered EMMA user should be accepted on behalf of an issuer unless the issuer has affirmatively indicated that it wishes to take control over which parties can submit on its behalf.

Three commentators jointly stated that "third parties should be able to submit on behalf of an issuer if and only if the issuer has affirmatively designated the third party agent to do so [emphasis in original]."³⁹ Two other commentators agreed,⁴⁰ while

³⁹ See letter from GFOA, NASACT and NAST.

another disagreed,⁴¹ stating that it was “concerned that if EMMA does not accept continuing disclosure from a third party, unless an issuer specifically authorizes the third party to EMMA, there will be cases of issuer inaction preventing timely disclosure.”

This commentator stated that, to avoid potential delays in the dissemination of disclosure to the marketplace caused by a requirement that the issuer authorize an agent to act on its behalf, it believed that “the current practice set forth in the standard Municipal Secondary Market Disclosure Information Cover Sheet should be continued, which requires the person/entity submitting information to represent affirmatively that the person is authorized to submit the information.”⁴²

The MSRB believes that the ultimate authority to determine who may submit documents on behalf of the issuer or obligated person should lie with such issuer or obligated person and, as a result, the MSRB is proposing to provide that issuers and obligated persons may designate agents to submit documents and information on their behalf, and may revoke such designation, through the EMMA on-line account management utility, and such designated agents must register to obtain password-protected accounts on EMMA in order to make submissions on behalf of the designating issuers or obligated persons. Any party identified in a continuing disclosure undertaking as a dissemination agent or other party responsible for disseminating continuing disclosure documents or other disclosure documents specified pursuant to such continuing disclosure undertaking may also act as a designated agent for such issuer or

⁴⁰ See letters from NAHEFFA; First Southwest.

⁴¹ See second letter from SIFMA.

⁴² See second letter from SIFMA. The Cover Sheet referenced in the comment is a voluntary form created by industry participants for use in connection with submissions of continuing disclosures.

obligated person, without the necessity of the issuer or obligated person making a designation through the EMMA on-line account management utility, upon such party certifying through the EMMA on-line account management utility as to its authority to make submissions on behalf of the issuer or obligated person under the continuing disclosure undertaking. The issuer or obligated person, through the EMMA on-line account management utility, may revoke such authority to act as a designated agent.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

The MSRB has consented to an extension of the time period specified in Section 19(b)(2) of the Exchange Act to 120 days after the date of publication of notice of filing of this proposed rule change.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2008-05 on the subject line.

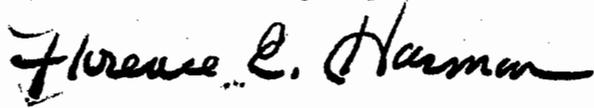
Paper comments:

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

All submissions should refer to File Number SR-MSRB-2008-05. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-MSRB-2008-05 and should be submitted on or before [insert date 45 days from publication in the Federal Register].

By the Commission.

A handwritten signature in black ink that reads "Florence E. Harmon". The signature is written in a cursive style with a large, prominent "F" and "H".

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2761 / July 30, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28344 / July 30, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13107

In the Matter of

**Pax World Management
Corp.,**

Respondent.

**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)
AND 203(k) OF THE INVESTMENT
ADVISERS ACT OF 1940 AND
SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF
1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Pax World Management Corp. ("Pax World" or "Respondent") pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to

document 18 of 22

Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

A. Summary

1. At all relevant times, investment adviser Pax World represented to investors and to the boards of the mutual funds it advised (the "Pax World Funds" or the "Funds") that it complied with various "socially responsible investing" ("SRI") restrictions, including, among other things, that it would not purchase for the Funds securities issued by companies that derived revenue from the manufacture of weapons, alcohol, tobacco or gambling products. Pax World acted contrary to these representations and violated the Funds' SRI restrictions from 2001 through 2005 when it purchased for the Pax World Growth and High Yield Funds ten securities that these Funds' SRI restrictions prohibited them from buying, including securities of companies that: (1) derived revenue from the manufacture of alcohol and/or gambling products; (2) derived more than 5% of their revenue from contracts with the U.S. Department of Defense; and (3) failed to satisfy the Funds' environmental or labor standards. During this period, Pax World also failed to consistently follow its own SRI-related policies and procedures with respect to these two funds that required that all securities be screened by Pax World's Social Research Department prior to purchase to ensure compliance with the SRI disclosures. In addition, during this period, Pax World did not consistently adhere to other SRI-related policies and procedures, including continuously monitoring fund holdings. As a result of conduct during the period from 2001 through 2005, the Pax World Funds held at least one prohibited security at all times from 2001 through early 2006.

B. Respondent

2. **Pax World** (SEC File No. 801-8517) is a private Delaware corporation with its headquarters in Portsmouth, New Hampshire. Pax World has been an investment adviser registered with the Commission since 1972 and provides investment advisory services to the four Pax World Funds, each of which is an investment company registered with the Commission.

C. Other Relevant Entities

3. **Pax World Funds** included at all relevant times the Pax World Balanced Fund (established in 1971), the Pax World Growth Fund (established in 1997), the Pax World High Yield Fund (established in 1999) and the Pax World Money Market Fund

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.

(established in 1998). At all relevant times, each of the Funds was a Delaware corporation headquartered in Portsmouth, New Hampshire, and each is an investment company registered with the Commission. In 2005, the Balanced Fund had approximately \$1.9 billion, the Growth Fund approximately \$100 million and the High Yield Fund approximately \$70 million in assets under management.

D. Facts

Pax World's Socially Responsible Investment Products

4. Pax World provides investment advisory services to Pax World Funds. At all relevant times, the Funds offered what are often referred to as SRI investment products. In addition, Pax World prepared and filed with the Commission the prospectuses, statements of additional information ("SAIs"), and other filings on behalf of each of the Funds.

5. At all relevant times, Pax World described SRI as integrating personal and social values into investment decisions. SRI mutual funds typically have investment restrictions which exclude investments in companies that derive revenue from certain activities identified in the funds' prospectuses and SAIs. SRI mutual funds determine a company's compliance with their stated SRI restrictions by researching and analyzing the company's activities. This process is known as "screening." One of the primary services Pax World provides to the Funds is to screen companies and perform other services relating to the Funds' compliance with their SRI restrictions.

Pax World's SRI Disclosures

6. At all relevant times, the Pax World Funds' principal SRI restrictions prohibited investments in companies that derived revenue from the manufacture of weapons, weapons-related products, alcohol, tobacco or gambling and investments in companies that engaged in "military activities." These restrictions (commonly referred to by Pax World as "exclusions") applied to each of the Funds' investments, not only at the time of purchase but throughout the entire period the portfolios held them and could only be changed by a vote of the Funds' shareholders. Pax World described these and other of the Funds' SRI restrictions in the Funds' prospectuses and SAIs. For example, SAIs during the relevant period stated:

The ethical investment policy of each Fund is to exclude from its portfolio securities of (i) companies engaged in military activities, (ii) companies appearing on the United States Department of Defense list of 100 largest contractors (a copy of which may be obtained from the Office of the Secretary, Department of Defense, Washington, D.C. 20301) if five percent (5%) or more of the gross sales of such companies derived from contracts with the United States Department of Defense, (iii) other companies contracting with the United States Department of Defense if five percent (5%) or more of the gross sales of such companies are derived from contracts with the United States Department of Defense, and (iv)

companies that derive revenue from the manufacture of liquor, tobacco and/or gambling products.

The SAIs also stated:

The Funds' policy is to invest in securities of companies producing goods and services that improve the quality of life, and that are not, to any degree, engaged in manufacturing defense or weapons-related products or companies that derive revenue from the manufacture of tobacco, liquor and/or gambling products.

For over 33 years, we've subjected potential investments to rigid social- and environmental- responsibility screens in addition to rigorous financial scrutiny.

Pax World's SRI Screening Policies

7. Pax World's Social Research Department was responsible for developing social screening policies and procedures, screening potential investments for compliance with the Funds' SRI restrictions before Pax World purchased the investments and monitoring portfolios for ongoing SRI compliance.

8. Pax World's SRI policies and procedures required that portfolio managers purchase only securities that the Social Research Department had screened for compliance with the Funds' SRI restrictions and approved for purchase.

9. During the relevant period, Pax World authorized its portfolio managers to purchase only securities that were approved in advance by the Social Research Department. This requirement was designed to ensure that its securities purchases complied with the Funds' SRI restrictions. Pax World disclosed this policy to the Funds' boards during the period.

Pax World Purchased or Held Securities Prohibited by Fund SRI Restrictions

10. From 2001 through 2005 ("the relevant period"), Pax World purchased ten prohibited securities for the Growth and High Yield Fund portfolios. Seven prohibited securities were purchased in the Growth Fund; three were purchased in the High Yield fund. Three of the prohibited securities violated Fund SRI restrictions because the companies that issued them derived revenue from the manufacture of alcohol and/or gambling products; three violated Fund SRI restrictions because the companies that issued them derived more than 5% of their revenue from contracts with the U.S. Department of Defense; and four failed to satisfy the Funds' environmental or labor standards.

11. At the time of purchase, six of the ten prohibited securities were listed by the Social Research Department as having been issued by companies that failed their most recent screen. The remaining four prohibited securities failed the Social Research Department's screen when it became aware of the purchases and subsequently screened

the security. Examples of prohibited securities Pax World held during the relevant period included:

- a) In 2003, Pax World purchased for the Growth Fund securities issued by an oil and gas exploration company that had failed its three most recent screens. Pax World's Social Research Department's list of approved investments reflected the failed screens and indicated that this company's securities were a prohibited investment.
- b) In 2004, Pax World purchased for the High Yield Fund securities issued by a conglomerate primarily engaged in the shipping industry but which derived revenue from gambling and the manufacture of liquor. This purchase violated the Funds' exclusionary screens prohibiting investments in companies that derived any revenue from gambling or the manufacture of liquor.

12. Pax World's failure to follow its own policies requiring that it purchase only securities that the Social Research Department had approved for purchase resulted in the Growth and High Yield Funds' holding prohibited securities. Overall, Pax World failed to screen, prior to purchase, 41 of the 495 securities purchased for the Growth and High Yield Funds during the relevant period, or approximately 8% of all new security purchases for these two funds.

13. During the relevant period, 24 of the 150 securities Pax World purchased for the Growth Fund were purchased without first obtaining Social Research Department approval for the purchase, of which seven were the excluded securities referenced above. The other 17 complied with Pax World's SRI restrictions but had not been screened before the purchase. This reflects a failure to comply with Pax World's SRI policies and procedures in connection with approximately 16% of the Growth Fund's new securities purchases, representing from 3% to 8% of the Fund's net assets under management.

14. During the relevant period, 17 of the 345 securities Pax World purchased for the High Yield Fund were purchased without first obtaining Social Research Department approval for the purchase, of which three were the excluded securities referenced above. The other 14 complied with Pax World's SRI restrictions but had not been screened before the purchase. This reflects a failure to comply with Pax World's SRI policies and procedures in connection with approximately 5% of the High Yield Fund's new securities purchases, representing approximately 2% of the Fund's net assets under management.

15. In addition, from at least 2004 until early 2006, due to Pax World's failure to adhere to its SRI policies, two Pax World Funds held securities issued by a company that derived revenue from the manufacture of weapons-related products and that had been on the approved list at the time of initial purchase. Pax World did not divest the holding until early 2006.

Pax World Failed to Continuously Monitor the Funds' Portfolios

16. Although during the relevant period the Funds' SAIs stated that Pax World continuously monitored fund portfolios for compliance with the Funds' SRI restrictions, Pax World had no policy or procedure for continuously monitoring the portfolios until 2004. Before 2004, the Social Research Department reviewed portfolio holdings for ongoing compliance with the Funds' SRI restrictions as time permitted. Nevertheless, in a letter included in the Funds' 2001 annual report, Pax World reported to shareholders on the Social Research Department's "regularly scheduled reviews of all of the Funds' holdings." Pax World's failure to continuously monitor or regularly review Fund portfolios put compliance with the Funds' SRI restrictions at risk.

17. In October 2004, Pax World adopted a policy that the Social Research Department screen every holding at least every six months. Thereafter, the Company did not consistently comply with this policy. In addition, until late 2005, Pax World permitted portfolio managers to add to existing holdings whether or not the holding had been screened within the six-month period as required under the policy.

Pax World's Divestment Policies

18. In addition to screening investments, the Social Research Department was responsible for ensuring that portfolio holdings that fell out of compliance with the Funds' SRI restrictions for whatever reason (e.g., a merger or acquisition) were divested. Pax World's SRI policies required that any holding that fell out of compliance with the Funds' SRI restrictions be sold within six months of the date the holding was found to be noncompliant. In particular, the SAIs stated:

If it is determined after the initial purchase by a Fund that a company's activities fall within the exclusion described above, (either by acquisition, merger or otherwise), the securities of that company will be eliminated from the Fund's portfolio as soon thereafter as possible taking into consideration (i) any gain or loss which may be realized from such elimination, (ii) the tax implications of such elimination, (iii) market timing, and the like. In no event, however, will that security be retained longer than six (6) months from the time the Fund learns of the divestment qualification. This requirement may cause a Fund to dispose of a security at a time when it may be disadvantageous to do so.

19. Pax World made no distinction between securities found to be noncompliant as of the initial purchase or those that fell out of compliance with the Funds' SRI guidelines after the initial purchase. Thus, a portfolio manager could – and did – purchase a security either without having the company screened first or after the company failed a screen (in either case in violation of the Funds' SRI restrictions) and then hold the stock for up to six months.

Impact on Portfolio Holdings

20. As a result of the conduct set forth in paragraphs 11 through 20 above, the Pax World Funds held at least one prohibited security at all times from 2001 through early 2006.

Pax World Failed to Report SRI Noncompliance to the Growth and High Yield Fund Boards

21. Pax World reported on SRI issues to the Funds' boards at each quarterly board meeting during the relevant period, but it never disclosed that Pax World had in ten instances purchased prohibited securities or that these non-complying purchases were primarily a result of Pax World purchasing stocks for the Growth and High Yield Funds without Social Research Department approval.

22. Pax World's reports to the Boards included information about SRI divestments – that is, situations in which the Funds sold a security because it did not comply with the Funds' SRI restrictions. Most of these SRI divestments involved securities that initially complied with Pax World's SRI policies but fell out of compliance during the period the securities were in the portfolios, thus triggering the need to divest the security.

23. In some cases, the SRI divestments Pax World reported to the boards involved situations in which Pax World purchased prohibited securities in the first instance. However, in reporting these SRI divestments, Pax World failed to disclose to the boards that these securities were initially purchased at a time when they failed to comply with the Funds' SRI restrictions.

24. In addition, Pax World did not disclose to the Fund boards or to investors that it was not continuously monitoring fund portfolios as stated by the Funds' SAIs.

Pax World's Subsequent Remedial Actions

25. Beginning in 2005 Pax World undertook additional efforts to comply with the Funds' SRI restrictions. In particular, Pax World: (1) replaced its (a) senior management, (b) the High Yield and Growth Fund portfolio managers, (c) director of social research, and (d) chief compliance officer; (2) developed and distributed a new compliance manual addressing SRI and other compliance issues; and (3) implemented new computer software for SRI compliance.

Violations

26. As a result of the conduct described above, Respondent Pax World willfully violated Section 206(2) of the Advisers Act in that it engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit

upon clients or prospective clients.² Specifically, Pax World failed to adhere to the SRI restrictions set forth in the prospectuses, SAIs and other published material Pax World prepared and filed on behalf of the Funds, and it failed to comply with its own internal SRI screening and periodic review policies which had been disclosed to the Fund boards.

27. As a result of the conduct described above, Pax World caused violations of Section 13(a)(3) of the Investment Company Act by the Pax World Growth Fund and the Pax World High Yield Fund in that it caused the Funds' deviation from the Funds' SRI investment policy that was changeable only if authorized by shareholder vote and their deviation from policies recited in their respective registration statements pursuant to Section 8(b)(3) of the Investment Company Act.

28. As a result of the conduct described above, Pax World willfully violated Section 34(b) of the Investment Company Act in that it made untrue statements of material fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act, or omitted to state therein, any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. Specifically, Pax World misrepresented that it adhered to the SRI restrictions set forth in the prospectuses, SAIs and other published material Pax World prepared and filed on behalf of the Funds.

Respondent's Cooperation and Remedial Acts

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

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(k) of the Advisers Act, and Section 9(f) of the Investment Company Act, Respondent shall cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act, and Sections 13(a)(3) and 34(b) of the Investment Company Act.

² A willful violation of the securities laws means merely "that the person charged with the violation knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

B. Pursuant to Section 203(e) of the Advisers Act, Respondent is hereby censured.

C. Respondent shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$500,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Pax World Management Corp. as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, MA 02210.

By the Commission.



Florence E. Harmon
Acting Secretary

*Commissioner Walter -
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58250 / July 30, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13106

In the Matter of

E*Trade Clearing LLC and
E*Trade Securities LLC

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS, PENALTIES AND
A CEASE-AND-DESIST ORDER PURSUANT
TO SECTIONS 15(b)(4), 21B 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 administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against E*Trade Clearing LLC and E*Trade Securities LLC ("Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement ("Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the Commission's jurisdiction over Respondents 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, Penalties and a Cease-and-Desist Order Pursuant to Sections 15(b)(4), 21B and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Respondents

1. E*Trade Clearing LLC and E*Trade Securities LLC (collectively, hereinafter through section III, "E*Trade") are wholly owned indirect subsidiaries of E*Trade Financial Corporation, a Delaware corporation headquartered in New York. E*Trade Clearing LLC and E*Trade Securities LLC are broker-dealers registered with the Commission pursuant to Section 15(b) of the Exchange Act and are members of the Financial Industry Regulatory Authority ("FINRA").

Summary

2. These proceedings arise out of E*Trade's violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, which require a broker-dealer to comply with the reporting, recordkeeping and record retention requirements in regulations implemented under the Bank Secrecy Act ("BSA"),¹ including the requirements in the customer identification program ("CIP") rule applicable to broker-dealers.² The CIP rule generally requires a broker-dealer to establish, document, and maintain procedures for identifying customers and verifying their identities. E*Trade established, documented and maintained a CIP that specified it would verify all accountholders in a joint account; however, from October 2003 to June 2005, E*Trade failed to verify the identities of 65,442 secondary accountholders in joint accounts. Consequently, E*Trade's documented procedures differed materially from its actual procedures.

3. By failing to document accurately its customer verification procedures, E*trade willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder.

Findings

4. For the 20-month period between October 2003 and June 2005, E*Trade's CIP procedures stated that the firm would verify customer identities by using, primarily, a method of comparing customer information with a third-party vendor. E*Trade's CIP procedures further required the firm to keep records that include a description of identifying information relied upon to verify the customer's identity.

5. During the relevant period, E*Trade failed to follow the verification procedures set forth in its CIP. Specifically, E*Trade did not verify the identities of secondary accountholders in newly opened joint accounts. E*Trade's 20-month failure to accurately document its CIP was systemic, resulting from the lack of a cohesive organizational structure, the lack of adequate

¹ Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the Bank Secrecy Act), 12 U.S.C. § 1829b, 12 U.S.C. §§ 1951-1959, and 31 U.S.C. § 5311-5330.

² 31 CFR § 103.122.

management oversight, and miscommunications between personnel in several E*Trade business groups.

6. For example, prior to the effective date of the CIP rule, E*Trade expanded its contractual agreement with a third-party vendor to include vetting new customer information for CIP purposes.³ E*Trade's CIP procedures included submitting the names of new customers to the vendor at the end of each day via a computerized "batch file." However, E*Trade's systems did not submit the names of secondary accountholders in newly opened joint accounts. At this time, E*Trade's written CIP procedures required the firm to confirm the identities of customers in joint accounts, yet E*Trade failed to modify its batch file process to be in compliance with its own procedures and failed to document accurately its CIP.

7. For example, in June and July 2004, nine months after the CIP compliance deadline, the risk operations group noticed that secondary accountholder information was still not being properly vetted and reported the non-compliance to E*Trade's three top compliance officers and other members of senior management, yet E*Trade failed to fix the problem.

8. For example, thirteen months after the CIP compliance deadline, in November 2004, the problem resurfaced again when E*Trade hired a new risk operations manager who assumed CIP responsibilities. No one briefed the new risk operations manager on the firm's ongoing failure to revise its systems to vet secondary accountholder information in joint accounts or to accurately document its CIP and these CIP failures continued for six more months.

9. Finally, in June 2005, seven months after assuming the position, the risk operations manager noticed E*Trade's CIP failure, identified a total of 65,442 active joint accounts that were opened after the CIP compliance date, and manually submitted the secondary accountholder information for verification. According to E*Trade, the verification process did not identify any joint accounts that should not have been opened.

10. As a result of the conduct described above, Respondents willfully⁴ violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder by failing to document accurately its CIP.

Legal Discussion

11. Section 17(a) of the Exchange Act and Rule 17a-8 thereunder require a broker-dealer to comply with certain reporting, recordkeeping and record retention requirements in the regulations implemented under the BSA. These regulations include the CIP rule which had a compliance date of

³ The CIP rule defines "customer" as "a person that opens a new account" and individuals that open new accounts for individuals that lack legal capacity or for an entity that is not a legal person. See 31 CFR § 103.122(a)(4).

⁴ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." see *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

October 1, 2003.⁵ The CIP rule requires that broker-dealers establish procedures for making and maintaining records of all information obtained to comply with the rule, including records describing the methods and results of any measures undertaken to verify the identities of customers.⁶

12. E*Trade's written CIP specified that it would verify secondary accountholders. In fact, E*Trade's actual procedures did not include verifying the identities of these customers. Accordingly, E*Trade did not accurately document its CIP as required pursuant to the CIP rule.

13. E*Trade, by failing to document accurately its CIP, did not comply with the recordkeeping and record retention requirements under the CIP rule and therefore willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder.

Undertakings

14. E*Trade has undertaken to do the following actions:

a. E*Trade will retain, within thirty (30) days of the issuance of this Order, at E*Trade's expense, a qualified independent compliance consultant ("Consultant"), not unacceptable to the Commission staff, to conduct a comprehensive regulatory review of E*Trade's CIP, including a review and test of the firm's CIP technology and customer verification procedures related to Section 17(a) of the Exchange Act and Rule 17a-8 thereunder. E*Trade will provide a copy of the engagement letter detailing the Consultant's responsibilities to Merritt A. Gardiner, Senior Counsel, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-5631B ("Enforcement Staff").

b. E*Trade will require the Consultant, within sixty (60) days of the Consultant's engagement, to develop a written plan of sufficient scope and detail to achieve the regulatory review objectives set forth in paragraph 14.d below. E*Trade will require the Consultant and other qualified persons hired by the Consultant ("Qualified Persons") to have adequate knowledge and understanding of E*Trade's CIP compliance policies and procedures. E*Trade will require the Consultant and the Qualified Persons to exercise due professional care and independence in performing the regulatory review. E*Trade will require the Consultant to formulate conclusions concerning its assessment, as described in Paragraph 14.d below, based on sufficient evidence that is obtained through, among other things; (i) inspection of documents, including written procedures, rules, and staff files; and (ii) interviews of appropriate personnel of E*Trade.

⁵ The BSA, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (Pub. L. 107-56), directed the Department of Treasury and the Commission to jointly issue regulations requiring, among other things, broker-dealers to implement reasonable procedures to verify the identity of any person seeking to open an account (to the extent reasonable and practicable) and to maintain records of the information used to verify the person's identity. See Customer Identification Programs for Broker-Dealers, Release No. 34-47752 (April 29, 2003), 68 CFR 25113 (May 9, 2003).

⁶ 31 CFR 103.122(b)(3).

c. E*Trade will within ninety (90) days from the entry of this Order create, implement, and maintain written policies and procedures designed to ensure that at all times E*Trade is in full compliance with the CIP rule, including provisions describing in reasonable detail the processes utilized to verify the identification of E*Trade customers.

d. E*Trade will require the Consultant to assess (i) the adequacy of E*Trade's CIP policies and procedures; and (ii) whether E*Trade is in substantial compliance with its statutory CIP obligations and the policies and procedures referenced in paragraph 14 herein.

e. No later than forty-five (45) days after the Consultant's review is concluded, E*Trade will require the Consultant to (i) prepare a Report identifying the scope of the regulatory review and detailing its assessment as to (a) the adequacy of E*Trade's CIP policies and procedures; (b) whether E*Trade is in substantial compliance with the policies and procedures referenced in paragraph 14 herein, and (ii) submit the Report to E*Trade's Board of Directors, to the Commission's Enforcement Staff, to the Commission's Director of the Office of Compliance, Inspections and Examinations and to the Commission's Director of the Division of Trading and Markets. With respect to any policies, practices and procedures not in compliance with the CIP rule, E*Trade will require the Consultant to make recommendations for how E*Trade should modify or supplement its policies, practices and procedures to remedy the deficiencies identified by the Consultant in the Report.

f. One year after the Consultant's Report is submitted to the entities identified in paragraph 14.e above, E*Trade will require the Consultant to assess E*Trade's remediation of any deficiencies identified by the Consultant in its Report. No later than forty-five (45) days after the Consultant completes this follow-up review, E*Trade will require the Consultant to submit a supplemental report to the entities identified in paragraph 14.e above summarizing the Consultant's findings concerning E*Trade's remediation efforts.

g. E*Trade will cooperate fully with the Consultant and Qualified Persons, and will provide the Consultant and Qualified Persons with access to its files, books, records (excluding any privileged documents) and staff as reasonably requested for the regulatory review.

h. E*Trade may apply to the Commission's staff for an extension of the deadlines described above before their expiration, and upon a showing of good cause by E*Trade, the Commission's staff may, in its sole discretion, grant such extensions for whatever time period it deems appropriate.

i. E*Trade (i) will not terminate the Consultant without prior written approval of the Commission's staff; and (ii) will compensate the Consultant and Qualified Persons engaged to assist the Consultant for services rendered pursuant to this Order at their

reasonable and customary rates.

j. E*Trade will require the Consultant to enter into an agreement that provides that, for the period of the engagement and for a period of two years from completion of the engagement, the Consultant will not enter into any employment, consultant, attorney-client, reviewing or other professional relationship with E*Trade or any of their present or former affiliates, directors, officers, employees or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any Qualified Person engaged to assist the Consultant in the performance of his/her duties under this Order will not, without the prior written consent of the Commission's staff, enter into any employment consultant, attorney-client, reviewing or other professional relationship with E*Trade, or any of its present or former affiliates, directors, officers, employees or agents acting in its capacity as such, for the period of the engagement and for a period of two years after the engagement.

15. Notwithstanding the above, E*Trade may revise its CIP policies and procedures to reflect any subsequent changes in the applicable rules and regulations.

IV.

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

V.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed upon in Respondents' Offers of Settlement.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder;

B. Respondents are censured pursuant to Section 15(b)(4) of the Exchange Act;

C. Pursuant to Section 21B of the Exchange Act, Respondents shall, within 30 days of the entry of this Order, each pay a civil money penalty of \$500,000.00 (for a total of \$1 million) 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, United States Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover of a letter that identifies E*Trade Clearing LLC and E*Trade Securities LLC as the Respondents in these

proceedings and the file number of these proceedings. A copy of the cover letter and money order or check shall be sent to Cheryl Scarboro, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-5631B; and

D. Respondents shall comply with the undertakings enumerated in section III above.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58257 / July 30, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2762 / July 30, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2854 / July 30, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13108

In the Matter of

PHILLIP R. BENNETT,

Respondent.

ORDER INSTITUTING
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 proceedings 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 Phillip R. Bennett ("Bennett" or "Respondent").

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II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.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 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Bennett, age 60, a resident of Gladstone, New Jersey was associated with Refco Securities, LLC, a registered broker-dealer, from August 1999 to October 2005. Bennett held a controlling interest in Refco Securities until August 2004. In addition, from December 1999 to October 2005, Bennett was a member of the board of managers of Refco Securities, which managed and controlled the broker-dealer's business and affairs. From August 1999 to October 2005, Bennett held a controlling interest in and was chairman of the board of managers of Forstmann-Leff Associates LLC and FLA Asset Management LLC, both of which were registered as investment advisers with the Commission. He is not currently associated with any regulated entity.

2. On July 29, 2008, a final judgment was entered by consent against Bennett, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5, 13b2-1, and 15d-14 and from aiding and abetting violations of Sections 13(b)(2)(A), 13(b)(2)(B), and 15(d) of the Exchange Act and Exchange Act Rules 15d-2 and 15d-13, in the civil action entitled United States Securities and Exchange Commission v. Phillip R. Bennett, Civil Action Number 08-cv-1631 (GEL), in the United States District Court for the Southern District of New York.

3. The Commission's complaint in that action alleged, among other things, that from at least 1998 to October 2005, Bennett orchestrated a fraudulent scheme that repeatedly concealed, at the end of Refco fiscal periods, hundreds of millions of dollars owed to Refco Inc. and its corporate predecessor Refco Group Ltd. (together "Refco") by a non-Refco entity that Bennett controlled. In addition, the complaint alleged that, in 2004 and 2005, Bennett directed practices that artificially inflated Refco's results of operations. As a result of this conduct, Refco provided false and materially misleading information in registration statements and other reports it filed with the Commission and provided to investors.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Bennett'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 Bennett 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 to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Florence E. Harmon
Acting Secretary


By: Jill M. Peterson
Assistant Secretary

Commissioner Walter -
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 31, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13109

In the Matter of

Lexington Resources, Inc.,
Grant Atkins, and
Gordon Brent Pierce,

Respondents.

ORDER INSTITUTING CEASE-AND-DESIST
PROCEEDINGS PURSUANT TO SECTION
8A OF THE SECURITIES ACT OF 1933 AND
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Lexington Resources, Inc. ("Lexington"), Grant Atkins ("Atkins") and Gordon Brent Pierce ("Pierce") (collectively "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

Nature of the Proceeding

1. This matter involves the unregistered distribution of stock in a Las Vegas microcap company, allowing a Canadian stock promoter to reap millions of dollars in unlawful profits without disclosing to investors information mandated by the federal securities laws. Between 2003 and 2006, Lexington Resources, Inc., a purported oil and gas company, and its CEO and Chairman Grant Atkins, issued nearly five million shares of Lexington common stock to promoter Gordon Brent Pierce and his associates. Pierce and his associates then spearheaded a massive promotional campaign, including email spam and mass mailings. As Lexington's stock price skyrocketed to \$7.50 per share, Pierce and his associates resold their stock to public investors through an account at an offshore bank, netting millions of dollars in profits; Lexington's operating subsidiary subsequently filed for bankruptcy and its stock now trades below \$0.02 per share.

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2. Lexington's issuance of stock to Pierce was supposedly covered by Form S-8 registration statements, a short form registration statement that allows companies to register offerings made to employees, including consultants, using an abbreviated disclosure format. Form S-8 is to be used by issuers to register the issuance of shares to consultants who perform bona fide services for the issuer and are issued by the company for compensatory or incentive purposes. However, Form S-8 expressly prohibits the registration of the issuance of stock as compensation for stock promotion or capital raising services. Pierce provided both of these services to Lexington, and thus the registration of these issuances of shares purportedly pursuant to Form S-8 was invalid. As a result, both Lexington's sales to Pierce, and Pierce's sales to the public, were in violation of the registration provisions of the federal securities laws.

Respondents

3. Lexington is a Nevada corporation formed in November 2003 pursuant to a reverse merger between Intergold Corp. ("Intergold"), a public shell company, and Lexington Oil and Gas LLC, a private company owned by an offshore entity. In connection with the reverse merger, Intergold changed its name to Lexington Resources, Inc. and Lexington Oil and Gas became a wholly-owned subsidiary of Lexington Resources, Inc. Lexington's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and quoted on the pink sheets under the symbol "LXRS." On March 4, 2008, Lexington's primary operating subsidiary, Lexington Oil and Gas, filed for Chapter 11 bankruptcy. The petition was converted to a Chapter 7 liquidation on April 22, 2008. Lexington's only other operating subsidiary filed for Chapter 7 liquidation on June 11, 2008.

4. Grant Atkins has been CEO and Chairman of Lexington since its inception in November 2003 and was CEO and Chairman of Lexington's predecessor, Intergold. Atkins, 48, is a Canadian citizen residing in Vancouver, British Columbia.

5. Gordon Brent Pierce has acted as a "consultant" to Lexington and other issuers in the U.S. and Europe through various consulting companies that he controls. Pierce, 51, is a Canadian citizen residing in Vancouver, British Columbia and the Cayman Islands.

Facts

Lexington and Atkins Issued Millions of Shares to Pierce Using Form S-8

6. On November 19, 2003, Atkins and Pierce formed Lexington through a reverse merger between Intergold (at that point a non-operational shell company) and Lexington Oil and Gas, a new private company owned by an offshore entity set up by Pierce. Atkins became the sole officer and director of Lexington, a purported natural gas and oil exploration company.

7. Within days of the reverse merger, Atkins caused Lexington to file a registration statement on Form S-8 and immediately began issuing stock to Pierce and several of Pierce's longtime business associates. Between November 2003 and March 2006, Atkins caused Lexington to issue more than 5 million shares to Pierce and his associates purportedly registered on Form S-8. Pierce told Atkins who should receive the shares and how many.

8. Form S-8 is an abbreviated form of registration statement that may be used to register an issuance of shares to employees and certain types of consultants; Form S-8 does not provide the extensive disclosures or Commission review required for a registration statement used for a public offering of securities. A company can issue S-8 shares to consultants only if they provide bona fide services to the registrant and such 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.

9. Contrary to the express requirements of Form S-8, Pierce served as both a stock promoter and capital-raiser for Lexington. During the entire period from late 2003 to 2006, Pierce personally met with individual and institutional investors to solicit investments in Lexington and directed an investor relations effort that included speaking with and distributing promotional kits to thousands of potential investors. Pierce used some of his S-8 stock to compensate others who helped with this effort. Pierce also coordinated an extensive promotional campaign for Lexington through spam emails, newsletters, and advertisements on investing websites. All of these services promoted or maintained a market for Lexington stock and therefore could not be compensated with securities registered pursuant to Form S-8.

10. Pierce's stock promotion campaign was successful. From February to June 2004, Lexington's stock price increased from \$3.00 to \$7.50 per share, with average trading volume increasing from 1,000 to about 100,000 shares per day. (The price subsequently collapsed, and the stock currently trades at under \$0.02 per share.)

11. Pierce also engaged in extensive capital-raising activities on behalf of Lexington, contrary to the plain terms of Form S-8. Pierce raised all of the capital for Lexington's first year of drilling operations by finding investors to provide loans to Lexington. He transferred some of his S-8 shares to these investors. Pierce also raised capital for Lexington by selling most of his S-8 shares through an offshore company that he operated, and funneling money back to Lexington and Atkins.

12. Lexington and Atkins also issued shares under Form S-8 to indirectly raise capital and exhibited control over the resale of shares by arranging to have individuals who received S-8 shares pay off Lexington's pre-existing debts.

13. Lexington's purported registration of stock issuances to Pierce on Form S-8 was invalid because Pierce was performing services expressly disallowed for Form S-8 registrations. By failing to register the issuance of shares to Pierce and his associates, Lexington failed to make all of the disclosures to the public for the registration of the issuances of shares for capital-raising transactions as required by law.

Pierce Engaged in a Further Illegal Distribution of Lexington Stock

14. After receiving the shares from Lexington, Pierce engaged in a further illegal distribution of his own. Pierce acted as an underwriter because he acquired the shares with a view to distribution. Almost immediately after receiving the shares, Pierce transferred or sold them through his offshore company.

15. Pierce and his associates deposited about 3 million Lexington shares in accounts at an offshore bank. Between February and July 2004, about 2.5 million Lexington shares were sold to the public through an omnibus brokerage account in the United States in the name of the offshore bank, generating sales proceeds of over \$13 million.

16. Pierce personally sold at least \$2.7 million in Lexington stock through the offshore bank in June 2004 alone. Pierce's sales were not registered with the Commission.

Pierce Failed to File Reports Disclosing His Stock Ownership

17. During most of the period from November 2003 to May 2004, Pierce owned or controlled between 10 and 60 percent of Lexington's outstanding stock. Pierce did not file the required Schedule 13D until July 25, 2006, however.

18. In the belatedly-filed Schedule 13D, Pierce inaccurately stated that he owned or controlled between 5 and 10 percent of Lexington's outstanding stock during late 2003, early 2004, and early 2006. In reality, Pierce owned or controlled more than 10 percent of Lexington's stock during most of the period from November 2003 to May 2004.

19. Although Pierce regularly traded Lexington stock in the open market for entities he controlled during 2004, Pierce never reported his ownership or changes in ownership on Forms 3, 4 or 5.

Violations

20. As a result of the conduct described above, Respondents Lexington, Atkins, and Pierce violated Sections 5(a) and 5(c) of the Securities Act, which, among other things, unless a registration statement is on file or in effect as to a security, prohibit any person, directly or indirectly, from: (i) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; (ii) carrying or causing to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale; or (iii) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security.

21. Also as a result of the conduct described above, Respondent Pierce violated Sections 13(d) and 16(a) of the Exchange Act, and Rules 13d-1, 13d-2, and 16a-3 thereunder, which require: (i) any beneficial owner of more than five percent of any class of equity security registered under Section 12 to file a statement with the Commission within 10 days containing the information required in Schedule 13D and promptly to file an amendment to Schedule 13D if any material change in beneficial ownership occurs, and (ii) any beneficial owner of more than ten percent of a class of equity security registered under Section 12 to file an initial statement of ownership on Form 3 within 10 days, statements of changes in ownership on Form 4 within two business days, and annual statements of ownership on Form 5 within 45 days of year-end.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate that cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. Whether, pursuant to Section 8A of the Securities Act, all Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 5(a) and 5(c) of the Securities Act;

C. Whether, pursuant to Section 21C of the Exchange Act, Respondent Pierce should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 13(d) and 16(a) of the Exchange Act, and Rules 13d-1, 13d-2, and 16a-3 thereunder; and

D. Whether Respondent Pierce should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents 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 Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally 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.

Florence E. Harmon
Acting Secretary

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

*Commissioner Walter-
not participating*

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 232, 239, and 274

[Release Nos. 33-8949; IC-28346; File No. S7-28-07]

RIN 3235-AJ44

**ENHANCED DISCLOSURE AND NEW PROSPECTUS DELIVERY OPTION
FOR REGISTERED OPEN-END MANAGEMENT INVESTMENT COMPANIES**

AGENCY: Securities and Exchange Commission

ACTION: Proposed rule; reopening of comment period.

SUMMARY: The Securities and Exchange Commission is reopening the period for public comment on amendments it originally proposed in Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)]. The rule proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus; and permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.

DATES: Comments should be received on or before August 29, 2008.

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-28-07 on the subject line; or

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- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. S7-28-07. 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>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Deborah D. Skeens, Senior Counsel, Office of Disclosure Regulation, Division of Investment Management, at (202) 551-6784, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is reopening the period for public comment on proposed rule and form amendments that are intended to enhance the disclosures that are provided to mutual fund

investors. These amendments were proposed on November 21, 2007,¹ and the comment period initially closed on February 28, 2008. The Commission's proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus. The proposals also would permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site. Upon an investor's request, mutual funds would also be required to send the statutory prospectus to the investor.

The Commission recently engaged a consultant to conduct focus group interviews and a telephone survey concerning investors' views and opinions about various disclosure documents filed by companies, including mutual funds. During this process, investors participating in focus groups were asked questions about, among other things, a hypothetical summary prospectus. Investors participating in the telephone survey were asked questions relating to several disclosure documents, including mutual fund prospectuses. We have placed in the comment file (available at <http://www.sec.gov>) for the proposed rule the following documents from the investor testing that relate to mutual fund prospectuses and the proposed summary prospectus: (1) the consultant's report concerning focus group testing of the hypothetical summary prospectus and related disclosures; (2) transcripts of focus groups relating to the hypothetical summary prospectus and related disclosures; (3) disclosure examples used in these focus groups;

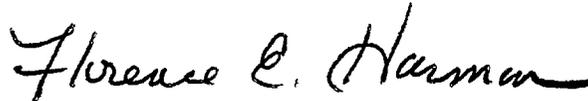
¹ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)].

and (4) an excerpt from the consultant's report concerning the telephone survey of individual investors. In order to provide all persons who are interested in this matter an opportunity to comment on these additional materials, we believe that it is appropriate to reopen the comment period before we take action on the proposal.

We invite additional comment on the proposal in light of these materials, and on any other matters that may have an effect on the proposal.

Accordingly, we will extend the comment period until August 29, 2008.

By the Commission.

A handwritten signature in cursive script that reads "Florence E. Harmon".

Florence E. Harmon
Acting Secretary

July 31, 2008